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TRIBUNAL REMANDS $100 MILLION SALES TAX REFUND CASE TO ALJ

By Hollis L. Hyans

After the New York State Appellate Division reversed the Tax Appeals Tribunal's earlier decision denying a sales tax refund of over $100 million, the Tax Appeals Tribunal has now remanded the case for a further hearing before an Administrative Law Judge to consider evidence of the funding of a pre-refund escrow account set up to facilitate repayment to customers of improperly collected sales tax. *Matter of New Cingular Wireless PCS LLC*, DTA No. 825318 (N.Y.S. Tax App. Trib., Mar. 8, 2018).

Background. In order to resolve litigation claiming that New Cingular Wireless, now known as AT&T Mobility ("ATTM"), improperly collected and remitted sales tax on charges for Internet access, ATTM entered into a nationwide class-action settlement agreeing to reimburse its customers, including New York customers, for the overcollected tax by filing refund claims on their behalf. Escrow accounts were created to receive sales tax refunded by the states, with funds to be distributed to the customers by an escrow agent under court supervision. In states like New York that require a vendor to refund the overcollected sales tax to its customers prior to receiving a refund from the state, ATTM agreed to fund a pre-refund escrow fund. However, ATTM had not made any payments to the pre-refund escrow fund with respect to the overcollected New York sales tax before claiming the refund for New York customers. The Department denied ATTM's refund claim on the grounds that the amounts had not been refunded to customers.

Prior Decisions. In July 2014, an ALJ upheld that denial, finding that, since ATTM had not repaid the tax to its customers, it could not obtain a refund, because Tax Law § 1139(a) provides that "[n]o refund or credit shall be made to any person of tax which he collected from a customer until he shall first establish to the satisfaction of the tax commission . . . that he has repaid such tax to the customer."

A month after the ALJ decision, in August 2014, ATTM filed a motion to reopen the record, claiming that it had not previously funded the New York escrow account because the Department had informed it that the refund claim would nonetheless be denied on other grounds; that it subsequently did fund the New York escrow account; and that it could submit evidence establishing that the account had indeed been funded. The ALJ denied the motion, holding that the Tribunal's Rules of Practice and Procedure, which are patterned after the New York Civil Practice Law and Rules applicable in New York State courts, only

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allow the record to be reopened for newly discovered evidence, and that this evidence was not considered "newly discovered" because it had not been in existence at the time of the original hearing.

[T]he Tribunal found that, at the least, the accuracy of the amount of the refund is still in issue, and while nullifying the original ALJ decision issued in July 2014, it determined that further administrative proceedings are necessary.

In February 2016, the Tribunal affirmed the ALJ on both grounds. First, it agreed that the record cannot be reopened for the admission of evidence that was not in existence at the time of the original hearing and only was created afterwards, and concluded that reopening the record would be contrary to the Tribunal's mission of providing a fair, efficient, and final hearing system. On the merits of the refund claim, the Tribunal found that the language of Tax Law § 1139(a) requires actual repayment or reimbursement to customers before a vendor may receive a refund, and that the various agreements among the parties did not constitute a sufficiently legally binding promise to pay. Because it refused to reopen the record to allow evidence of the escrow account funding, the Tribunal did not address the question of whether that funding would be sufficient to satisfy the repayment requirement.

Appellate Division Decision. In August 2017, the Appellate Division reversed the Tribunal, finding that, on "the particular facts of this case," it was an abuse of discretion for the Tribunal to deny ATTM's motion to reopen the record. It found that requiring a new refund claim to be instituted could run up against statute of limitations objections, which would result in what the court described as a "$106 million windfall" to the Department. It also found that, pursuant to the terms of the global settlement agreement, ATTM had "unquestionably" assigned all rights in the refund amounts to the settlement class customers, and the federal court that had approved the settlement had both sanctioned the payments and retained supervision of the distribution of the refund to ATTM's customers. The court granted ATTM's motion to reopen the record, and remitted the case to the Tribunal for further proceedings in light of the evidence that the escrow account had indeed been funded, noting that the Tribunal had never reached the question of whether funding the escrow account constituted sufficient repayment to the customers under the Tax Law.

Tribunal's Order on Remand. The Tribunal, following the direction of the Appellate Division, reversed the ALJ, reopened the record, and admitted into evidence the affidavit regarding the funding of the escrow account. It then determined that, under the Division of Tax Appeals' "two-stage tax appeals process," the matter needed to be remanded to an ALJ for consideration of the issue of whether funding the escrow account constitutes repayment and to resolve open factual issues.

The Tribunal found that because the original ALJ determination granted the Department's motion for summary determination, it "necessarily determined that there were no material or triable issues of fact." However, the Tribunal found that, at the least, the accuracy of the amount of the refund is still in issue, and while nullifying the original ALJ decision issued in July 2014, it determined that further administrative proceedings are necessary. The Tribunal acknowledged the direction of the Appellate Division that the process should not be "implemented in a manner that resulted in either a windfall to the [Department] or further (and unnecessary) delay in tendering the long overdue refund to which petitioner's 2,100,027 customers are entitled," but nonetheless determined that the factual issue must be resolved in the first instance by an ALJ. It remanded the case for assignment to an ALJ and to "be scheduled for hearing as soon as practicable."

ADDITIONAL INSIGHTS

The Appellate Division's decision was quite explicit in its view of the case: It found that sales tax had been improperly collected from New York State customers by ATTM, ATTM had acknowledged the overcollection and set up a mechanism to refund the tax under the supervision of a federal district court, and the customers had already waited long enough for their money, to which the Department was not entitled. Despite this strongly worded decision urging quick action, it appears that in the time after the decision was issued, the Department has not determined the accuracy of the claimed refund. While the Tribunal may have had no choice under its procedures but to remand for further factual findings, and its decision acknowledges the need for expeditious proceedings, it appears that this already long-standing matter may not be resolved very quickly.

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NYC ALJ FINDS TAXPAYER DID NOT FILE FRAUDULENT TAX RETURNS AND THAT LIMITATIONS PERIOD REMAINS CLOSED

By Kara M. Kraman

A New York City Administrative Law Judge held that a taxpayer's New York City real property transfer tax returns were not false or fraudulent and therefore the Department of Finance could not reopen the closed three-year statute of limitations period for assessment. *Matter of Steuben Delshah, LLC, et al.*, TAT (H) 12-12 (RP), *et al.* (N.Y.C. Tax App. Trib., Admin. Law Judge Div., Jan. 9, 2018) (released Feb. 22, 2018). The ALJ rejected the Department's claim that the reporting position taken on the returns — that the transfers were exempt transfers by or to a charitable organization — was itself a basis for finding fraud. The taxpayer in this case was represented by Irwin M. Slomka and Kara M. Kraman of Morrison & Foerster, LLP.

The Transactions. Steuben Delshah, LLC ("Steuben") sought to purchase real property in Staten Island (the "Property") that was owned by Greentree Steuben, LLC ("Greentree"). In order to reduce the potential real property transfer tax ("RPTT") due on the transfer, Steuben worked with a local tax-exempt organization, the African American Parent Council ("AAPC"), to purchase the property in order to qualify for the exemption for transfers by or to a charitable organization. First, Greentree and AAPC entered into a Contract of Sale under which Greentree agreed to sell the property to AAPC for $22,000,000. Then, AAPC entered into an Assignment and Assumption Agreement with Steuben under which it agreed to transfer its rights and obligations under the Greentree-AAPC Contract of Sale to Steuben. AAPC and Steuben then entered into their own Contract of Sale for the Property for the purchase price of $22,030,000. Greentree executed a deed transferring the property to AAPC, and AAPC then executed a deed transferring the Property to Steuben.

In 2008, the parties presented the deeds to the Richmond County Clerk for recording, along with New York City RPTT returns. The RPTT returns accurately reported all of the relevant information about the transfers, including the information about the tax exempt organization, and claimed that the transfers were exempt from the RPTT. Although the County Clerk conducted a two month examination of the AAPC-Steuben deed before accepting it for recording, it ultimately accepted both deeds for recording.

The Assessment. In 2009, approximately a year after the RPTT returns were filed, the Department of Finance became aware of the transfers to and from AAPC and began to gather information regarding those transactions. In early 2012 — more than three years after the returns were filed — the Department issued Notices of Determination collapsing the two transactions into one single taxable transfer from Greentree to Steuben and asserting fraud penalties. It was undisputed that the three years statute of limitations for assessing RPTT had expired.

Law. New York City imposes the RPTT upon transfers of real property based on the consideration for the transfer. However, transfers to and from charitable organizations are exempt from the RPTT. Admin. Code § 11-2106(b)(2). The open period for assessment of RPTT is three years from when the RPTT return is filed, but this three year limitation period does not apply to "false or fraudulent return[s] with intent to evade the tax." Admin. Code § 11-2116(b). The Department claimed that the RPTT returns were false or fraudulent and that, therefore, the statute of limitations was inapplicable. Steuben brought a summary determination motion, asserting that even more than three years after the Notices were issued, and after extensive discovery, the Department still had not made a prima facie showing of fraud.

[T]he ALJ found that the returns at issue substantially complied with the law because they disclosed the requisite information essential to the making of assessments, and that they did not misrepresent or conceal any material information.

Determination of the ALJ. The ALJ determined that in order to carry its burden that the returns were false or fraudulent, the Department had to first establish that the returns contained "a fraudulent misrepresentation or omission of a material fact." Citing to both federal law and the Department's own letter rulings, the ALJ further noted that the statute of limitations for assessment commences when a return is filed that is "in substantial compliance with the requirements of the law with respect to disclosing the requisite information essential to the making of assessments." Applying these standards, the ALJ found that the returns at issue substantially complied with the law because they disclosed the requisite information essential to the making of assessments, and that they did not misrepresent or conceal any material information. In so

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finding, the ALJ noted that "[i]t is axiomatic that information cannot be concealed if that information is neither asked for, nor required to be reported."

The ALJ also rejected the Department's claim that the mere filing of the returns reporting the transfers to and from AAPC was an act constituting a false representation. The ALJ noted that in New York, no court or Tribunal has ever considered a tax return to be fraudulent based solely upon its reporting position. He found that a finding of fraud requires more than the intent to avoid taxation; it requires a material concealment or false reporting. While the ALJ acknowledged that the record raised questions as to whether the transactions should have been collapsed into one taxable transaction as asserted by the Department, he noted that a timely Notice would have permitted full inquiry into the underlying transfers. The ALJ therefore cancelled the Notices in their entirety.

ADDITIONAL INSIGHTS

This decision makes an important distinction between transactions undertaken solely to avoid taxation and transactions which involve false reporting, fraudulent information, or concealment. The former may be subject to tax under the economic substance, substance over form, sham transaction, and step transaction doctrines. In essence, those doctrines can be invoked by the Department as a basis for taxing transactions based on their substance rather than on their form. However, this decision confirms that under New York law those doctrines cannot, without more, be used as a basis for assessing tax after the statute of limitations has expired. The Department has filed an Exception to the ALJ decision.

NYS TAX DEPARTMENT DID NOT MEET ITS BURDEN OF PROVING FRAUD TO AVOID THE THREE-YEAR STATUTE OF LIMITATIONS

By Irwin M. Slomka

The deductibility of a deceased individual's losses from investments in oil and gas partnerships, and the Tax Department's ability to assess income tax after the three-year statute of limitations has closed, is the subject of an interesting recent decision by a New York State Administrative Law Judge. The decision addresses whether the taxpayer filed false or fraudulent returns (for which there is no statute of limitations) and whether the deficiency was attributable to an "abusive tax avoidance transaction" (for which there is a six-year statute of limitations). *Matter of Richard Siegal* (*Estate of*), *Gail Siegal*, *Administrator*, DTA Nos. 826661 & 826750 (N.Y.S. Div. of Tax App., Feb. 15, 2018).

Facts. Richard Siegal (now deceased) was a New York resident during the tax years 2001 and 2002. He had been involved in the oil and gas industry since the 1970s and created partnerships to participate in oil and gas ventures. For the years in issue, he was a general partner in several oil and gas partnerships that generated losses, principally through the deduction of intangible drilling costs. The taxpayer reported his distributive shares of those losses for both federal and New York State personal income tax ("PIT") purposes. In 2003, following an audit of those partnerships by the Department's Tax Shelter Unit for the years 2000 and 2001, the Department concluded its audit without adjustment and notified the taxpayer that no further action was required with respect to his New York State returns.

In 2005, the Department's Field Audit Bureau commenced an audit of the taxpayer's PIT returns, initially for the years 2002 through 2004, and later expanded to include 2001, primarily relating to his claimed losses from the oil and gas partnerships. The Department's Tax Shelter Unit informed the Field Audit Bureau that there were other audit cases involving the same partnerships, and that the partnerships "might be questionable." The three-year statute of limitations for assessment had already expired for 2001, but the Field Audit Bureau took the position that the six-year statute of limitations for understatements attributable to tax shelter activity was instead applicable. With that six-year period about to expire for the 2001 tax year, the Department issued a notice of deficiency ("Notice") based on the disallowance of the taxpayer's losses from the partnerships. A separate Notice was issued asserting a fraud penalty based on the taxpayer's alleged failure to participate in a 2005 New York State voluntary compliance initiative.

In 2013, while the Notice for 2001 was being contested at the Department's Conciliation Bureau, the Department issued a Notice for 2002, also based in the disallowance of the partnership losses, and also asserting a penalty for failure to participate in the 2005 voluntary compliance initiative. Both the three-year and six-year statute of limitations for the 2002 year had expired, but the Department took the position that the taxpayer's returns were false or fraudulent and it claimed that therefore no statute of limitations was applicable. It is unclear from the decision when and on what basis the initial fraud determination was made, but the Department's auditor testified that the fraud determination was made by the Department's Office of Counsel. The taxpayer's estate maintained that the Notices were time-barred.

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The decision — which is 74 pages long — goes into considerable detail regarding the nature of the oil and gas industry, including drilling risks and drilling contract types, as well as the taxpayer's cash and subscription note investments in those partnerships, all of which is beyond the scope of this article (although it is recommended reading for learning about the industry). The decision discusses the fact that the oil and gas partnerships entered into "turnkey drilling arrangements." Under this common arrangement, a turnkey driller accepts a fixed fee to develop the oil and gas wells and runs the considerable risk of cost overruns. As a result, turnkey contracts are more costly to investors.

The ALJ found that the Department's "asserted basis for finding fraud has been fluid and inconsistent throughout the proceedings herein," and she did not find the testimony of the Department's expert to be "compelling."

More than half of the wells drilled by the partnerships generated hundreds of millions of dollars of oil and gas revenues. However, they were all designed to be eligible to deduct intangible drilling costs in the first year of operation. The taxpayer's finance and valuation expert testified at the hearing that the three principal purposes for investing in oil and gas ventures — potential profit, portfolio diversification, and tax benefits — were all present here. The taxpayer's oil and gas expert testified that the terms of the turnkey drilling contracts were reasonable relative to industry standards. The Department's petroleum engineer expert testified that the industry-standard mark-up for turnkey drilling contracts was 10-25% above drilling costs, far less than the mark-ups in question, which were paid to drilling companies controlled by the taxpayer. However, the Department's expert admitted that he had limited experience evaluating turnkey contracts, and he made several concessions regarding the limited scope of his research.

Law. As relevant here, there are two exceptions to the three-year statute of limitations. First, the tax may be assessed at any time if a "false or fraudulent return" is filed "with intent to evade tax." Tax Law § 683(c)(1)(B). The limitation period is extended to six years "if the deficiency is attributable to an abusive tax avoidance transaction." Tax Law § 683(c)(11)(B). The *Department* bears the burden of proving that the taxpayer filed a false or fraudulent return (here, for the 2002 tax year). On the other hand, the *taxpayer* bears the burden of proof to rebut an assertion of an abusive tax avoidance transaction (for the 2001 tax year).

ALJ determination. The ALJ first concluded that for 2002 the Department did not meet its burden of proof to show that the taxpayer filed a false or fraudulent return through "clear, definite and unmistakable evidence of every element of fraud." The ALJ found that the Department's "asserted basis for finding fraud has been fluid and inconsistent throughout the proceedings herein," and she did not find the testimony of the Department's expert to be "compelling." Moreover, the ALJ rejected the claim made in the Department's post-hearing brief that the taxpayer promoted abusive tax shelters, noting that the assertion was not at issue at the hearing.

As for whether the taxpayer's investments in the oil and gas partnerships were abusive tax avoidance transactions triggering a six-year statute of limitations, the test was whether the taxpayer proved that his investments were not "for the principal purpose of avoiding tax." The ALJ found that the taxpayer met his burden for some, but not all, of the partnerships. The critical difference among them was that for some partnerships the subscription note for the taxpayer's partnership investment was shown to be genuine debt but for other partnerships similar proof was not provided.

The ALJ distinguished *Matter of Sznajderman*, DTA No. 824235 (N.Y.S. Tax App. Trib., July 11, 2016), *appeal to 3rd Dep't pending*, where the Tribunal upheld the Department's reliance on the six-year statute of limitations for abusive tax avoidance transactions in a case involving some of the same oil and gas partnerships as were involved here, and for one of the same tax years. The ALJ found that the "lynchpin" of that decision — that the investor's subscription note obligation representing his investment in the partnership lacked "economic reality" — was not present in this case, and she ruled that the Department's reliance on *Sznajderman* was misplaced.

For two of the partnerships for which the taxpayer did not meet his burden of proof regarding tax avoidance, however, the ALJ found that the Department lacked a rational basis for disallowing the taxpayer's share of losses, noting that the Department did not explain the reason for disallowing losses resulting from the taxpayer's cash-only investments in those partnerships.

Finally, for the disallowed losses that were found to be timely asserted, the ALJ upheld the imposition of penalties for the taxpayer's failure to participate in the 2005 New York State voluntary compliance initiative, noting that there are no provisions in the Tax Law for the abatement of such penalties.

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ADDITIONAL INSIGHTS

The Department's claim that the taxpayer's 2002 return was false or fraudulent return seems particularly tenuous, and the ALJ provides a thorough analysis of why the Department did not meet its considerable burden of proof as to fraud. While the tax benefits of investing in an oil and gas partnership invite scrutiny, there was scant evidence that the taxpayer's income tax returns were false or fraudulent.

The question of whether the taxpayer's investments constituted abusive tax avoidance transactions (thereby permitting a six-year statute of limitations for 2001) was less clear cut, as evidenced by the ALJ's fact-intensive analysis for why the taxpayer met his burden of proof as to some partnerships but not as to others. While *Sznajderman* involved similar facts and issues, the ALJ found that the decision was not determinative because of the crucial differences regarding the economic substance of the respective taxpayers' subscription notes for their investments.

It is interesting that while it appears that the Department and the IRS cooperated on their audits of the oil and gas partnerships, and the IRS did not propose any adjustments, the ALJ did not reference that fact in the ALJ's conclusion.

Both this decision and the decision in *Matter of Steuben Delshah, LLC* (discussed in the preceding article) illustrate the significant evidentiary hurdles that the New York State and City tax departments must meet in order to disregard the statute of limitations by proving that the taxpayer filed a false or fraudulent return with willful intent to evade tax.

TRIBUNAL FINDS TAX ON GAIN ON SALE OF PROPERTY OWNED BY AN ESOP PREEMPTED BY ERISA

By Hollis L. Hyans

The New York State Tax Appeals Tribunal has reversed the decision of an Administrative Law Judge and held that New York personal income tax cannot be imposed on a gain on the sale of real property owned by a limited liability company that was in turn owned by an Employee Stock Ownership Plan ("ESOP"). *Matters of Patrick Murphy & Kathleen Murphy*, DTA No. 825277 (N.Y.S. Tax App. Trib., Mar. 6, 2018). The Tribunal found that the federal Employee Retirement Income Security Act of 1974 ("ERISA") supersedes state laws that relate to employee benefit plans, leaving the Tribunal without authority to rule on whether the trust qualified under ERISA, and therefore canceled the deficiency.

Facts. The gain in question arose from the 2006 sale of real property located in Manhattan (the "Property") to an unrelated party for $5.5 million, generating a gain of approximately $2.2 million. At the time of the sale, the Property was owned by JJF Associates LLC ("JJF Associates"), a limited liability company treated as a partnership for tax purposes. JJF Associates reported the gain on its 2006 New York State partnership return.

At the time of the sale, JJF Associates was owned 99% by JJF Realty Employees Stock Ownership and Plan Trust ("JJF ESOP"), and 1% by Triune Foundation, Inc. Triune had been incorporated in 1994 as a not-for-profit corporation and was tax exempt under Internal Revenue Code § 501(c)(3). Mr. Murphy was its president, and was also the sole trustee of JJF ESOP at the time of sale, and Mr. and Mrs. Murphy were the only participants and beneficiaries of JJF ESOP.

In 1996, Triune had contributed the Property to JJF Associates, which was done, according to testimony from Mr. Murphy, to allow for the Property's management and generation of income for Triune, which was established to create educational programs such as funding scholarships.

The petitioners described JJF ESOP as a tax-exempt pension trust established for the benefit of the employees of JJF Realty Management, Inc. ("JJF Realty"), an entity wholly owned by JJF ESOP, and claimed they were employees of JJF Realty during the 2006 year in issue. They were also JJF Realty's president and secretary, respectively, and JJF Realty had no other officers or employees as of 2006. JJF Realty's certificate of incorporation stated that its purpose was to own and operate the Property. JJF Realty was dissolved by proclamation of the New York Secretary of State on June 25, 2003. Nonetheless, JJF Realty filed a New York State corporation franchise tax return for 2007, although not for 2006 or any previous year.

Federal Filings. JJF ESOP's federal forms 5500-EZ for 2006 and 2008 indicated JJF ESOP first became effective on May 31, 2005. Both the 2006 and 2008 returns stated that the plan had no assets at the beginning of each year, but had $2,000,500 at the end of each year. However, JJF Associates' 2006 federal tax return showed JJF ESOP as having $3 million in assets. JJF ESOP's 2006 federal return reported a gain of $2,268,774 on the Property, and stated that, other than the petitioners, JJF Realty had no employees.

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ESOP Documentation. During the audit, JJF ESOP provided a "JJF Realty, Inc. Employee Stock Ownership Trust" ("ESOP Trust Agreement") between JJF Realty, as the employer, and Triune, as the trustee. The ESOP Trust Agreement provides that JJF Realty established an employee stock ownership plan for the benefit of eligible employees of JJF Realty, to be administered by a committee appointed by the board of directors of JJF Realty. The Murphys also submitted a "JJF Realty Management Inc. Employee Stock Option Plan & Trust" ("JJF ESOP Plan"), which states that eligible JJF Realty employees included full-time employees, as well as those with at least 1,000 hours of service each year.

The deed evidencing the August 2006 sale of the Property, the Real Estate Transfer Tax ("RETT") filing summary associated with the sale of the Property, and the New York City real property transfer tax form all listed JJF Associates as the seller. However, an "Amendment to Agreement" dated February 28, 2006 between JJF ESOP and the purchaser of the Property identified JJF ESOP as the seller. Mr. Murphy testified that title to the Property was transferred from JJF Associates to JJF ESOP prior to its sale in 2006.

After an audit of both JJF Associates and JJF ESOP, the Department of Taxation and Finance concluded that the gain on the sale of the property was taxable to petitioners because they were "ineligible participants" of JJF ESOP, since they were not employees of JJF Realty. The Murphys provided a waiver of the statute of limitations, extending the time to assess until December 15, 2010, but refused requests for further waivers. On November 8, 2010, after sending a proposed audit adjustment, the Department advised the Murphys that an additional waiver would be needed to give it time to review any additional materials, and that if no waiver was received, a notice of deficiency would be issued. On November 12, 2010, petitioner Patrick Murphy sent a letter stating that the original waiver was revoked "eo instanti," that it had been obtained in violation of petitioners' rights under the Due Process clause and the New York State taxpayer bill of rights, and that it was contrary to the Department's audit guidelines.

A notice of deficiency was issued on November 22, 2010. The petitioners requested a conciliation conference, which resulted in a conciliation order sustaining the assessment. Petitioners later became aware that the auditors and the conciliation conferee had substantive discussions regarding the matter without petitioners' involvement.

ALJ Hearing and Determination. The ALJ had decided, first, that the notice of deficiency was not preempted by ERISA as the petitioners claimed, and rejected the petitioners' arguments that the notice was issued untimely and lacked a rational basis, despite claims that the Department changed its theory at the hearing and did not proceed on its original theory. The ALJ then dealt with the argument that JJF ESOP should be disregarded as a "sham entity" with no economic substance. The ALJ agreed that JJF ESOP was a sham trust, and that the gain from the sale should be attributed directly to Mr. and Mrs. Murphy, noting, among other facts, that they alone beneficially owned and controlled the Property, both before and after the creation of JJF ESOP, that they were the only ones to benefit from the sale, and that Mr. Murphy was not an independent trustee since he controlled JJF Realty, the creator of the trust, and was also a primary beneficiary. The ALJ further found Mr. Murphy's testimony at the hearing to be "confusing, evasive and contradictory," rejected the arguments that petitioners were denied due process by the audit or by the *ex parte* communications between the conciliation conferee and the auditors during the conciliation process, and found that Mr. Murphy's attempt to unilaterally revoke the waiver extending the limitations period "was of no consequence."

The Tribunal held that it would be "plainly contrary to the preemption clause's 'goal of uniformity' for the Division of Tax Appeals to determine whether a trust is qualified under" IRC § 401(a).

Tribunal Decision. First, the Tribunal agreed with the ALJ that the notice of deficiency issued on November 22, 2010 was timely, and that Mr. Murphy's attempt to unilaterally revoke the waiver by letter on November 12, 2012 was not effective.

However, on the preemption issue, the Tribunal reversed the ALJ. It found, first, that the gain from the sale of the Property resulted in long term capital gain that was reported as such on JJF Associates' 2006 partnership return, and that the full amount of the gain was reported on its 99%-member JJF ESOP's K-1 and thus was passed through to JJF ESOP. An ESOP qualified under IRC § 401(a) is exempt from tax, and responsibility for tax ultimately falls to the trust's beneficiaries when distributions from the trust are taxable to the distributee in the year of distribution under IRC § 402(a). An ESOP qualified under IRC § 401(a) is an employee benefit plan as defined in ERISA, and falls within the scope of the ERISA preemption provision, which states that ERISA's provisions "supersede any and all State laws insofar as they . . . relate to any employee benefit plan." 29 U.S.C.A. § 1144(a).

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To determine the scope of the federal preemption, the Tribunal reviewed federal cases and, while noting the presumption that Congress generally does not intend to preempt state law, particularly in an area of "traditional state regulation" such as tax, pointed out that the ERISA statute expressly provides that state tax laws are not exempt from preemption.

The Tribunal found that the term "relates to" in the preemption statute is interpreted in its "normal sense," and that an ERISA plan preempts state law if the law has a "connection with or reference to such a plan." It noted that, under *Ingersoll-Rand Co. v. McClendon*, 498 U.S. 133 (1990), preemption would apply, because here, as in *Ingersoll-Rand*, the existence of a plan subject to ERISA regulation is a "critical factor" in determining liability. The petitioners seek to prove that JJF ESOP exists and is qualified under IRC § 401(a), and the Tribunal found that the administrative proceeding relates to the "'essence' of JJF ESOP, the putative ERISA plan, and therefore relates to ERISA." The Tribunal held that it would be "plainly contrary to the preemption clause's 'goal of uniformity' for the Division of Tax Appeals to determine whether a trust is qualified under" IRC § 401(a).

The Department's theory was based on its position that the ESOP was a sham [but] . . . that question — the validity of an ESOP — is explicitly preempted from state review by federal law . . . .

The Tribunal acknowledged that there might be a potential for abuse if the mere claim of the existence of an ERISA plan were to create a shield of preemption, but found that not to be the case here, since the record contained the JJF ESOP Trust Agreement, JJF ESOP Plan, JJF ESOP's forms 5500-EZ for the years 2006 and 2008 through 2012, and JJF ESOP's 2006 Form K-1, and that the authenticity of those documents was not in question. The Tribunal found that the record creates prima facie evidence of the existence of JJF ESOP, and that it was therefore preempted from making a determination regarding the qualification of a trust under IRC § 401(a). It granted the petition and canceled the notice of deficiency.

ADDITIONAL INSIGHTS

The ALJ's decision concentrated primarily on the rather complicated facts, potentially inconsistent documents, numerous overlapping relationships among several commonly owned entities, including the ESOP, and testimony by Mr. Murphy that the ALJ found lacked credibility. The Tribunal focused instead on the broader issues presented by the Department's audit, and the documentation produced by the petitioners which was not contested by the Department. The Department's theory was based on its position that the ESOP was a sham and should be disregarded, and that was exactly the argument accepted by the ALJ and used as the basis for his decision. However, that question — the validity of an ESOP — is explicitly preempted from state review by federal law, and the Tribunal found that it could not address that issue at all.

INSIGHTS IN BRIEF

ALJ FINDS INTEREST ON RETROACTIVE PENSION PAYMENTS IS NOT EXEMPT

A New York State ALJ has sustained a notice of deficiency asserting New York State personal income tax on interest income received by a government retiree on retroactive pension benefits that were found due and owing pursuant to a class-action settlement. *Matter of Jerry & Rikki Weiner*, DTA No. 827337 (N.Y.S. Div. of Tax App., Mar. 8, 2018). While Tax Law § 612(c)(3)(i) specifically provides that a taxpayer's federal gross income is reduced by the amount of certain pension income for New York personal income tax purposes, that reduction applies only to the actual amounts of the pension payments, and not to the interest that was paid in this case when the income in question was retroactively determined to have been properly included in pension payments.

NYC TRIBUNAL HOLDS PAYMENT OF TAX CONSIDERED MADE ON THE DATE CHECK IS DELIVERED TO DEPARTMENT

The New York City Tax Appeals Tribunal upheld the determination of an ALJ, and held that a payment of real property transfer tax by check is made on the date the check is delivered to the Department. *Matter of Jamestown, L.P.*, TAT (E) 14-8 (RP) (N.Y.C. Tax App. Trib., Jan. 31, 2018). As an application for a refund of RPTT must be made within one year of payment, the Tribunal held that the taxpayer's refund request was time-barred. The Tribunal also clarified that the fact that a year is a leap year is disregarded when making this calculation, which is properly determined by counting 365 days from the date of payment.

NYC TRIBUNAL HOLDS CONSIDERATION IN REIT TRANSFER NOT LIMITED TO ESTIMATED MARKET VALUE OF THE UNDERLYING PROPERTY

The New York City Tax Appeals Tribunal has reversed an ALJ and held that for purposes of determining whether a transaction qualifies as a "REIT transfer" (for which the New York City real property transfer tax is computed at 50% of the otherwise applicable rate) consideration is not

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limited to the estimated market value of the underlying real property. *Matter of VCP One Park REIT, LLC, et al.*, TAT (E) 14-26 (RP) (N.Y.C. Tax App. Trib., Feb. 16, 2018). In order to qualify as a REIT transfer, the value of the ownership interests in the REIT received by the grantor as consideration must be equal to at least 40% of the equity interest in the real property conveyed. The Tribunal held that Administrative Code § 11-2102.e(3), which expressly provides that "consideration for a real estate investment trust transfer . . . shall be equal to the estimated market value of the real property," only applies if the REIT transfer is solely in exchange for REIT shares. Where, in this case, the transfer was in exchange for more than just shares in the REIT, the Tribunal held that it was appropriate to apply the more general definition of "consideration" found in Administrative Code § 11-2101.9. As a result, the Tribunal concluded that the transfer did not qualify as a REIT transfer because it did not meet the 40% test.

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