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MoFo New York Tax Insights

ALJ Holds New Resident's Gain on Sale of Former Connecticut Home is Subject to New York Income Tax

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By Irwin M. Slomka

An individual who sold her out-of-state home and moved into New York has received an unusual welcome—a New York State and City income tax bill on her gain from the sale of her former home. In a case of first impression at the Division of Tax Appeals, an Administrative Law Judge held that the individual's gain from the sale of her Connecticut home, the closing for which took place 20 days *after* she moved into New York, accrued to her New York resident period and was therefore subject to New York State and City resident income tax. *Matter of Glenna Michaels*, DTA No. 823370 (N.Y.S. Div. of Tax App., Apr. 12, 2012).

The Tax Law contains a section dealing specifically with "accruals upon change of residence." Under Tax Law § 639(b), an individual that changes his or her status from a

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Gain on Sale of Former Connecticut Home is Taxable in New York

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nonresident to resident must "accrue to the period of nonresidence items of income, gain, loss or deduction . . . accruing prior to the change of [resident] status." Capital gains must be computed for the respective resident and nonresident periods "on the same basis as if the taxable year of such individual . . . for Federal income tax purposes were limited to the taxable period covered by the applicable New York State income tax return." 20 NYCRR 154.7(a).

Glenna Michaels was a resident of Greenwich, Connecticut, where she owned a home since 1973. In September 2004, she entered into a contract to sell her home for $14 million, with a designated closing date of November 8, 2004. At the time of contract, the buyer paid a $1.4 million down payment, and Ms. Michaels executed a "mortgage deed," held in escrow, as collateral security for her obligations under the contract. The designated closing was delayed beyond November 8. In the meantime, on November 9, Ms. Michaels closed on, and began permanently residing in, a New York City condominium, thereby becoming a State and City resident. The closing on her Connecticut home eventually took place on November 29, 2004, 20 days after Ms. Michaels became a State and City resident. She recognized a capital gain from the sale of her home of nearly $12 million.

For the tax year 2004, Ms. Michaels filed an income tax return as a part-year resident of Connecticut from January 1 through November 9, and as a part-year resident of New York State and City from November 10 through December 31. She reported the gain as having accrued during her Connecticut residency period, resulting in approximately $576,000 of Connecticut income tax. She did not report the gain on her part-year resident return for New York State and City. Following an audit, the Department of Taxation and Finance determined that the capital gain accrued when the closing took place on November 29, during her New York residency period, and assessed tax, interest and penalty on the gain.

At the Division of Tax Appeals, Ms. Michaels argued that the gain accrued during the period of her Connecticut residency, specifically in September 2004, where she entered into the sales contract. She claimed that she had a fixed right to the sale proceeds on that date, and thus for purposes of the "accrual rule" contained in Tax Law § 639(b), a completed sale occurred at that time. The Department took the position that the presence of various certain contingencies in the sales contract, and the fact that Ms. Michaels continued to bear the burdens and benefits of ownership until the closing, meant that she did not have a fixed right to the income until the closing date, which was after she became a State and City resident.

The ALJ began by noting that Tax Law § 639 requires conformity with the federal income tax rules for accruals, particularly "in the absence of New York case law." The ALJ thus applied the federal income tax "all events test" to determine when income is recognized. Under that test, an item must be included in income when all of the events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy. The ALJ held that, applying the all events test, there was no completed sale until the closing, with all risk of loss having been retained by Ms. Michaels until the closing. While a completed sale can occur under the all events test even if legal title has not yet passed, the ALJ noted that this only occurs when the benefits and burdens of ownership pass to the purchaser, which did not occur here until the closing. The mortgage deed given by Ms. Michaels in September 2004 did not change this conclusion, because its only purpose was as security for the substantial down payment given by the purchaser.

HAD MS. MICHAELS SIMPLY RESIDED IN TEMPORARY QUARTERS OUTSIDE NEW YORK FOR THE 20-DAY DELAY IN THE CLOSING ON HER CONNECTICUT HOME, SHE WOULD NOT HAVE BECOME A NEW YORK DOMICILIARY.

The ALJ also addressed the taxpayer's argument that an example in the Department's regulations (contained in 20 NYCRR § 154.10(d)) was inconsistent with the Department's position, and should be controlling in this case. The ALJ concluded that "to the extent the example . . . is not consistent" with the accrual rules under Tax Law § 639 and the federal tax precedent, "it is rejected and will not be considered or relied upon for guidance herein."

The ALJ did find reasonable cause for the waiver of penalties, finding this to be "a case of first impression" and holding that "the confusion raised by [the example in the regulations] must be construed most favorably" to the taxpayer.

Additional Insights. The decision is a reminder of the importance of timing of transactions when an individual changes his or her state of residency. Clearly, had the closing taken place before Ms. Michaels became a New York resident, the gain would not have been taxable in New York. Moreover, had Ms. Michaels simply resided in temporary quarters outside New York for the 20-day delay in the closing on her Connecticut home, she would not have become a New York domiciliary, since that requires two conditions to be met: (i) abandoning her former domicile and (ii) adopting a new domicile.

The decision does not indicate whether Ms. Michaels could still

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timely claim a refund of the Connecticut tax paid on the gain, or whether a resident tax credit was available for the Connecticut tax paid. Interestingly, there is no mention in the decision regarding the 165 Departmental emails concerning the accrual rule, which the same ALJ last year ruled could be subpoenaed by Ms. Michaels' attorney (discussed in the August 2011 issue of *New York Tax Insights*).

Tribunal Reinstates Peter Madoff Petition

By Hollis L. Hyans

Reversing a decision of an Administrative Law Judge, the New York State Tax Appeals Tribunal has overturned the dismissal of Peter Madoff's petition as untimely and remanded the matter for further proceedings. *Matter of Peter Madoff*, DTA No. 823411 (N.Y.S. Tax App. Trib., Apr. 19, 2012).

The petition was filed to challenge a Notice of Determination dated May 4, 2009, arising from an audit of Bernard L. Madoff Investment Securities, LLC, assessing sales and use taxes of over $900,000. The Notice was issued to Peter Madoff and, according to the Department, mailed to his home address. Mr. Madoff claimed he never received the Notice, and that the first knowledge he had of the assessment was a Notice and Demand dated August 27, 2009. On September 3, 2009, within a week of receipt of the Notice and Demand, Mr. Madoff's representative filed a request for a conciliation conference, which was dismissed as untimely, since it had not been filed within 90 days of the May 4 Notice date. Mr. Madoff then filed a petition for a hearing with the Division of Tax Appeals, alleging that the May 4 Notice was not received or properly served, and also challenging the computation of tax and interest.

As reported in the October 2011 issue of *New York Tax Insights*, the ALJ dismissed the petition, relying on evidence of timely mailing submitted by the Department, including copies of the records of mailing, two affidavits from its employees, and an affidavit from a U.S. Postal Service employee. The documents set forth the usual practice and procedure for processing statutory notices, identified the items that were mailed on September 4, 2009, including the one at issue, and explained the processes used. The ALJ held that the evidence established proper mailing.

The Tribunal disagreed. First, it noted that a presumption of delivery arises when sufficient evidence of mailing has been profferred, and that the Department, in order to establish proper mailing, must first prove standard mailing procedure by testimony of an individual with personal knowledge, and must then prove that the standard procedure was followed in the case at issue. Here, the Department relied on affidavits from its employees, and the Tribunal reviewed the affidavits carefully. One affidavit, submitted by the supervisor of the Case and Resource Tracing System, covered the processing of statutory notices prior to their shipment to the Department's Mail Processing Center. That affiant was found not competent to prove the procedures in the Mail Processing Center. Another affidavit was submitted by the mail and supply supervisor of the staff of the Mail Processing Center. However, the supervisor's affidavit indicated that he had been with the Department since February 2010, and did not clearly represent how he knew the Mail Processing Center's operation and procedures on May 4, 2009, the date the notice was claimed to have been mailed.

Finding that this discrepancy raised "a triable and material issue of fact," the Tribunal reversed the determination, and remanded to the ALJ for further proceedings on the issue of the timeliness of the petition, and, if appropriate, on the underlying merits of the challenge to the Notice.

Additional Insights. While attempts to challenge the Department's proof of proper mailing are only rarely successful, the Tax Appeals Tribunal does require that all elements of the Department's burden be met before a petition is dismissed without reaching the merits. Here, that proof was found to be deficient in a critical element. Further proceedings may reveal whether the defect in the affidavit is easily cured—for instance, by a substitute affidavit from a Department employee with the requisite personal knowledge—or whether the Department remains unable to establish its mailing procedures at the relevant time.

Banking Department's Definition of "Gross Income" Not Properly Promulgated

By Amy F. Nogid

A mortgage bank successfully challenged an assessment issued by the New York State Banking Department (now called the New York State Department of Financial Services), which had applied a broad interpretation of "gross income" to determine the amount of the annual General Assessment. *Homestead Funding Corp. v. State of New York Banking Dept.*, No. 513553, 2012 NY Slip Op. 3499 (3d Dep't, May 3, 2012). While not involving a tax, this decision is of interest because of the limitations it discusses on the actions of government agencies, which would include the

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Definition of "Gross Income" Not Properly Promulgated

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New York State Department of Taxation and Finance and the New York City Department of Finance.

The General Assessment is the mechanism that the State uses to recoup from certain regulated industries the expenses incurred to operate the Banking Department. Mortgage bankers and brokers are assessed based on "gross income." Starting with the 2010-2011 fiscal year, the Banking Department instructed mortgage banks that their "gross income" must include not only mortgage loan origination income, but income from secondary market sales of mortgages and mortgage loan servicing activities.

Homestead Funding sought review in the Albany County Supreme Court of its General Assessment that had been computed on this basis, and requested a declaration that the methodology was arbitrary and capricious and constituted an unconstitutional tax. The Albany County Supreme Court dismissed the action, but the Third Department has now reversed.

EVEN THOUGH THE LAW MAY PROVIDE A GOVERNMENT AGENCY WITH BROAD POWER TO IMPLEMENT AN ENACTMENT, THE AGENCY IS NOT FREE TO REDEFINE STATUTORY TERMS WITHOUT COMPLYING WITH SAPA.

First, the Third Department agreed with the Banking Department that the General Assessment was a fee—because its purpose was to allow the State to recoup the direct expenses for running the agency—and not a tax imposed to raise revenue for governmental purposes generally. It also ruled that requiring industries that are regulated by the Banking Department to pay for their supervision was not arbitrary and capricious, and that applying different methodologies to different regulated businesses did not result in an equal protection violation, since like-kind entities were subject to the same industry-specific formula.

However, the court found that, in changing its interpretation of "gross income" to include income from secondary market sales of mortgages and mortgage loan servicing activities, the Banking Department failed to comport with the State Administrative Procedure Act ("SAPA"). SAPA requires that agency interpretations of general application comply with rule-making procedures. These procedures require, *inter alia*, that (1) the agency seeking the rule submit a notice of proposed rule-making to the secretary of state, which must include a statement describing the anticipated impact of the rule upon regulated parties; (2) the secretary of state publish a notice of the proposed rule in the state register; (3) the public receive the opportunity to submit written comments on the proposed rule and/or receive the opportunity to comment orally on the proposed rule at a public hearing; and (4) the agency and the secretary of state ensure publication of any adopted rule in the state register. SAPA reflects the Legislature's intent that "it is [in] the best interests of the state for all citizens . . . to be aware of and involved in the rule making process." 1987 N.Y. Laws, ch. 610, § 1. The court found that the Banking Department's new, "expansive definition of income" was applied across the board to all mortgage banks, and was not just an explanation of methodology or an interpretation of existing policy. Since the Banking Department had not complied with the requirements of SAPA, its broad interpretation of "gross income" was not properly promulgated, and the assessment based on the rule was annulled.

Additional insights. The decision serves as a reminder that even though the law may provide a government agency with broad power to implement an enactment, the agency is not free to redefine statutory terms without complying with SAPA. While state agency interpretations of statutes are generally upheld, it is not unknown for state agencies, including revenue departments, to adopt policies and positions that do not merely further the enactment but go well beyond the statutory provisions. In such cases, it is important to consider whether the revenue department may have overstepped its authority by adopting a rule of general application without complying with SAPA.

Court Upholds Denial of Access to World Trade Center Site Leases on Grounds of Tax Secrecy

By Kara M. Kraman

A New York County Supreme Court judge has upheld the New York City Tax Appeals Tribunal's denial of an individual's request for documents under the Freedom of Information Law ("FOIL") on grounds of tax secrecy. *Matter of Margaret L. Donovan v. Hauben*, No. 111865/2011, 2012 NY Slip Op. 50793U (N.Y. Sup. Ct., Apr. 16, 2012). In upholding the Tribunal's decision to withhold the requested documents, submitted into evidence in an unrelated tax case, the judge took note of, but ultimately decided

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Trade Center Site Leases Protected By Tax Secrecy

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not to follow, an advisory opinion issued on behalf of the requester by the New York State Committee on Open Government urging disclosure of the documents. *Advisory Opinion*, FOIL-AO-18681 (N.Y.S. Comm. on Open Gov't, Sept. 6, 2011).

Requester Margaret L. Donovan is co-founder of The Twin Towers Alliance, an entity formed to "advance the public interest at the World Trade Center site" in part by uncovering how the public is allegedly being forced to pay for the construction of the Freedom Tower. She submitted a FOIL request to the City Tribunal requesting the "2001 Silverstein Leases and the 2006 Master Development Agreement" after reading a 2009 Tribunal decision involving the World Trade Center entities' liability for commercial rent tax ("CRT") that referenced those documents. Ms. Donovan had previously and unsuccessfully made a similar request to the Port Authority for the same documents. She was not a party to the 2009 CRT case.

The Tribunal denied her initial request. Ms. Donovan appealed the denial. In a letter to Ms. Donovan denying her FOIL request, the Tribunal's appeals officer explained that the Tribunal was prohibited from furnishing the requested documents because they related to returns which were submitted pursuant to the CRT law.

Under the CRT tax secrecy provisions contained in Administrative Code § 11-716(a), the City Tribunal is prohibited from disclosing "any information relating to the business of a taxpayer contained in any return required" under the CRT. The appeals officer noted that the documents requested, while not tax returns themselves, were compiled by the taxpayers in support of their returns, and were therefore subject to the tax secrecy provisions. The appeals officer cited to *Matter of Tartan Oil Corporation v. State of New York Department of Taxation & Finance*, 239 A.D.2d 36 (3d Dep't 1998), in which a landlord sought records concerning tax audits of its tenants that included hearing transcripts and purchase invoices, among other things. In that case, the Third Department held that the purpose of the applicable tax secrecy statute (which mirrored Administrative Code § 11-716(a)) would be thwarted "if materials and records compiled by taxpayers in support of their returns and reports were subject to disclosure."

After receiving the City Tribunal's denial of her appeal, Ms. Donovan requested an advisory opinion on the matter from the New York State Committee on Open Government. The Committee opined in its advisory opinion that *Matter of Tartan Oil* was not applicable in Ms. Donovan's situation since, among other things, the contracts requested were between private entities and public ones. Ms. Donovan then commenced an Article 78 proceeding in the Supreme Court of New York to appeal the Tribunal's denial.

NOT ONLY TAX RETURNS, BUT ALL MATERIAL COMPILED BY TAXPAYERS IN SUPPORT OF THEIR RETURNS, ARE SHIELDED FROM PUBLIC DISCLOSURE.

The Supreme Court judge disagreed with the Committee, and held that *Matter of Tartan Oil*, which provides that not only tax returns, but all material compiled by taxpayers in support of their returns, are shielded from public disclosure, was controlling precedent. The judge noted that *Matter of Tartan Oil* made no distinction based on whether records were between public or private entities, and that advisory opinions issued by the Committee on Open Government are not binding on the court. The judge further noted that "providing these records to the public, such as petitioner who was not even a party with respect to the 2009 determination, would impair the confidentiality and privacy of litigants who appear before the Tax Appeals Tribunal." Accordingly, the court upheld the City Tribunal's denial of Ms. Donovan's FOIL request.

Additional Insights. In affirming the denial of Ms. Donovan's FOIL request made with the City Tribunal, the court commented that Ms. Donovan did not explain why she did not pursue other available remedies, such as following up on her request made with the Port Authority, which could not invoke the issue of tax secrecy regarding the requested documents. Had the Supreme Court judge followed the Committee's advice and compelled disclosure, it would have been contrary to more than 25 years of both State and City Tribunal policy that documents submitted as evidence at administrative hearings are protected from disclosure by tax secrecy. Undoubtedly, the disclosure of such evidentiary documents would impair the ability of many taxpayers to contest City tax assessments by placing in the public domain tax secret or otherwise confidential documents used to contest the assessments.

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Insurance Company's Franchise Tax Payment Cannot Offset Prior Year's Retaliatory Tax Liability

By Open Weaver Banks

In *Prudential Insurance Co. of America v. Wrynn*, No. 102267-2011, 2012 N.Y. Slip Op. 22111 (N.Y. Sup. Ct., Apr. 16, 2012), the Supreme Court, New York County, denied Prudential's claim against the Superintendent of the New York State Department of Insurance for a refund and credit against retaliatory tax. Prudential claimed that an additional payment of the Article 33 franchise tax on insurance companies entitled it to a refund and credit against retaliatory tax arising in prior years.

In New York, the Insurance Department is responsible for assessing and collecting the retaliatory tax imposed on foreign insurers. New York's retaliatory tax scheme, set forth at Insurance Law § 1112, is typical of state retaliatory taxation of insurance companies throughout the country.

The New York retaliatory tax requires two calculations. The first calculation is the total amount of franchise tax, aside from any potential retaliatory tax, that New York imposes on the foreign insurer. The second calculation is the total amount of tax that the foreign insurer's state of domicile would impose on a comparable New York insurer. If the foreign state's hypothetical tax bill is higher than New York's actual bill, New York adopts the foreign state's greater tax burden as its own and imposes it on the foreign insurer. However, in assessing the retaliatory tax imposed, the tax due is reduced by the Article 33 franchise tax paid. Tax Law § 1511(b). In that way, the total tax the foreign insurer pays to New York (Article 33 franchise tax plus the retaliatory tax) should equal the total amount of tax that would be imposed on a comparable New York insurer doing business in the foreign insurer's state of domicile.

Prudential, a foreign insurer, sought a refund and credit of retaliatory tax as the result of an additional payment of franchise tax arising from an Internal Revenue Service adjustment to Prudential's claimed net operating loss ("NOL") for the years 1997 through 2001, which Prudential had carried back to 1995. The federal NOL adjustment increased Prudential's Article 33 franchise tax liability for 1995. In 2006, Prudential paid the additional franchise tax liability for the 1995 year. Thereafter, Prudential applied for a refund or credit of retaliatory tax paid in 2003, and cancellation of an assessment of retaliatory tax for 2007. While the Insurance Department did not dispute that retaliatory tax may be offset by the amounts paid for franchise tax *for the same year*, it denied Prudential's claim.

In support of its claim, Prudential relied upon Insurance Law § 9109(a)(1), which permits the Insurance Department to issue a refund to an insurer whenever the Superintendent is satisfied that "because of cancellations, some mistake of fact, error in calculation, or erroneous interpretation of a statute," the insurer has paid amounts in excess of the amount legally chargeable against it during the three-year period immediately preceding the cancellations or the discovery of such overpayment.

The court characterized Prudential as trying to fit its circumstances within Insurance Law § 9109(a)(1) by arguing that "because of" a 1995 underpayment of franchise tax, the recalculation of which took place in 2006, an "overpayment" occurred in 2003. The court rejected this argument, finding that "no error was made within three years of the purported 2006 discovery, resulting from the IRS audit." According to the court, the alleged error was made in 1995, or arguably, from 1997 through 2001, the years in which Prudential overstated its NOL deductions. Thus, in the court's view, the refund and credit sought had "insufficient nexus" to the alleged mistake made in 1995 (or 1997 through 2001).

Prudential also argued that it was entitled to a credit against retaliatory tax under Tax Law § 1511(b), which grants the credit for "any taxes" paid under Article 33. Prudential relied on *Matter of Phoenix Home Life Mutual Ins. Co. v. Curiale,* 162 Misc. 2d 142 (N.Y. Sup. Ct. 1994), in which the New York Supreme Court rejected the argument that Tax Law § 1511(b) requires a year-to-year matching of the credit. In fact, in *Phoenix Home*, the court permitted a credit of retaliatory tax for the tax year 1990, as a result of franchise tax payments made in 1992, for the 1980 tax year.

IN THE COURT'S VIEW, THE REFUND AND CREDIT SOUGHT HAD "INSUFFICIENT NEXUS" TO THE ALLEGED MISTAKE MADE IN 1995.

In Prudential's case, the court reasoned that while Tax Law § 1511(b) allows a credit against retaliatory tax for "any taxes paid under this article," the word "any" refers to the *type* of taxes paid under the article, not the period of time for which a credit is permitted. The court further found that if the Insurance Department did not have the authority under Insurance Law § 9109 to grant a refund or credit, the court could not read Tax Law § 1511 as requiring that such a refund or credit be granted.

Additional Insights. Instead of interpreting the date of payment as the event that starts the running of the three-year period set forth in Insurance Law § 9109(a)(1), the court in *Prudential*

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Franchise Tax Payment Cannot Offset Retaliatory Tax Liability

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essentially found that the date of the occurrence of the error starts the running of the three-year period. The court's reasoning arrives at a fair result in a situation where an insurance company makes an overpayment on its original return and files for a refund within three years. In that case, the error and the overpayment occur at the same time. However, in Prudential's case, the error was an underpayment that was not corrected for 11 years.

It is difficult to reconcile the decision in *Prudential* with *Phoenix Home*. In *Phoenix Home*, the court found that "[t]here is no requirement for a matching of taxable years in order for an [insurer] to claim a credit against its retaliatory taxes [due] pursuant to section 1511(b)." The insurance company in *Phoenix Home* paid additional franchise tax for the 1980 tax year in 1992 and the court found that as a consequence, the insurance company was entitled to a refund of retaliatory tax paid in 1990. Under the reasoning of *Phoenix Home*, Prudential should be able to obtain a refund of any retaliatory tax paid during the three-year period immediately preceding the date of the additional payment of franchise tax. Thus, according to *Phoenix Home*, Prudential's payment of franchise tax in 2006 created an overpayment of retaliatory tax in 2003, for which Prudential was entitled to a credit or refund.

It is also worth noting that although facially discriminatory against out-of-state businesses, retaliatory taxes on foreign insurance companies have been upheld as constitutional because they serve a narrow regulatory purpose and are not intended to raise revenue. According to the United States Supreme Court, the purpose of retaliatory tax laws "is to promote the interstate business of domestic insurers by deterring other States from enacting discriminatory or excessive taxes." *Western & Southern Life Insur. Co. v. State Board of Equalization of California*, 451 U.S. 648, 667 (1981). Additionally, Congress removed Commerce Clause limitations on the authority of the states to regulate and tax the business of insurance under the McCarran-Ferguson Act, 15 U.S.C. § 1011 *et seq*.

In the absence of Commerce Clause protection, foreign insurance companies that believe they have been discriminated against may still assert a violation of the Equal Protection Clause of the Fourteenth Amendment. For example, in *United Services Automobile Association v. Curiale*, 88 N.Y.2d 306 (1996), the New York Court of Appeals held that the denial of a credit for certain surcharges in the computation of the retaliatory tax was unsupported by a legitimate purpose and, therefore, violated the Equal Protection Clause.

ALJ Finds Electronic Newsletter Content to be a Taxable Information Service

By Irwin M. Slomka

After several recent litigation setbacks for the Department of Taxation and Finance regarding the sales tax on information services, an Administrative Law Judge has held that the contents of an electronic newsletter of interest to scientists, engineers and other technical professionals constituted a taxable information service that is not personal or individual in nature. *Matter of GlobalSpec, Inc.*, DTA No. 823435 (N.Y.S. Div. of Tax App., May 10, 2012).

GlobalSpec, located in Troy, New York, provides a specialized search engine geared to the needs of scientific, engineering, technical and industrial professionals. Beginning in 2005, it began to publish a variety of specialized electronic newsletters, delivered via email each month to interested professionals who used its website and who registered to receive the newsletter. GlobalSpec did not charge subscribers for the newsletters, but derived revenues from advertising.

GlobalSpec purchased the contents of its newsletters by engaging associate and freelance "editors," whose responsibility was to find and highlight content in the technical fields covered by the newsletters, and to furnish it to GlobalSpec in a prescribed newsletter format. The editors gathered relevant content from a variety of sources, including the Internet and technical print publications, and wrote short summaries for the newsletter, from which the reader could link to the full referenced article. The newsletters were not prepared in response to individual technical questions from subscribers. The editors were paid by GlobalSpec for each newsletter that they produced in their field of expertise.

Following an audit, the Department assessed sales tax on GlobalSpec's purchases of content from the editors that was used to provide the electronic newsletter. Since the newsletters were not "sold" to subscribers, the tax was not imposed on the furnishing of the newsletters themselves to those subscribers.

Sales tax is imposed on "the furnishing of information . . . including the services of collecting, compiling or analyzing information . . ." Tax Law § 1105(c)(1). In determining whether information was being furnished, the ALJ applied the "primary function" test, cited in *Matter of SSOV '81 Ltd.*, DTA Nos. 810966 & 810967 (N.Y.S. Tax App. Trib., Jan. 19, 1995), and concluded that the primary

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Electronic Newsletter Content Held to be a Taxable Information Service

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function—*i.e.*, the true aim—of the electronic newsletters was to furnish timely, relevant and useful information to subscribers. According to the ALJ, the function and process fell within the ambit of Tax Law § 1105(c)(1), noting that the editors were "compiling" information and that the newsletters constituted "furnished reports" containing that information. The introductory paragraphs written by the editors for each article were not the primary function, but merely a strategy to compel readers to access the linked articles.

The ALJ also held that even though each of the various newsletters was geared to a particular subset of subscribers, the information did not make it personal or individual in nature so as to be an excludable information service.

THE PRIMARY FUNCTION—I.E., THE TRUE AIM—OF THE ELECTRONIC NEWSLETTERS WAS TO FURNISH TIMELY, RELEVANT AND USEFUL INFORMATION TO SUBSCRIBERS.

Additional Insights. Unlike recent decisions holding that what was being furnished was a nontaxable service, with information being merely a component of that service, here the ALJ found that the principal function was the furnishing of the information itself. Although the decision discusses the primary function of the newsletters furnished to subscribers, the Department was actually taxing GlobalSpec's purchases of newsletter content from the third-party editors. Presumably, the thrust of the decision is that the editors were furnishing information *to GlobalSpec*, so that the primary function of the newsletter *to subscribers* would not appear to be relevant.

If GlobalSpec had charged subscribers for the electronic newsletters, presumably it would have been making its own taxable sales of information. In that case, it should only have been required to collect sales tax on sales to subscribers located in New York State, rather than, as here, being taxed on 100% of its purchases of newsletter content because the company was located in the State. By selling the newsletters to subscribers, GlobalSpec's purchases of content from the third-party editors may have qualified as nontaxable purchases for resale.

Factual Issues Concerning Alleged "Tax Avoidance Transactions" Prevent Summary Judgment for Taxpayer

By Hollis L. Hyans

In *Matter of Marc S. Sznajderman and Jeannette Sznajderman*, DTA No. 824235 (N.Y.S. Div. of Tax App., Apr. 12, 2012), an Administrative Law Judge held that the taxpayers had failed to demonstrate they were entitled to summary judgment on the grounds the assessment was barred by the three-year statute of limitations.

The Sznajdermans filed their income tax return for the 2001 year on April 15, 2002. On their return, the Sznajdermans claimed an intangible drilling cost deduction, which was disallowed by the Department, generating the additional tax asserted in the Notice of Deficiency at issue. Under the ordinary three-year statute of limitations, the assessment, which was issued on March 14, 2008, was clearly time barred. However, the Department sought to rely on a statute allowing tax to be assessed within six years after the return was filed if the deficiency is attributable to an "abusive tax avoidance transaction."

The Sznajdermans had invested in oil and gas partnerships, the Belle Island Drilling partnerships, promoted by an individual, Richard Siegal, who had been identified in audit projects conducted by the Department's Tax Shelter Unit, working with the Internal Revenue Service, as having been a promoter of allegedly abusive transactions. In January 2008, the Department requested information, including an Investment Proposal, from the Sznajdermans regarding the Belle Island Drilling partnerships, but received no response. Two months later, the assessment was issued. The Department also issued a subpoena to the Sznajdermans seeking information about the partnerships, and a challenge filed by the Sznajdermans to the subpoena was rejected by the court.

The Department eventually obtained the Investment Proposal in October 2010, and relied in part for its position that the transactions were abusive on invitations to investors to consider the "redeployment of 'upper bracket tax dollars into certain investments,' creating income and cash flow rather than paying the same money to federal, state and municipal governments." The Department also analyzed the financial projections provided in the Investment Proposal and the Partnership Agreement for Belle Island and concluded, since yearly revenue was $15,000

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"Tax Avoidance Transactions" Keep Statute Open

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and yearly expense was $14,400, that no reasonable investor would invest in the partnership without tax savings since it was generating less than a 1% return. The Department also found that, using only the yearly profit, it would take 300 years to repay the promissory note to the partnership.

The Sznajdermans pointed out that the IRS had examined many of the partnerships promoted by Richard Siegal, and had considered offering compromised resolutions to several investors, and had issued "No Adjustments Letters" to various drilling companies.

THE DEPARTMENT SOUGHT TO RELY ON A STATUTE ALLOWING TAX TO BE ASSESSED WITHIN SIX YEARS AFTER THE RETURN WAS FILED IF THE DEFICIENCY IS ATTRIBUTABLE TO AN "ABUSIVE TAX AVOIDANCE TRANSACTION."

The ALJ rejected the Sznajdermans' claim that the Notice of Deficiency was barred by the statute of limitations, at least based on the record before him, including the references to tax motivations and the unlikelihood that substantial profits, aside from tax advantages, could be obtained. He found that the statute, Tax Law § 685(p-1)(5), provided that the abusive tax avoidance transactions giving rise to the six-year statute of limitations are not limited to listed transactions or reportable transactions, and that the burden of proof regarding whether the partnerships were abusive tax avoidance transactions was on the Sznajdermans, which they had failed to meet. The fact that the IRS had offered settlements concerning issues arising from similar partnerships, which the Sznajdermans did not establish had ever been finalized, did not conclusively establish that the Belle Island venture was not an abusive tax avoidance transaction. He also rejected the Sznajdermans' argument that the Department did not perform an audit of their return, finding that that issue was caused by their failure to provide requested documentation.

Additional Insights. The ALJ recognized that federal case law places the burden of proof on the IRS to show that a variation from the standard three-year statute of limitations is justified. Nonetheless, in reliance on the Tax Appeals Tribunal's decision in *Matter of Sholly,* DTA Nos. 801151 & 801152 (N.Y.S. Tax App. Trib., Jan. 11, 1990), the ALJ found that the "express statutory directive" in New York was different, and rejected reliance on federal case law. However, the main statute relied upon both in *Sholly* and by the ALJ, Tax Law § 689(e), is simply the general provision that the taxpayer ordinarily bears the burden of proof when challenging an assessment, except in certain specified instances. The same rule also applies in litigation challenging an assessment by the IRS, and yet the federal courts have placed the burden of establishing variation from the usual statute of limitations on the IRS. The ALJ does not address at all the particular issues raised by the shifting to the taxpayer of a burden to establish an essential element of the basis for the assessment—that it was issued in time—which would ordinarily be expected to rest on the Department. While it is not clear from the decision that the result would necessarily have been different if the burden had been on the Department to establish the transaction as abusive and, therefore, coming within the six-year rule, certainly the question would have been closer.

Insights in Brief

First New York "Whistleblower" Case Filed

On April 19, 2012, the New York Attorney General filed a lawsuit against Sprint Nextel Corp., alleging it had failed to collect over $100 million in New York state and local sales tax by improperly characterizing payments from its customers for wireless voice services. *People of the State of New York and State of New York ex rel. Empire State Ventures, LLC v. Sprint Nextel Corp. et al.,* Index No. 103917-2011 (superseding complaint filed April 19, 2012). In addition to the tax, the action seeks treble damages and penalties. This is the first state tax whistleblower action made public under New York's False Claims Act, covered in the March 2011 issue of *New York Tax Insights*, which was amended in 2010 to include actions involving alleged violation of the state tax laws as the basis for the Attorney General to recover treble damages, plus penalties, attorneys' fees and costs, from anyone found to have submitted a "false claim" for money or property to state government.

No Property Tax on Fiber Optics Lines

In *RCN New York Communications, LLC v. Tax Commission of the City of New York,* No. 7534-7535-260046/08 260044/08 7536, 2012 NY Slip Op. 3523 (1st Dep't May 3, 2012), the Appellate Division affirmed a lower court decision voiding assessments of real property tax on fiber optics lines, poles, wires, supports and enclosures. The tax was assessed pursuant to RPTL § 102(12)(i), which applies to "lines, wires, poles, supports and inclosures for electrical conductors…." Since the property in question was not

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Insights in Brief

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"for electrical conductors," the court found it "unambiguous" that the property was not covered. The court also found that, at the time the statute was enacted, the legislature was aware of fiber optic technology, and chose not to include such property in the definition.

Chocolate Product Containing No Natural Sugar Deemed Candy or Confectionery for Sales Tax Purposes

The New York State Department of Taxation and Finance ruled that a chocolate product, marketed as promoting a healthy weight, which contains no natural sugar but which does contain cocoa, has a sweet taste, and is wrapped in individual pieces is not exempt from the sales tax as a food or food product because it falls into the exclusion for taxable "candy and confectionery." *Advisory Opinion*, TSB-A-12(9)S (N.Y.S. Dep't of Taxation & Fin., May 3, 2012). In the same opinion, the Department declined to rule whether the vendor, who sold the chocolate product in the State through independent sales representatives, had nexus for sales tax purposes because the Department lacked sufficient information to make such a determination.

Transfer of a Gun by Federal Firearms Licensee Not Subject to Sales Tax

The Department of Taxation and Finance has ruled that a New York Federal Firearms Licensee is not required to collect sales or use tax when, as required by various federal and state laws, the licensee transfers a gun from an out-of-state seller to a New York buyer. *Advisory Opinion*, TSB-A-12(8)S (N.Y.S. Dep't of Taxation & Fin., Apr. 13, 2012). The Department ruled that because the firearms licensee did not (i) sell the gun to the buyer, (ii) collect the sales price, (iii) solicit business for the seller, (iv) operate under the seller, or (v) obtain the property from the actual out-of-state seller, the licensee was not a vendor or a co-vendor under the sales tax law, and he was therefore not required to collect sales tax when transferring the gun to the buyer. The Department also ruled that the firearms licensee's fee for performing the administrative tasks necessary to meet the requirements of federal and state firearms laws was not subject to sales tax, because such services are not among the enumerated taxable services under the sales tax law.

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ABB v. Missouri
Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
AE Outfitters Retail v. Indiana
American Power Conversion Corp. v. Rhode Island
Citicorp v. California
Citicorp v. Maryland
Clorox v. New Jersey
Colgate Palmolive Co. v. California
Consolidated Freightways v. California
Container Corp. v. California
Crestron v. New Jersey
Current, Inc. v. California
Deluxe Corp. v. California
DIRECTV, Inc. v. Indiana
DIRECTV, Inc. v. New Jersey
Dow Chemical Company v. Illinois
Express, Inc. v. New York
Farmer Bros. v. California
General Mills v. California
General Motors v. Denver
GMRI, Inc. (Red Lobster, Olive Garden) v. California
GTE v. Kentucky
Hair Club of America v. New York
Hallmark v. New York
Hercules Inc. v. Illinois
Hercules Inc. v. Kansas
Hercules Inc. v. Maryland
Hercules Inc. v. Minnesota
Hoechst Celanese v. California
Home Depot v. California
Hunt-Wesson Inc. v. California
Intel Corp. v. New Mexico
Kohl's v. Indiana
Kroger v. Colorado
Lanco, Inc. v. New Jersey
McGraw-Hill, Inc. v. New York
MCI Airsignal, Inc. v. California
McLane v. Colorado
Mead v. Illinois
Nabisco v. Oregon
National Med, Inc. v. Modesto
Nerac, Inc. v. NYS Division of Taxation
NewChannels Corp. v. New York
OfficeMax v. New York
Osram v. Pennsylvania
Panhandle Eastern Pipeline Co. v. Illinois
Panhandle Eastern Pipeline Co. v. Kansas
Pier 39 v. San Francisco
Powerex Corp. v. Oregon
Reynolds Metals Company v. Michigan Department of Treasury
Reynolds Metals Company v. New York
R.J. Reynolds Tobacco Co. v. New York
San Francisco Giants v. San Francisco
Science Applications International Corporation v. Maryland
Scioto Insurance Co. v. Oklahoma
Sears, Roebuck and Co. v. New York
Shell Oil Company v. California
Sherwin-Williams v. Massachusetts
Sparks Nuggett v. Nevada
Sprint/Boost v. Los Angeles
Tate & Lyle v. Alabama
Toys "R" Us-NYTEX, Inc. v. New York
Union Carbide Corp. v. North Carolina
United States Tobacco v. California
USV Pharmaceutical Corp. v. New York
USX Corp. v. Kentucky
Verizon Yellow Pages v. New York
Wendy's International v. Virginia
Whirlpool Properties v. New Jersey
W.R. Grace & Co.—Conn. v. Massachusetts
W.R. Grace & Co. v. Michigan
W.R. Grace & Co. v. New York
W.R. Grace & Co. v. Wisconsin

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