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NEW YORK TAX INSIGHTS

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# THE TOP 10 NEW YORK TAX HIGHLIGHTS OF 2019

By Irwin M. Slomka

As we do each January, we set out below our annual list of the Top 10 New York tax highlights for the past year.

1. ***Court of Appeals Issues Far-Reaching Sales Tax Decision in Wegmans Food Markets.*** In what may turn out to be one of the most significant tax decisions by New York's highest court in recent years, a sharply divided Court of Appeals upheld the assessment of sales tax on information services – competitor pricing information furnished to a supermarket chain – holding that the sales tax exclusion for information services that are "personal or individual in nature" is inapplicable to information obtained from publicly available sources. *Wegmans Food Mkts., Inc. v. Tax Appeals Trib.*, 33 N.Y.3d 587 (2019). Yet, it is the court's holding on statutory interpretation (by a slender 4-3 majority) that ambiguities in a statutory *exclusion* provision (like the "personal or individual" information services exclusion) must be interpreted like a tax *exemption* statute – that is, in favor of the government rather than the taxpayer – that could have the most far-reaching impact.

2. ***Treatment of GILTI Undergoes Two Different State Legislative Changes.*** In April 2019, Governor Cuomo signed legislation enacting a New York State and New York City corporate tax sourcing rule for GILTI, requiring that it be included in the denominator, but not in the New York numerator, of a corporation's apportionment fraction, for taxable years beginning on or after January 1, 2018. Some business groups had urged that the legislation exclude GILTI from the income tax base altogether, and it was generally known that the Governor and State Tax Department had been open to such an approach had New York City agreed to it, but since the City did not, the legislation was enacted as proposed. Then, in June 2019, in the closing hours of the legislative session, the April 2019 legislation was replaced by a new rule for New York State purposes that, for taxable years beginning after 2018, allows an exclusion of 95% of a corporation's GILTI from the New York State corporate income tax base (leaving in place for 2017 the initially enacted GILTI rule). However, in light of New York City's continued resistance, the Legislature did not enact the same 95% exclusion for New York City corporate tax purposes. As a result, there is now a stark dichotomy between the State and City corporate taxes on GILTI treatment starting in 2019. It seems reasonable to expect the Legislature to be asked to reconcile this considerable disparity between the State and City laws when it convenes again in early 2020.

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3. ***U.S. Supreme Court Denies Review of Constitutional Challenge to NYS Disallowance of State Tax Credits Claimed by Statutory Residents.*** Hoping that the legal landscape may have changed in light of the U.S. Supreme Court decision in *Comptroller of the Treasury v. Wynne*, 135 S. Ct. 1787 (2015), in June 2019, two separate New York State non-domiciliaries who were New York "statutory residents" asked the Supreme Court to review two New York court decisions that upheld the denial of credits for taxes paid to Connecticut, their state of domicile, on their investment income. The taxpayers argued that, under *Wynne*, where the Court had held that Maryland's resident income tax credit regime violated internal consistency under the dormant Commerce Clause, it was unconstitutional for New York State to deny a credit for taxes paid to Connecticut on the same investment income also being taxed by New York State. However, in October 2019, the Supreme Court denied *certiorari*, evidencing the difficulties that taxpayers may face, at least for the foreseeable future, in persuading the Court to accept a legal challenge to New York State's controversial statutory residency regime. *Chamberlain v. N.Y.S. Dep't of Taxation & Fin*., 166 A.D.3d 1112 (3d Dep't 2018) and *Edelman v. N.Y.S. Dep't of Taxation & Fin*.,162 A.D.3d 575 (1st Dep't 2018), *cert. denied*, 140 S. Ct. 134 (2019).

4. ***Federal Judge Dismisses New York State Lawsuit Challenging $10,000 SALT Deduction Cap.*** In a case that generated considerable press coverage, a federal district court judge dismissed a lawsuit brought by New York State (together with Connecticut, New Jersey, and Maryland) seeking to invalidate on constitutional grounds the $10,000 cap on state and local tax deductions that was enacted as part of the federal TCJA of 2017. *New York v. Mnuchin*, No. 18-CV-6427 (JPO) (S.D.N.Y. Sept. 30, 2019). The court rejected New York's two principal arguments, that the Constitution precludes any congressional attempt to meaningfully limit the SALT deduction and that the purpose for the limitation was to unconstitutionally "coerce" the states into changing their tax policies (*i.e.*, imposing high state and local taxes). The lawsuit was widely viewed as more of a political act than a bona fide constitutional challenge, and the dismissal of the lawsuit was not surprising. Nonetheless, in November 2019, New York State and the other states filed a Notice of Appeal with the U.S. Court of Appeals. *New York v. Mnuchin*, No. 19-3962 (2d Cir., Nov. 26, 2019).

5. ***Tribunal Finally Given Opportunity to Rule on Sourcing of "Other Business Receipts."*** After several years of litigation, the Tax Appeals Tribunal was finally given the opportunity to rule on the Tax Department's controversial interpretation of the sourcing of receipts from services provided "electronically" under the pre-2015 corporate tax, and it rejected the Department's attempt to apply customer-based sourcing for the years at issue. *Matter of Catalyst Repository Sys., Inc.*, DTA No. 826545 (N.Y.S. Tax App. Trib., July 24, 2019). Catalyst earned receipts from the provision of litigation support services, which it made available to customers online through its computer software system. The Tribunal agreed with the Department that the receipts were not from the performance of services, but rather constituted "other business receipts" under the Tax Law, and should be sourced based on where they are "earned." The Tribunal nonetheless held that the Department could not source the receipts – which the Tribunal concluded were from the licensing of the taxpayer's computer system – based on customer location. In two earlier cases, ALJs had also rejected the Department's attempt to apply customer-based sourcing in analogous circumstances, but in those cases the Department chose not to appeal, so the ALJ decisions remained non-precedential. Although customer-based sourcing is now the general rule under the New York corporate tax beginning after 2014, the Tribunal decision in *Catalyst*, which cannot be appealed by the Department and is precedential, should provide some clarity for corporations facing similar assertions by the Department for pre-2015 tax years.

6. ***Marketplace Provider Sales Tax Collection Law Finally Enacted.*** In April 2019, after several failed attempts in prior years, the New York State Legislature finally passed "marketplace provider" legislation, requiring marketplace providers with the requisite nexus (including specified amounts of in-State sales) to collect sales tax on taxable sales of tangible personal property that they "facilitate" for marketplace sellers. Part G, Ch. 59, New York Laws of 2019. The legislation went into effect on June 1, 2019, less than two months after it was signed into law, and surprisingly with little apparent controversy. Although initially made applicable to marketplace providers with an annual New York sales tax threshold of $300,000 for the four immediately preceding quarters, regardless of physical presence, in June 2019 the Legislature increased the threshold to $500,000. Whether that increased threshold validated the statement in the Governor's memorandum in support



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of the originally enacted legislation that it applied only to "large marketplace providers" is subject to debate.

7. ***Appellate Court Upholds Denial of Deductions for Payments to Captive Insurance Company.*** In May 2019, the Appellate Division, Third Department, held that a corporate taxpayer could not deduct insurance payments it made to its wholly owned captive insurance company because the payments did not qualify as valid insurance premiums under federal income tax law due to the absence of risk shifting and risk distribution. *Matter of Stewart's Shops Corp. v. N.Y.S. Tax Appeals Trib.*, 172 A.D. 3d 1789 (3d Dep't 2019). The deductibility of insurance payments to captive insurers has long been a controversial issue for New York State and City corporate tax purposes. The decision suggests that if risk shifting and risk distribution are present under the federal income tax rules for insurance, there should be no impediment to deducting arm's-length insurance payments made to captive insurers.

8. ***ALJ Decisions Issued Denying Deductions for Royalties Received From Foreign Non-taxpayer Affiliates.*** Under the former New York State corporate tax law, a corporation was entitled to deduct from income royalties it received from a related member, unless the payments were not required to be added back by the related member under another provision of the Tax Law. The deductibility of royalty income received from non-U.S. non-taxpayer affiliates – entities that have no obligation to file Article 9-A returns – has been the subject of considerable New York audit activity, with the Tax Department taking the position that such royalties are not deductible since the foreign affiliate is not required to add them back for New York since the foreign affiliate does not file New York returns. This past May, a NYS ALJ upheld the denial of the deduction, rejecting the taxpayer's argument that the statute itself contained no requirement that the royalty payor must be a New York taxpayer. *Matter of Walt Disney Co. & Consolidated Subsidiaries*, DTA No. 828304 (NY.S. Div. of Tax App., May 30, 2019). The case is on appeal to the Tax Appeals Tribunal and, as we went to press, yet another ALJ decision was issued denying the deduction on similar grounds (see *Insights in Brief*, page 6).

9. **State ALJ Upholds Limitation on Scope of Special Broker-Dealer Sourcing Law.** The 2017 reversal by the New York State Tax Department of its earlier guidance concluding that a corporation was entitled to apportion using the special securities broker-dealer sourcing in order to properly reflect its income, even though the corporation was not itself a registered broker-dealer, was at issue in *Matter of BTG Pactual NY Corp.*, DTA No. 827577 (N.Y.S. Div. of Tax App., Mar. 7, 2019). The ALJ upheld the Tax Department's reversal of its position, holding that under the Tax Law only a *registered* broker-dealer qualified for the special sourcing. According to the ALJ, the fact that the taxpayer corporation – the sole member of two single-member LLCs, one a registered broker-dealer, the other an investment advisor – treated both disregarded SMLLCs as divisions, was relevant only to the question of which entity was taxed on its receipts, but could not be used to determine whether the receipts from the investment advisor qualified for broker-dealer sourcing. The case is currently on appeal to the Tax Appeals Tribunal.

10. ***NYS Tribunal Holds That Taxpayer Timely filed "Informal" Refund Claim.*** In one of the more welcome, and in some ways surprising, decisions of 2019, the Tax Appeals Tribunal, reversing an ALJ decision, held that a corporate taxpayer had filed a timely "informal" Article 9-A refund claim for the 2007 tax year – which did not actually claim the refund – when it filed its return for 2008 claiming a portion of the refund, and was therefore entitled to the balance of an otherwise time-barred refund for 2007. *Matter of Accidental Husband Intermediary, Inc.*, DTA No. 827186 (N.Y.S. Tax App. Trib., Apr. 11, 2019). The Tribunal concluded that the "informal refund claim" doctrine was met because, among other things, the taxpayer's 2008 Article 9-A tax return was sufficient to have put the Tax Department on notice of the claim and to enable the Department to investigate further. There was otherwise no dispute as to the taxpayer's entitlement to the refund, and the Tribunal ordered that the refund be granted.

Although certainly not a 2019 "highlight," this past year witnessed the practical demise of the New York State Department of Taxation and Finance Advisory Opinion process. In 2019, the Tax Department issued only *two* Advisory Opinions. In 2009, by way of contrast, it issued 104 Advisory Opinions, 64 of which related to sales tax. (The New York City Department of Finance private letter ruling process also results in few rulings, which curiously are not even timely posted on its website.) The reduced output is likely attributable to often extensive delays by the Department in issuing them, which in turn discourages taxpayers from requesting them in the first place. This is not a new trend, and there may be valid reasons for the reduced output, but without question 2019 yielded the lowest output of Advisory Opinions in many years.

# THREE ALJ DECISIONS ISSUED CONCERNING TAX PREPARER PENALTIES

By Hollis L. Hyans

Three different Administrative Law Judges recently issued decisions in matters involving challenges by tax return preparers to penalties assessed by the Department of Taxation and Finance. In two cases, the penalties were upheld; in one they were canceled.

**Penalties imposed for filing returns taking improper positions.**

Two cases involved the assertion of penalties against tax preparers under Tax Law former § 685(aa)(1), which provided for tax preparer penalties of up to $1,000 with respect to each return or claim when a return or refund claim takes a position for which "there was not a reasonable belief" that the tax treatment was more likely than not correct, the preparer knew or reasonably should have known of the position, and the position was not disclosed or there was no reasonable basis for the treatment.

In *Matter of Lael Cathey*, DTA No. 827909 (N.Y.S. Div. of Tax App., Nov. 21, 2019), the Department asserted that the preparer had filed returns for the 2013 and 2014 years on behalf of personal income taxpayers who had claimed unsubstantiated itemized deductions for amounts such as employee job expenses and charitable deductions. The Department asserted that on 789 returns – which amounted to approximately 79% of the returns that the preparer, Ms. Cathey, had prepared – the taxpayers' deductions had been questioned by the Department. Of those returns, 506 had been selected for pre-refund audit inquiry and, according to an affidavit from a Department employee, none of the 506 taxpayers "was able to substantiate the itemized deductions." However, the record did not disclose the number of taxpayers who responded or whether, even in the absence of a response, the Department was able to reach a conclusion about the propriety of the deductions. The Department's position was that a significant, although unspecified, number of Ms. Cathey's taxpayer clients were public sector employees, and she should have known that their job expenses were reimbursed or reimbursable by their employers, so she should not have treated the expenses as deductible on the returns.

The Department also alleged that approximately 84 pieces of supporting documentation, submitted for more than 20 different taxpayers, appeared to be fraudulent. For example, four letters were submitted to verify the expenses claimed by the taxpayers, but the letters, despite ostensibly coming from different employers with different letterheads, were essentially identical and bore the exact same signature of the identical "HR Manager." Similarly, four photocopies of the same receipt for police equipment that were identical in amount, date, items purchased, and cost were submitted showing four different individuals as purchasers.

**The ALJ found that tax preparers may reasonably and in good faith rely on information supplied by their clients and are not under an obligation to audit or examine books and records**

To determine whether the imposition of penalty was warranted, the ALJ applied three criteria: the egregiousness of the position; the audit success; and the total number of returns on which the position was claimed. The ALJ found that the reporting position taken on the returns "was not, per se, an improper position" because taxpayers are clearly entitled to claim deductions for gifts to charities and unreimbursed expenses, and that the taxpayers' inability to provide substantiation on audit "does not necessarily support" the finding that the deductions were an improper reporting position. While the Department claimed that Ms. Cathey could not reasonably rely upon her clients' desire to claim the expenses in the absence of supporting documentation, the ALJ found that tax preparers may reasonably and in good faith rely on information supplied by their clients and are not under an obligation to audit or examine books and records, as is recognized by the Department's regulation, which provide that a "tax return preparer . . . generally may rely in good faith without verification upon information furnished by the client." 20 N.Y.C.R.R. 2600-4.3[h][6].

The ALJ did find "very troubling" the submission to the Department of what it described as "obviously manufactured documents," and noted that they could expose Ms. Cathey to unspecified sanctions other than tax preparer penalties. However, the ALJ determined that those documents did not necessarily establish that Ms. Cathey knew at the time of filing the returns that the claimed deductions were not valid. He rejected



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the Department's argument that Ms. Cathey should generally have known that expenses were not deductible by state and municipal employees as a "thin rationale," and found it an insufficient basis to support the imposition of penalties.

In the second case involving tax preparer penalties, *Matter of Yesenia Almonte*, DTA No. 827891 (N.Y.S. Div. of Tax App., Dec. 12, 2019), the Department had asserted penalties against Ms. Almonte for preparing returns on behalf of her clients on which "other losses" from businesses engaged in by the taxpayers had been claimed. Many of Ms. Almonte's clients had losses from their investments in a business loaning money to others, which turned out to be a "pyramid type scheme," and many of these clients had advised her that they understood they could report those losses on IRS Form 4797. After conducting "internet research" and consulting with unidentified individuals to research her clients' loan businesses, Ms. Almonte reported her clients' purported losses by filing a Form 4797, and including the amount of loss on line 8 of the clients' Forms IT-201. Ms. Almonte charged her clients between $75 and $350 for preparation of their returns.

The Department audited 713 of the 1408 returns filed by Ms. Almonte for the 2014 year, and found that none of the taxpayers were entitled to claim losses on Form 4797, which applies only to taxpayers who sold or exchanged assets used in a trade or business, while the taxpayers at issue claimed such items as capital losses or adjustments to federal income for student loan interest. The Department assessed penalties of $713,000, $1,000 for each of the 713 returns.

In this case, the ALJ sustained the penalties. She found that Ms. Almonte, who was a registered tax return preparer, had completed college course accounting work and a tax preparation course at H&R Block, and should have known that the use of Form 4797 and the filing positions taken on the returns were incorrect. The ALJ also noted, without explaining the relevance to the imposition of tax preparer penalties, that Ms. Almonte did not report any of the income she earned from her tax preparation business on her own personal income tax return, paid her employees in cash, and did not pay withholding tax or file Forms W-2 with regard to her employees.

### Penalties for Failing to File Electronically

Finally, the third case, *Matter of Ronald Bellantonio and Richard Rock*, DTA Nos. 828044 & 828045 (N.Y.S. Div. of Tax App., Dec. 5, 2019), involved penalties of $4,900 asserted under Tax Law § 29, which requires all tax return preparers who prepare more than 100 returns in a calendar year to file the tax returns electronically, and imposes a penalty for failure to file electronically unless the failure is due to reasonable cause and not willful neglect. Here, the tax preparer argued that all of his clients were "middle-aged, older and elderly" and "not astute in the area of tax and money" or otherwise vulnerable to identity theft; that they elected to file paper returns for federal purposes; and that he "exercised professional judgment in not wanting to subject [the] clients' personal information to possible cyber theft."

The ALJ sustained the penalties. She noted, first, that New York State does not have the opt-out provision to avoid electronic filing that is available at the federal level, and also that Tax Law § 29 was explicitly amended in 2010 to remove as a basis for reasonable cause a taxpayer's election not to electronically file. The ALJ also found that the allegations about the clients' age and status were not supported by the record, since most of the clients listed professional occupations on their returns and were not middle-aged or elderly.

## ADDITIONAL INSIGHTS

The difference in the results in the two cases involving preparer penalties for taking improper positions seems to involve the conduct that was charged. In the *Cathey* case, the positions taken on the taxpayers' returns were on their face correct and in accordance with the law. While the taxpayers may not have had the right circumstances and documentation to support their claims, the preparer was held to be entitled to rely on the information she had been given by the taxpayers. In the *Almonte* case, the treatment of the losses on the taxpayers' returns was improper on its face, since it relied on a statute and submission of a tax form that would not have applied even accepting the facts supplied to the preparer by the taxpayers.

The statute imposing tax return preparer penalties that was at issue in the first two cases, Tax Law former § 685(aa), expired and was deemed repealed on July 1, 2015. It was initially replaced by a new version that applied until April 12, 2019, and then by the current version, effective beginning April 12, 2019. The statute now provides for the imposition of penalties if the preparer takes a position that either understates the tax liability or increases a refund claim, and, similar to the language in the earlier version, knew or reasonably should have known that the position was not proper, and the position was not adequately disclosed on the return. Under these circumstances, the statute now imposes a penalty of between $100 and $1,000. However, if the position is due to the preparer's "reckless or intentional disregard of the law, rules or regulations," the statute imposes a penalty of between $500 and $5,000.

# INSIGHTS IN BRIEF

## ALJ DENIES TAXPAYER'S PETITION FOR AWARD OF COSTS AND DEPARTMENT'S MOTION FOR FRIVOLOUS PETITION PENALTIES

An individual who refused to respond to a desk audit request to substantiate itemized deductions to support a personal income tax refund, but who eventually substantiated those deductions and refund claim at a conciliation conference, was not entitled to an award of costs available to a prevailing party. *Matter of Brenda Collins*, DTA No. 829379 (N.Y.S. Div. of Tax App., Nov. 21, 2019). The ALJ concluded that the Tax Department was substantially justified in denying the refund (and issuing a notice of deficiency) in light of the individual's initial refusal to substantiate her claimed deductions. However, the ALJ also denied the Department's motion to impose a frivolous petition penalty under Tax Law § 2018, concluding that the taxpayer's petition seeking costs, while "poorly reasoned," was not so "completely without merit" as to constitute a "frivolous petition."

## NYC RULES THAT SALE OF BUILDING PRINCIPALLY OCCUPIED AS A SINGLE RESIDENCE QUALIFIED FOR LOWER RESIDENTIAL REAL PROPERTY TRANSFER TAX RATE

The sale of a four-story building principally occupied by the property owner and his family as a single residence, but where the ground floor was used as a medical office and later as a nursing business, nonetheless qualified for the lower residential NYC real property transfer tax rate of 1.425% applicable to one, two, or three family houses. *Finance Letter Ruling*, FLR 19-4998 (N.Y.C. Dep't of Fin., July 9, 2019), released Nov. 2019. The building was listed in the NYC real property tax assessment rolls as Class 1 Property, which includes houses "used primarily for residential purposes." The Department of Finance concluded that, in the absence of information indicating that the property tax classification was incorrect, the Class 1 classification was controlling and the sale qualified for the lower rate, even though approximately 20% of the gross floor footage constituted commercial space.

## FIRST DEPARTMENT AFFIRMS AVAILABILITY OF TAX EXEMPTION FOR DIALYSIS CENTER

The Appellate Division, First Department, has held that a corporation providing dialysis services to its affiliates – a large nonprofit hospital complex in Brooklyn and a nonprofit institute for nursing and rehabilitation – qualified for an exemption from real property taxation, notwithstanding its own for-profit status. *Brookdale Physicians' Dialysis Assocs., Inc. v. Dep't of Fin.*, No. 156074/2017, 2019 NY Slip Op. 08636 (1st Dep't Dec. 3, 2019). The court found that the dialysis center provided the critical healthcare services of hemodialysis and peritoneal dialysis to its nonprofit affiliates, and placed any profit it earned from renting the dialysis center from the institute back into its nonprofit healthcare-provider affiliates. Because the building was used to provide dialysis services for patients of the hospital and the nursing institute, and the services were "reasonably incident" to the institute's purpose of funding and supporting its healthcare affiliates, the building qualified for tax-exempt status.

## DEDUCTION DENIED FOR ROYALTIES RECEIVED FROM FOREIGN NON-TAXPAYER AFFILIATES

Once again, a New York State ALJ has upheld the Department of Taxation and Finance's denial of a deduction claimed under Tax Law former § 208(9)(o)(3) for royalties received from foreign affiliates. *Matter of Int'l Bus. Machs. Corp. and Combined Affiliates*, DTA Nos. 827825, 827997 & 827998 (N.Y.S. Div. of Tax App., Dec. 19, 2019). The statute had provided that a taxpayer could deduct from its taxable income royalty payments received from a "related member" during the taxable year, "unless such royalty payments would not be required to be added back" under the expense disallowance provisions or other similar provisions of the Tax Law. The ALJ denied the deduction, finding that the foreign royalty payors would never be required to add back the royalty payments because they were not subject to Article 9-A, and that instead of furthering the legislative intent of the addback and exclusion provisions, which had been to tax royalty transactions between related parties only once, allowing taxpayers to deduct royalties paid to non-taxpayer foreign affiliates would instead result in the royalty income not being subject to tax at all.

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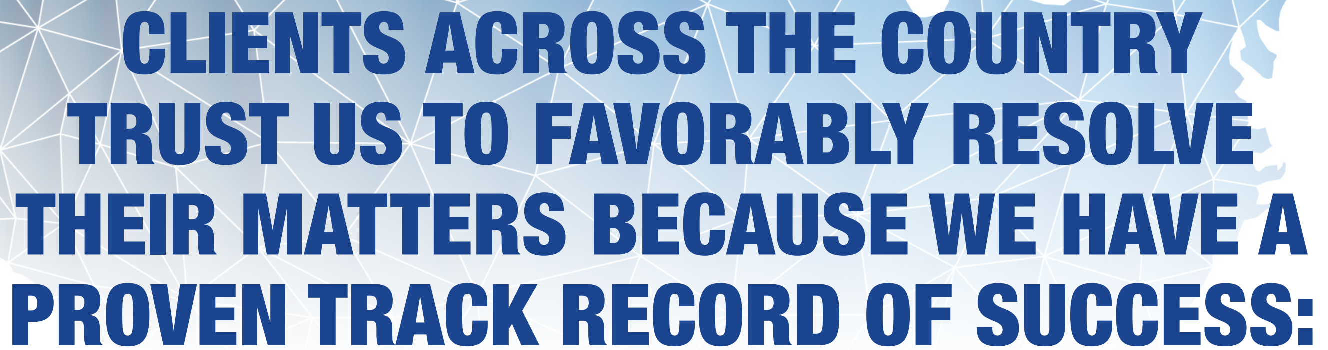


ADP Vehicle Registration, Inc. v. New Jersey (NJ Tax Ct. 2018)

AE Outfitters Retail Co. v. Indiana (IN Tax Ct. 2011)

Agilent Technologies, Inc. v. Colorado (CO Sup. Ct. 2019)

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