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NEW YORK STATE 2019-20 BUDGET BILL ENACTED

As we went to press, the New York State Legislature passed the New York State Budget Bill for 2019-20, containing several new and important tax provisions. S. 1509-C/A. 2009-C. We will include an analysis of the Budget Bill in the May issue of New York Tax Insights.

STATE ALJ UPHOLDS TAX DEPARTMENT POLICY LIMITING SCOPE OF BROKER-DEALER SOURCING LAW

By Irwin M. Slomka

A New York State Administrative Law Judge has upheld the State Tax Department's policy limiting the availability of securities broker-dealer sourcing by a corporate member of two single-member limited liability companies for the receipts of the LLC that is a registered broker-dealer. *Matter of BTG Pactual NY Corp.*, DTA No. 827577 (N.Y.S. Div. of Tax App., Mar. 7, 2019). The decision addresses questions about the scope of the broker-dealer sourcing statute for years before 2015, when Article 9-A corporate tax reform adopted broad-based customer sourcing rules.

Background. Since 2001, Article 9-A has contained special sourcing rules for apportioning specified receipts earned by a registered securities or commodities broker or dealer, generally using a market-based approach to apportion receipts such as brokerage commissions and fees for various advisory services. A "registered securities or commodities broker or dealer" is defined as one that is registered as such with the Securities and Exchange Commission ("SEC"). Tax Law former § 210(3)(a)(9)(B). In 2013, the Tax Department had issued guidance stating that a corporation that, through a tiered partnership structure, received a *pro rata* share of receipts earned by an affiliated registered broker-dealer qualified for a discretionary adjustment to its receipts factor to apply broker-dealer sourcing to avoid the improper reflection of its income, even though the corporation was not registered as such with the SEC and was not required to be registered because it was an "associated person" of a broker-dealer.

Facts. BTG Pactual NY Corporation ("BTG"), whose ultimate parent is a Brazilian investment bank, was the sole member of two single-member LLCs ("SMLLC"). One SMLLC, BTG Pactual US Capital LLC ("Broker-

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Dealer”), is registered as a securities broker-dealer with the SEC and also with the Financial Industry Regulatory Authority. The other SMLLC, BTG Pactual Asset Management US LLC (“Investment Advisor”), is registered as an investment adviser with the SEC. The two SMLLCs are treated as disregarded entities for federal and New York State income tax purposes, and therefore are treated as divisions of BTG. They are, however, considered separate legal entities for U.S. regulatory purposes. BTG itself is neither a registered broker-dealer nor a registered investment advisor.

The ALJ upheld the denial of BTG’s refund claims, concluding that Broker-Dealer’s status as a registered broker-dealer did not allow Investment Advisor’s receipts to qualify for broker-dealer sourcing.

For the 2012 tax year, BTG reported $243 million in total receipts, $54 million from Broker-Dealer and $189 million from Investment Advisor. In 2013, BTG reported approximately $180 million in total receipts, $73 million from Broker-Dealer and $106 million from Investment Advisor. BTG earned minimal receipts of its own.

On its originally filed Article 9-A returns, BTG sourced Broker-Dealer’s receipts in its receipts factor using the broker-dealer sourcing rules, but sourced receipts from Investment Advisor based on where it performed the services. BTG later amended its Article 9-A returns by also applying the broker-dealer sourcing rules to receipts from Investment Advisor — which, as noted above, was not a registered broker-dealer — thereby reducing its receipts factor from 82% to 5.6% in 2012, and from 66% to 8% in 2013, and requested a refund. The Tax Department commenced an audit of BTG’s amended Article 9-A returns and, after six months had expired, BTG filed a Petition with the Division of Tax Appeals seeking a refund of $7.5 million in tax.

On August 2, 2017, in response to inquiries it had received, the Department issued a pronouncement, *Tax Guidance*, “Receipts Factor Methodology for the Owners of Single Member Limited Liability Companies that Are Registered Broker-Dealers,” NYT-G-17(2) C (N.Y.S. Dep’t of Taxation & Fin., Aug. 2, 2017). The *Tax Guidance* limited the availability of broker-dealer sourcing in situations involving partnerships and other flow-through or disregarded entities. It concluded that an SMLLC’s status as a registered broker-dealer did not entitle its indirect corporate owner — which was not a registered broker-dealer — to qualify for broker-dealer sourcing on its *pro rata* share of receipts generated by a non-broker-dealer investment advisor partnership, but did allow it with respect to the owner’s *pro rata* share of the receipts of the registered broker-dealer disregarded entity that flowed to it through a chain of partnership entities. The Department also qualified two prior Advisory Opinions, in which it concluded that a partner in a partnership that was a registered broker-dealer was itself deemed to be a registered broker-dealer, stating that “the better view” was that the partner could source its share of the partnership’s receipts “*as if* the partner was a registered securities broker-dealer.”

At the administrative hearing, BTG produced expert testimony that its structure — with Broker-Dealer and Investment Advisor in separate legal entities — was prevalent in the securities industry because of the burdensome regulatory requirements, including strict net capital requirements, imposed by the SEC on securities broker-dealers. BTG took the position that, since Broker-Dealer was a disregarded entity, BTG should be considered a registered broker-dealer for all purposes and therefore permitted to apply the broker-dealer sourcing rules to all its income, not just to its *pro rata* share of Broker-Dealer’s receipts.

ALJ determination. The ALJ upheld the denial of BTG’s refund claims, concluding that Broker-Dealer’s status as a registered broker-dealer did not allow Investment Advisor’s receipts to qualify for broker-dealer sourcing. Broker-Dealer’s check-the-box election to be disregarded as a separate entity for income tax purposes was found by the ALJ to relate only to which entity was taxed on its receipts — here, the corporate taxpayer — but did not “dictate whether [Investment Advisor’s] receipts are [broker-dealer] receipts” qualifying for broker-dealer sourcing.

The ALJ found no evidence that the Legislature intended to apply customer-based sourcing to receipts earned by entities other than registered broker-dealers. Finally, the ALJ found no constitutional violation resulting from the Department’s position, noting that, to the extent the taxpayer was making an Equal Protection argument, it had not adequately demonstrated that limiting broker-dealer sourcing here was “palpably arbitrary or results in invidious discrimination.”

ADDITIONAL INSIGHTS

The statute in question was applicable to “registered securities or commodities broker[s] or dealer[s],” which required being registered as a broker-dealer with the SEC. The ALJ found that text to be unambiguous.

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However, the Department had previously applied the broker-dealer sourcing rules to an affiliate of a broker-dealer under its discretionary authority to adjust the business allocation percentage to avoid an improper reflection of the taxpayer's income and activity within New York, notwithstanding the statutory language. The decision does not address the use of the Commissioner's discretionary authority, or indicate whether it was even an issue in the case.

The ALJ also concluded that the check-the-box election that resulted in the SMLLCs being disregarded did not determine *where* that entity's receipts are sourced or the nature of those receipts for Article 9-A purposes. However, the election did have the effect of treating the disregarded entity as a division of the sole member. In the case of a single registered broker-dealer, qualifying receipts earned by different operating divisions of the same broker-dealer would undoubtedly qualify for broker-dealer sourcing. The Department did not contest that the receipts in question were qualifying receipts for a broker-dealer. A question remains as to whether such disparate treatment here was justified.

The case did not involve the issue of whether an entity may qualify for broker-dealer sourcing even if not a registered broker-dealer, so long as it complied with SEC requirements to act as a broker-dealer, an issue on which the New York City Department of Finance reversed its policy in 2016.

STATE COURT GRANTS PROPERTY TAX EXEMPTION TO NONPROFIT DRUG POLICY ORGANIZATION

By Hollis L. Hyans

The Supreme Court, New York County, has ordered the New York City Department of Finance to grant a tax exemption to the Drug Policy Alliance (the "Alliance"), rejecting the position of the Department of Finance and the Tax Commission that the organization's activities relating to pursuing legislative changes are not sufficiently educational or charitable to qualify for the exemption. *Drug Policy All. v. N.Y.C. Tax Comm'n*, No. 103827/2012, 2018 NY Slip Op. 33484(U) (Sup. Ct. N.Y. Cty., Nov. 23, 2018, filed Jan. 8, 2019). The legal challenge has had a lengthy procedural history, and has already been the subject of one appeal to the Appellate Division.

Background and procedural history. The Alliance is a not-for-profit organization and was formed, according to its articles of incorporation, to conduct research and educate the public about the "medical, scientific and sociological effects of drugs and developments in the drug laws." It is exempt from both federal income tax and New York State and New York City sales and use taxes as an educational and charitable nonprofit organization.

In 2011, the Alliance purchased a condominium unit located in Manhattan to use as its headquarters and filed an application for exemption from the New York City real property tax, specifying its purpose as "educational." The Department denied the application, stating only that "[a]dvocacy of a cause does not qualify as an exempt purpose." The Alliance appealed the denial to the Tax Commission. At the hearing, the Alliance presented the testimony of three fact witnesses, including its chief financial officer and executive directors. The Department did not present any witnesses or factual evidence, and the Commission denied the Alliance's request to question the Director of the Department who had issued the denial.

In May 2012, the Department's tax assessment on the property became final and, in September 2012, to preserve its appeal rights, the Alliance filed a petition for review under Article 78, claiming that the denial of the exemption was arbitrary and capricious and contrary to law. After this Article 78 proceeding was commenced, the Tax Commission issued a determination denying the Alliance's application for the exemption, stating that, while education may be a "component" of the Alliance's operation, "it is clear from the record that the aims of legislative and policy change overwhelmingly dominate its activities" and that its "primary purpose is the pursuit of legislative or governmental policy change."

A Supreme Court judge, in response to the Article 78 petition, issued a decision finding that the denial of the exemption was arbitrary or irrational, and directing the Department to grant the tax exemption. The Department and the Tax Commission appealed that decision to the Appellate Division, First Department, which held that the court had made a procedural error in resolving the Article 78 petition on the merits without having complied with the notice provision under the CPLR and without directing the respondents to file an answer. The Appellate Division therefore remanded the matter to the Supreme Court to allow the Department and the Tax Commission to file an answer and to allow the

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Alliance to raise procedural arguments, and for the court to only then decide the matter on the merits.

Supreme Court decision. On remand, the court again allowed the exemption. First, with regard to the Alliance's procedural claims, the court found that the Alliance should have been given the opportunity to cross-examine the Director of the Department, particularly since the Alliance bore the burden of proof. The court also noted that the Department's denial of the objection had consisted of only one sentence, which "was completely devoid of any articulation of factual and rational basis" for the denial, and that the Department had provided no explanation of what facts it was using to determine that the Alliance's activities were "advocacy of a cause," which was an undefined term. The Director of the Department had been ready and willing to testify at the hearing, and the court found that the Tax Commission's failure to allow cross-examination violated the applicable law and procedures. It also found that the Tax Commission further failed to follow the applicable rules because its determination contained findings of fact that were not based exclusively on the record of the Tax Commission hearing, but also relied on information taken from the Alliance's website after the hearing, without any opportunity for the Alliance to respond.

After reviewing appellate decisions, the Supreme Court judge determined that the Court of Appeals has "signaled a clear departure" from narrow interpretations of the exemption and applied a broad construction of the necessary exempt purpose . . . .

On the merits, the court found that the Alliance was entitled to the property tax exemption. The statute, RPTL 420-a(1)(a), provides a mandatory real property exemption for property owned by a nonprofit that was organized "exclusively for religious, charitable, hospital, educational, or moral or mental improvement . . . purposes," and "used exclusively for carrying out . . . one or more of such purposes." This is a two-part test, addressing first the purpose of the organization, which is determined by reviewing organizational documents, and addressing second the use of the property, which is not necessarily dependent upon the language in the documents, but involves a determination of whether the use of the property is "reasonably incidental" to the exempt purpose.

After reviewing appellate decisions, the Supreme Court judge determined that the Court of Appeals has "signaled a clear departure" from narrow interpretations of the exemption and applied a broad construction of the necessary exempt purpose, finding, for example, that preservation of wilderness areas, providing below–market rate housing for the elderly, providing performing arts instruction, and promoting appreciation of the arts and musical theater have all been found to be qualifying purposes.

The Department and the Tax Commission argued that the exemption should not apply because the Alliance does not provide services or direct assistance to community programs or citizens and is primarily involved in advocacy to promote legislative or governmental reform, and that allowing the exemption would "open the door for tax exemption 'expenditures' to every group seeking to influence public opinion or governmental policy." The court rejected these arguments, finding that the legislature did not exclude "advocacy" or "pursuit of legislative or governmental policy change" from the categories of exempt purpose, and that an undefined standard of "advocacy for cause" is too imprecise, since the Tax Commission does not explain what types of advocacy would lead to disqualification, or identify criteria to be applied.

The court also found that the Tax Commission's characterization of the Alliance's primary activities as compiling and merely distributing information to be unsupported by the record, finding that, while some of the Alliance's activities involved compiling and disseminating information, the Alliance also researched, tracked, and prepared analyses of drug legislation and policies, and developed model policies for the proper control of drugs.

ADDITIONAL INSIGHTS

The New York City Tax Commission, which shares a president with the New York City Tax Appeals Tribunal, hears appeals of real property tax determinations made by the Department of Finance. Its numerous decisions are not made available online on the Tax Commission's website, unlike decisions of the Tax Appeals Tribunal, which are all available soon after they are issued. This makes it difficult to readily determine the standards that are being applied in these proceedings and to understand the circumstances in which exemptions are being granted or denied, unless an appeal is filed in court, thereby making the decision public.

Although not explicitly mentioned in this latest decision, the 2013 decision that originally upheld the exemption noted that the Alliance was claiming that its activities were similar to those of other organizations that engage

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in public advocacy, such as the NAACP Legal Defense Fund and the Catholic Diocese of New York, which are exempt from property tax, and that the denial was impermissibly based on the subject matter of its advocacy.

The Department and the Tax Commission have filed an appeal to the Appellate Division.

FRAUD PENALTIES UPHELD BY STATE ALJ

By Kara M. Kraman

A New York State Administrative Law Judge upheld the Department of Taxation and Finance's imposition of fraud penalties against an S corporation taxpayer whose sole owner and president had pleaded guilty to sales tax fraud in a related criminal matter. *Matter of Express Fleet Service, Inc.*, DTA No. 828056 (N.Y.S. Div. of Tax App., Feb. 14, 2019).

Facts. Gregory Gottorff was the sole owner and president of a motor vehicle repair business organized as an S corporation, Express Fleet Service, Inc. ("Fleet"), until October 2010, when he sold the business to new owners. After receiving a tip from the new owners, the Rochester District Office of the Department's Criminal Investigation Division ("CID") began an investigation into whether Fleet had been underpaying its sales tax obligations from September 2004 through the October 2010 sale date. After an investigation in which it conducted interviews with both the new owners and Mr. Gottorff and reviewed multiple sets of records, including Fleet's point-of-sale software records, Fleet's bank records listing deposits, and Fleet's corporate income tax returns, the CID concluded that Fleet had underpaid sales tax during that period. As a result, the CID turned the matter over to the Monroe County District Attorney's office for prosecution.

Mr. Gottorff subsequently entered into a plea agreement with the District Attorney's office under which Mr. Gottorff pleaded guilty to one count of "offering a false instrument for filing" in 2010 and one count of "committing a tax fraud act" during September 2009 through August 2010. The plea agreement also imposed a sentence of five years' probation, and required Mr. Gottorff to pay $68,840 in restitution to the Department. The email containing the plea agreement also expressly noted that "[t]he Defendant understands that the plea agreement in this criminal case has no effect upon the civil liabilities that Defendant may have to the NYS Department of Taxation and Finance or any other governmental agency or authority."

Subsequent to Mr. Gottorff entering into the plea agreement, the Department issued to Fleet a Notice of Determination asserting sales tax fraud penalties plus interest for a total amount due of $291,014. Fleet filed a petition protesting the Notice with the Division of Tax Appeals.

Mr. Gottorff had pleaded guilty to a tax fraud act in the third degree, which requires the same fraudulent intent needed for the imposition of civil fraud penalties, and therefore the ALJ concluded that the Department satisfied its burden of proof regarding fraudulent intent.

Law. The Department may impose fraud penalties of two times the amount of the tax due, plus interest at the minimum rate of 14.5% where there is an underpayment of sales tax "due to fraud." A finding of fraud requires the Department to show "clear, definite and unmistakable evidence of every element of fraud, including willful, knowledgeable and intentional wrongful acts or omissions constituting false representation, resulting in deliberate nonpayment or underpayment of taxes due and owing." *Matter of Sona Appliances, Inc., et al.*, DTA Nos. 815394 & 815395 (N.Y.S. Tax App. Trib., Mar. 16, 2000).

ALJ determination. Citing to *Matter of Aqua-Mania, Inc.*, DTA No. 820492 (N.Y.S. Tax App. Trib., Mar. 6, 2008), *leave to appeal denied*, 13 N.Y.3d 707 (2009), the ALJ noted that, in order to establish fraudulent intent, the Department must show that Fleet, acting through its owner, Mr. Gottorff, acted deliberately, knowingly, and with the specific intent to violate the Tax Law. The ALJ found that the Department met its burden of establishing fraud for the portion of the audit period covered by the plea agreement through the doctrine of collateral estoppel, which is based on the principle that it is not fair to permit a party to relitigate an issue that has previously been decided against him or her in a proceeding in which he or she had a fair opportunity to fully litigate the point, noting that the Tax Appeals Tribunal has applied collateral estoppel to find that the guilty plea of a sole owner also applies to the corporation. The ALJ reasoned that, in this case, Mr. Gottorff had pleaded guilty to a tax fraud act in the third degree, which requires the same fraudulent

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intent needed for the imposition of civil fraud penalties, and therefore the ALJ concluded that the Department satisfied its burden of proof regarding fraudulent intent. The ALJ also held that Fleet was collaterally estopped from contesting the amount of the restitution, because by pleading guilty and agreeing to pay restitution, which "is the return of all the fruits of a crime" (citation omitted), Mr. Gottorff waived his right to challenge that amount.

Regarding the portion of the audit period not covered by the guilty pleas, i.e., September 2004 through August 2009, the ALJ held that Fleet was not collaterally estopped from contesting the fraudulent-intent aspect of the fraud penalties. The ALJ nevertheless held that the Department met its burden of proof for that period because, while the guilty plea did not cover those periods, it was evidence of fraudulent intent for the entire audit period of assessment. Moreover, the ALJ found the fact that the underpayment of sales tax was both "substantial and continuous" over the whole six-year audit period to also constitute strong evidence of fraud. The ALJ noted that Fleet never supplied an adequate explanation for the underpayment of sales tax, other than to claim that Mr. Gottorff was "a poor bookkeeper."

ADDITIONAL INSIGHTS

If the Department imposes fraud penalties, the burden of proof to show fraud is on the Department, not on the taxpayer to disprove fraud. Indeed, the Tax Appeals Tribunal has held that a finding of fraud requires the Department to show "clear, definite and unmistakable evidence" of each element of fraud. This burden is a high one and as a result there are few, if any, cases in New York in which the Department has met its burden of proof regarding fraud without relying upon a finding of either criminal tax fraud, other related criminal activity, or the active concealment from the taxing authority of relevant facts. However, in a case like this, where the taxpayer has already pleaded guilty to tax fraud (or been found guilty of tax fraud), the Department can, and often will, successfully use that criminal plea or verdict to support its own imposition of fraud penalties, even where the periods at issue do not entirely overlap.

INSIGHTS IN BRIEF

TAX DEPARTMENT RULES THAT AN ONLINE MARKETPLACE OPERATOR IS A SALES TAX VENDOR

A company that operates online marketplaces in which it facilitates taxable sales of prewritten software products by unrelated software vendors will be considered a "vendor" by the New York State Department of Taxation and Finance for sales tax purposes if the marketplace operator has sufficient nexus with the State. *Advisory Opinion*, TSB-A-19(1)S (N.Y.S. Dep't of Taxation & Fin., Mar. 7, 2019). The company hosts and supplies the prewritten software to customers on behalf of the software vendors, processes customer payments, and remits the sales proceeds to each software vendor after subtracting a service fee. The Advisory Opinion concludes that the statutory definition of a vendor allowed the Department to treat as a vendor an intermediary that performs key acts in facilitating taxable sales by others. It also concludes that the Department may treat the company as a "co-vendor." The Department states that TSB-A-99(49)S (Nov. 17, 1999), in which it reached a contrary conclusion, "no longer reflects the Department's policy and should no longer be followed."

TRIBUNAL SUSTAINS ALJ DECISION DISALLOWING EXPENSE DEDUCTIONS

The New York State Tax Appeals Tribunal has sustained an ALJ determination increasing the petitioners' reported income and disallowing certain expense deductions claimed by the petitioners on their personal income tax returns for 2004 through 2006. *Matter of Walter & Chaya Greenfeld*, DTA No. 826733 (N.Y.S. Tax App. Trib., Mar. 7, 2019). The Tribunal found that, despite multiple requests from the Department, the petitioners had provided no documentation substantiating the income and deductions they claimed, and that the submissions made at the hearing lacked any supporting testimony explaining their relevance or any third-party support. The Tribunal also rejected the petitioners' claim that the ALJ had developed a personal bias against them, finding that no affidavit setting forth facts of such alleged bias had been presented and that the only support the petitioners cited was the ALJ's letter denying an extension of the due date to file a brief, after multiple prior extensions had previously been granted.

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