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EDITORS

Hollis L. Hyans
hhyans@mofo.com

Irwin M. Slomka
islomka@mofo.com

STATE + LOCAL TAX GROUP

NEW YORK

Craig B. Fields cfields@mofo.com
Hollis L. Hyans hhyans@mofo.com
Nicole L. Johnson njohnson@mofo.com
Mitchell A. Newmark mnewmark@mofo.com
Irwin M. Slomka islomka@mofo.com
Philip S. Olsen polsen@mofo.com
Michael A. Pearl mpearl@mofo.com
Rebecca M. Balinskas rbalinskas@mofo.com
Matthew F. Cammarata mcammarata@mofo.com
Eugene J. Gibilaro egibilaro@mofo.com
Kara M. Kraman kkraman@mofo.com

CALIFORNIA

Bernie J. Pistillo bpistillo@mofo.com
William H. Gorrod wgorrod@mofo.com
Maureen E. Linch mlinch@mofo.com

WASHINGTON, D.C.

Philip M. Tatarowicz ptatarowicz@mofo.com

MORRISON FOERSTER

GOVERNOR RELEASES PROPOSED 2019-20 NEW YORK STATE EXECUTIVE BUDGET

By Irwin M. Slomka

On January 15, 2019, New York State Governor Andrew M. Cuomo released the New York State 2019-20 Executive Budget, applicable to the State's fiscal year beginning April 1, 2019, which contains several significant tax proposals, including the following:

1. **Require marketplace providers to collect sales tax**. For the third straight year, the Governor is proposing to impose a New York sales tax collection obligation (now captioned as "Eliminate Internet Tax Advantage") on "marketplace providers," defined as persons who collect the purchase price and provide the physical or virtual "forum" (*e.g.*, a store or an Internet website) where the sales transaction occurs, on most sales of tangible personal property that they "facilitate." Unlike last year's proposal, there is no "safe harbor" for marketplace providers that facilitate sales exclusively on the Internet of less than $100 million annually. Sellers that receive from the marketplace provider a certification that the provider is collecting sales tax on the facilitated sales would be relieved of the sales tax collection responsibility for those sales. If enacted, the proposed law would apply to sales made on or after September 1, 2019. (Part G.)

2. **Tax nonresidents on "carried interests" and impose a 17% "fairness fee" but only if nearby states conform**. The Governor is again proposing legislation that would treat carried interests earned by hedge fund and private equity fund managers as income earned from a New York trade or business, thereby enabling the State to tax non-resident managers with New York hedge fund and private equity fund operations on their carried interests. It would also impose a 17% "carried interest fairness fee," which would remain in effect until federal law is amended to treat carried interests as service income. If enacted into law, these provisions would not go into effect, however, until "legislation having substantially the same effect" is also enacted in four nearby states (Connecticut, Massachusetts, New Jersey, and Pennsylvania), reflecting the concern that enactment by New York alone would cause hedge funds to simply move their operations from New York into those states. (Part Y.)

3. **Provide a receipts factor sourcing rule for GILTI apportionment**. The Governor proposes an important new sourcing provision, under both the New York State and New York City corporate taxes, for corporations with global intangible low-taxed income ("GILTI"). Under this proposal,

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corporations with GILTI that constitutes business income would include in the denominator of the apportionment fraction – but not in the numerator – their "net global intangible low-taxed income," defined as GILTI less the amount deducted federally under IRC § 250(a)(1)(B)(i). There has been considerable concern about the potentially harsh impact of the inclusion of GILTI in the tax base without any representation in the apportionment fraction. The New York State Tax Department has already released its 2018 corporate tax forms authorizing a discretionary adjustment along the lines of the proposed legislation. (Part C.)

4. **Decouple from federal basis in determining whether a manufacturer is a qualified manufacturer**. Under existing Article 9-A, a "qualified New York manufacturer" is entitled to reduced tax rates, including a zero tax rate on business income, where, among other things, it has New York property with an adjusted basis for federal income tax purposes of at least $1 million. The Federal Tax Cuts and Jobs Act allows corporations to treat certain capital expenditures as qualifying for 100% bonus depreciation, which may result in reduced federal adjusted basis of a corporation's New York property. The Governor's proposal would decouple from the federal adjusted basis and substitute the New York State adjusted basis. (Part D.)

5. **Extend top personal income tax rates for five years**. The existing top personal income tax bracket for individuals, currently 8.82%, would be extended for an additional five years. That top rate, previously enacted as a temporary rate increase, is currently set to expire after 2019. (Part P.)

6. **Enact the Cannabis Regulation and Taxation Act**. The Governor is proposing to legalize adult-use cannabis, and to impose a three-part tax on adult-use cannabis products under a new Article 20-C. One tax would be imposed on the cultivation of cannabis, a second tax on the sale by a wholesaler to a retail dispensary (at 20% of the invoice price), and a third tax on the same sale to the retailer (at 2% of the invoice price), collected in trust for the applicable local county. (Part VV.)

The proposed Executive Budget does not contain the New York State unincorporated business tax on partnerships and certain other unincorporated entities, which had been the subject of a much-discussed May 2018 "discussion draft" released by the State Tax Department.

The deadline for enactment of the New York State budget is April 1, 2019.

NOTICE ON SALES TAX REGISTRATION REQUIREMENTS ISSUED FOR BUSINESSES WITH NO IN-STATE PHYSICAL PRESENCE

by Kara M. Kraman

On January 15, 2019, the New York State Department of Taxation and Finance released *Important Notice N-19-1*, "Notice Regarding Sales Tax Registration Requirement for Businesses with No Physical Presence in New York State" (N.Y.S. Dep't of Taxation & Fin., Jan. 2019). The Notice provides information on sales tax registration requirements in light of the U.S. Supreme Court's decision in *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018), for businesses that have no physical presence in New York.

Background. In *Wayfair*, the U.S. Supreme Court held that the U.S. Constitution does not require a physical presence in a taxing state in order for the state to impose a sales and use tax collection obligation on an out-of-state seller. However, the Court also made clear in *Wayfair* that a substantial nexus between the taxing state and the business that it seeks to require to collect tax is still required. In *Wayfair*, the Court found that Wayfair had a substantial nexus with South Dakota "based on both the economic and virtual contacts" that it had with South Dakota, inasmuch as Wayfair had, on an annual basis, over $100,000 in sales of goods and services delivered into South Dakota, or 200 or more separate transactions for the delivery of goods and services into South Dakota. Significantly, the Court did not resolve whether the South Dakota law would violate the Commerce Clause prohibition against undue burdens upon interstate commerce for entities other than Wayfair. However, the Court noted that the following worked in favor of the South Dakota law's constitutionality: (1) the law provides a safe harbor to those who transact only limited business in South Dakota; (2) the law expressly does not apply retroactively; and (3) South Dakota has addressed uniformity with other states by adopting the Streamlined Sales and Use Tax Agreement.

At the time *Wayfair* was decided, New York already had in place an economic nexus statute similar to the one at issue in *Wayfair*. Specifically, the existing Tax Law provides that a seller will be considered to be a New York vendor for sales tax purposes: (i) if on an annual basis, it has over

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$300,000 of sales delivered into the state and more than 100 sales of property into the State; and (ii) "if such solicitation satisfies the nexus requirement of the United States constitution." Tax Law §§ 1101(b)(8)(i)(E), (b)(8)(iv). While this economic nexus standard for sales tax has existed under New York law for many years, New York did not enforce it because it conflicted with the Supreme Court nexus standard under *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), which required a physical presence.

Notice. In light of *Wayfair*, the Notice is not unexpected. It states that "[d]ue to [Wayfair], certain existing provisions in the New York State Tax Law that define a sales tax vendor immediately became effective." It also restates the more than $300,000 of sales/more than 100 sales nexus standards and advises sellers that meet this threshold, but have not yet registered as New York vendors, that they "should do so now." Although the Notice states that the existing New York economic nexus statute became effective "immediately" upon the Supreme Court's decision in *Wayfair*, the Notice is silent with respect to the effective date when it will be enforced. Therefore, it is not clear whether the Department will enforce the economic nexus standard retroactively, either back to June 21, 2018 (the date of the *Wayfair* decision), or to the date the Notice was released, or whether the Department will start enforcing this standard as of some other date.

ADDITIONAL INSIGHTS

While the bright-line test in the New York statute actually reflects a higher threshold than the one the Supreme Court found to be constitutional in South *Dakota v. Wayfair, Inc.*, that does not necessarily mean that the New York statute satisfies the Court's constitutional nexus standard. New York's sales tax regime employs multiple rates and is generally more complex than the one the Supreme Court considered in *Wayfair*. Moreover, unlike South Dakota, New York did not adopt the Streamlined Sales and Use Tax Agreement which standardizes taxes across states and reduces administrative and compliance costs for taxpayers, which the Supreme Court found relevant in its analysis of the South Dakota law. Therefore, New York's sales tax regime could still be subject to constitutional challenge on other grounds, for instance, that it discriminates against or poses an undue burden on interstate commerce.

As to the effective date of enforcement, it would seem most reasonable for the Department to enforce collection obligations under the Notice only prospectively from when the Notice was issued.

APPELLATE COURT AFFIRMS TRIBUNAL FINDING OF "ABUSIVE TAX AVOIDANCE TRANSACTION"

By Hollis L. Hyans

In *Sznajderman v. Tax Appeals Tribunal*, No. 523995, 2019 NY Slip Op. 00007 (3d Dep't, Jan. 3, 2019), the Appellate Division, Third Department, confirmed a New York State Tax Appeals Tribunal decision upholding an income tax assessment arising from investments in oil and gas partnerships that generated large deductions. The Appellate Division agreed with the Tribunal that the investments constituted "abusive tax avoidance transactions" under the Tax Law and therefore were governed by a six-year statute of limitations for assessment, making the Department's assessment timely.

Facts. Petitioner Marc Sznajderman became a general partner in Belle Isle Drilling Company ("Belle Isle"), a New York general partnership formed in 2001. The partnership, created and controlled by an individual named Richard Siegal, was engaged in oil and gas drilling ventures, which were designed to generate deductible intangible drilling costs ("IDCs") in the first year of operation.

A critical part of the deal was a "turnkey" arrangement, under which the driller accepts a fixed fee for developing wells up to the point that they enter production. Belle Isle entered into a turnkey contract with SS&T Oil Co., Inc. ("SS&T"), an entity also controlled by Mr. Siegal, under which Belle Isle agreed to pay SS&T approximately $10.8 million, partially in cash and partially in an interest-bearing note in the principal amount of approximately $7 million. Pursuant to an assumption agreement, Mr. Sznajderman assumed responsibility for a portion of the loan that the partnership had taken from SS&T. The pricing for the turnkey contract entered into by Belle Isle had been determined by Mr. Siegal.

Mr. Sznajderman signed a subscription agreement to purchase three partnership units for $840,000, payable in cash of $300,000 and a full recourse subscription note of $540,000, with an 8% interest rate. Interest on the note was payable quarterly the first year, and thereafter payable from his share of Belle Isle's net operating revenue; to the extent the revenue was insufficient, interest accrued. The Third Department noted that "[i]mportantly, [the] subscription note included

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a provision that . . . [it] would be assigned by Belle Isle to SS & T Oil Co., Inc., a Siegal-controlled entity, which was party to [the] turnkey drilling contract."

Mr. Sznajderman also was required to execute a separate collateral agreement, requiring him to purchase municipal bonds that could be used towards the repayment of his subscription note. Mr. Sznajderman agreed to pay SS&T 15% of the face value of his subscription note, which was $81,000, effectuated by the assignment of 60% of his Belle Isle distributions to SS&T until the sum was equal to the 15% face value of the subscription note. SS&T guaranteed that it would invest the money in municipal bonds so that, at the end of 25 years, the sum would be equal to the principal amount of the note. Mr. Sznajderman was assured in an email from Mr. Siegal that "no one has ever been required to pay any portion of their notes" since he began structuring these transactions in 1981.

From 2002 through 2011, Belle Isle generated substantial income from oil and gas production, accrued and reported interest income due on its partners' subscription notes, and accrued and deducted interest due on the turnkey note. It made quarterly cash distributions to its partners.

The Audit. Under New York legislation enacted in 2005, the statute of limitations for certain abusive tax shelter transactions was extended to six years from the usual three years. In order to meet the extended six-year statute of limitations, the Department issued a Notice of Deficiency to Mr. Sznajderman for 2001 on March 14, 2008, assessing personal income tax and imposing penalties.

Mr. Sznajderman filed a Petition challenging the assessment, claiming that the six-year statute of limitations was inapplicable, because his investment in the Belle Isle partnership was not an abusive tax avoidance transaction that had tax avoidance as a principal purpose. He argued that the Department had allowed his cash investment as deductible IDC, that his debt was genuine, and that the investment and the partnership transactions had economic substance and significant non-tax purposes. The Department argued that the chief purpose of the investment was to avoid or evade income tax and that therefore the six-year statute applied.

ALJ Determination. Relying on the U.S. Tax Court's examination of what the ALJ concluded was the same investment format as the one in Belle Isle in *Zeluck v. Commissioner*, 103 T.C.M.(CCH) 1537 (T.C. 2012), which found that the underlying subscription note and the assumption agreement constituted genuine debt, the ALJ concluded that the debt was valid. Nonetheless, the ALJ found that the terms of the turnkey contract also had to be considered, and that because Mr. Sznajderman failed to meet his burden to establish how the turnkey price was calculated or that it was reasonable, that failure amounted to "convincing evidence that the transaction had tax avoidance as its primary motive."

Tribunal Decision. While the Tribunal disagreed that the subscription note and the turnkey note created genuine debt, it affirmed the ALJ's determination that the structure amounted to abusive tax avoidance. The Tribunal concluded that the structure artificially inflated the actual capital contributions of the partners, and that Mr. Sznajderman failed to establish the reasonableness of the turnkey contract price.

[T]he court also found that the turnkey contract lacked economic reality, and that the 2001 losses, nearly all of which were claimed as IDCs, were not matched by any real economic losses to Mr. Sznajderman . . . .

Appellate Division Decision. The court reached the same conclusion as the Tribunal. First, it noted that the Tribunal's determination involved a "fact-based inquiry on a matter within the Tribunal's expertise" that would "not be disturbed if it is rationally based and is supported by substantial evidence in the record." The court found that the "overall financing structure artificially inflated the actual capital contributions of the Belle Isle partners, allowing large tax deductions based upon IDCs derived through the inflated turnkey contract." The court also found that, while the face value of the subscription note was $540,000, the additional collateral agreement meant that, as a practical matter, the principal was satisfied by payment of only 15% of the face value, which was used to purchase bonds that were not collateral but were "ostensibly" used to pay off the principal. The court agreed with the Tribunal's finding that Mr. Sznajderman's payment of first-year interest on the stated principal did not establish that the debt was genuine, since interest was paid only sporadically after the first year, even though operating revenues were available to make larger payments, and as of 2012, there was over $4.8 million in total unpaid accrued interest owed by all the partners.

The court also found that the turnkey contract lacked economic reality, and that the 2001 losses, nearly all of which were claimed as IDCs, were not matched by

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any real economic losses to Mr. Sznajderman, or nearly all the other investors, to the extent of 85% of the face value of the subscription note. The court determined that "the turnkey contract's price bore no relationship to reasonably projected or actual drilling costs," but had been artificially increased to create "the promised 250% tax deduction." The court concluded that Mr. Sznajderman had failed to establish that his primary purpose was not tax avoidance, and therefore the extended six-year statute of limitations applied and the assessment was timely.

ADDITIONAL INSIGHTS

The court, as had both the Tribunal and the ALJ, conducted a detailed review of the various agreements and undertakings, and concluded that the economic reality of the transactions limited Mr. Sznajderman's risk to his initial out-of-pocket investment, particularly since he had been assured that no investors had ever had to pay any portion of their notes. The court also noted that the fact that Mr. Sznajderman remained personally liable on the note "changes nothing," since the likelihood of his actual repayment was "almost nonexistent." Even though the business actually existed, had drilled for oil and returned profits, and therefore had economic substance, those activities were not sufficient to insulate the transaction from being treated as abusive, where the court determined that the tax benefits were out of all reasonable proportion to actual risk.

TRIBUNAL HOLDS SALE OF SECURITY SERVICES TO PROPERTY MANAGER FOR NYC HOUSING AUTHORITY IS EXEMPT FROM SALES TAX

by Kara M. Kraman

The New York State Tax Appeals Tribunal, affirming the determination of an Administrative Law Judge, has held that the sale of security services by a vendor to a property manager that managed various apartment buildings for the New York City Housing Authority ("NYCHA") was exempt from sales tax because the property manager was acting as an agent for NYCHA, a City government agency. *Matter of Garrison Protective Services, Inc.*, DTA No. 826738 (N.Y.S. Tax App. Trib., Dec. 27, 2018).

Facts. Garrison Protective Services, Inc. ("Garrison") provided security guard services to Grenadier Realty Corporation ("Manager"), as well as to several other entities. Manager contracted with NYCHA to manage various apartment buildings located in New York City. The contract described Manager as an "independent contractor." Pursuant to the terms of the contract, Manager agreed to provide management services that included, among other things, rent collection, inspection and maintenance, and security services. Manager was expressly authorized by the contract to hire a private security firm to provide the security services. In addition, the contract between Manager and NYCHA required Manager to follow NYCHA's procurement procedures, and to comply with prevailing wage rates as determined under HUD or the New York State Labor Law, and subjected Manager and its subcontractors (including Garrison) to NYCHA rules that required the hiring of NYCHA tenants to work in the apartment developments where feasible.

Garrison did not collect sales tax on its sale of security services to Manager because it understood that Manager was acting as an agent for NYCHA. Subsequently, the Department audited Garrison and assessed sales tax on its sale of security services to Manager, as well as its sales to certain other entities.

Law. Under New York law, the provision of security services is subject to sales and use tax. Tax Law § 1105(c)(8). However, purchases made by New York State agencies, instrumentalities, public corporations, and political subdivisions are exempt from tax. Tax Law § 1116(a)(1). In addition, purchases made by any person for resale are also exempt from tax. Pursuant to the Department's *Publication 765* (May 2005), a vendor may establish that a sale to a private entity is not taxable because that entity is acting as an agent for a New York State government agency by procuring both an Exempt Purchase Certificate for an Agent of a New York Governmental Entity (Form ST-122) and a Certification of Agency Appointment by a New York Governmental Entity (Form DTF-122).

ALJ Determination. The ALJ held that although Garrison did not produce properly completed ST-122 or DTF-122 forms, Manager purchased its security services as an agent of NYCHA. Applying a commonly accepted definition of "agency" as a relationship whereby "one retains a degree of direction and control over another" (*Garcia v. Herald Tribune Fresh Air Fund, Inc.*, 51 A.D.2d 897 (1st Dep't, 1976)), the ALJ found that the record established that an agency relationship existed between NYCHA and Manager because NYCHA had a fiduciary relationship with Manager, and exercised a high degree of direction and control over Manager's actions. The ALJ also held that even if Manager was not an agent of NYCHA, Garrison's sale of security services to Manager was not taxable as a sale for resale. The ALJ found that the security services were resold as such, and that it was NYCHA, an exempt

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government agency, and not Manager that was the ultimate consumer of the security services.

The Department appealed on several grounds, including that the record showed no manifestation of consent on the part of NYCHA that Manager act as its agent, that an employee of NYCHA expressly denied Manager was its agent, and that the record did not support the claim that NYCHA directed Manager's actions as a principal would direct an agent.

[T]he Tribunal found several characteristics of the relationship between Manager and NYCHA to support finding an agency relationship . . . .

Tribunal Decision. The Tribunal agreed with the ALJ, applying common law agency principles to conclude that Manager was acting as an agent for NYCHA. In reaching its conclusion, the Tribunal found several characteristics of the relationship between Manager and NYCHA to support finding an agency relationship, including that: (i) the management contracts between the two subjected Manager to many of the same statutory and regulatory requirements to which NYCHA was subject; (ii) in performing the services under the management contracts between Manager and NYCHA and the subcontract between Manager and Garrison, both Manager and Garrison were required to undertake their work in accordance with the directions of NYCHA and observe the requirements and parameters established by NYCHA; and (iii) Manager had the authority to alter the legal relationships between NYCHA and third parties, *i.e.*, tenants.

The Tribunal also held that a disclaimer of agency status by the controller of NYCHA, and the fact that the management contracts did not contain an express agency clause, were not determinative, but merely factors in the analysis of the parties' true relationship. Having held that Garrison's sales to Manager were exempt because Manager was acting as an agent for NYCHA, the Tribunal did not reach the ALJ's alternate conclusion regarding sales for resale, finding it to be moot.

ADDITIONAL INSIGHTS

Although the Tribunal did not decide the issue, the ALJ's alternative holding that Garrison's sales of security services were also exempt from sales tax as sales for resale would have also relieved Garrison of the obligation to collect sales tax. While an ALJ determination is not precedential, if correct, the principle would also logically extend to subcontractors that are not selling services to a government agency or its agents, with potentially far greater implications.

INSIGHTS IN BRIEF

COURT OF APPEALS DENIES REVIEW OF DECISION THAT NY RESIDENT DID NOT CHANGE HIS DOMICILE

The Court of Appeals, New York's highest court, has denied review of a decision by the Appellate Division confirming the New York State Tax Appeals Tribunal's decision that a longtime New York State domiciliary failed to demonstrate that he had changed his domicile from New York to Florida in advance of recognizing a large gain on the sale of Florida property. *Campaniello v. N.Y.S. Div. of Tax Appeals Trib.*, Mot. No. 2018-1054, 2019 NY Slip Op. 60817 (N.Y., Jan. 15, 2019). The petitioner had shown that he had significant business and personal ties to Florida, and the Appellate Division acknowledged that, if the Tribunal's decision had gone the other way, it would not have been unreasonable. Nonetheless, the Appellate Division found that petitioner did not prove by clear and convincing evidence that he changed his domicile, and confirmed the Tribunal's decision since it was "rationally based and supported by substantial evidence."

FEDEX SETTLES CIGARETTE SHIPPING CASE WITH NYS

The Attorney General announced on January 14, 2019, that a $35.3 million settlement had been reached with FedEx Ground Package System, Inc. ("FedEx") over claims by New York State and New York City that FedEx had shipped untaxed cigarettes. *Press Release*, N.Y.S. Office of the Att'y Gen., Attorney General James, NYC Corp. Counsel Announce $35 Million Settlement with Fedex over Shipping of Illegal Cigarettes (Jan. 14, 2019). The settlement resolves litigation pending in the federal district court for the Southern District of New York, which in October 2018 found FedEx liable for violations of a federal anti-cigarette-trafficking statute and a 2006 Assurance of Compliance with the New York Attorney General's office. Under the terms of the settlement, FedEx reportedly agreed to implement reforms, including ceasing all domestic shipments of tobacco products, with only limited exceptions; creating new communications and training for company employees; and retaining an independent consultant to advise FedEx and monitor the settlement agreement.

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SALES TAX ASSESSMENT AGAINST NEW JERSEY SELLER UPHELD FOR FAILURE TO REBUT PRESUMPTION OF TAXABILITY

A sales tax assessment against a New Jersey-based seller of hotel furnishings, for a six-year period prior to the seller having applied for a New York State certificate of authority to collect sales tax, was upheld by an Administrative Law Judge. *Matter of Hotel Depot, Inc., et al.*, DTA No. 827555 *et al.* (N.Y.S. Div. of Tax App., Jan. 3, 2019). The seller claimed that the tax assessment lacked a rational basis because the Department did not produce evidence that its shipments were made to New York locations, and that it should be presumed that its sales all occurred in New Jersey. The ALJ rejected this argument on the basis that certain sales invoices reviewed did list New York "ship-to" addresses, and because the statutory presumption of taxability of receipts from all sales of property or services imposed a burden on the seller to prove that delivery occurred outside the State, which it failed to do.

BUSINESS EXECUTIVE HELD TO BE A NEW YORK STATE AND CITY DOMICILIARY

An Administrative Law Judge upheld a New York State and City personal income tax assessment against an individual, a business executive who claimed that he was a New Zealand domiciliary for the 2014 tax year. *Matter of Grant G. Biggar*, DTA No. 827817 (N.Y.S. Div. of Tax App., Jan. 10, 2019). The ALJ found that the individual's filing, four years earlier, of a part-year New York State resident return indicating that he "moved into New York State" in-mid 2010, meant that he bore the burden of proving that he changed his domicile from New York to New Zealand by 2014. The ALJ ultimately concluded that the individual's connections with New York – including his retention of an approximately $3 million apartment, extensive business investments, and his spending nearly as much time in New York City as in New Zealand – meant that he did not prove by clear and convincing evidence that he changed his domicile from New York.

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For more information about Morrison & Foerster's State + Local Tax Group, visit www.mofo.com/salt or contact Craig B. Fields at (212) 468-8193 or cfields@mofo.com.

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