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IN THIS ISSUE

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APPELLATE DIVISION HOLDS THAT BANK MUST APPLY NOLS IN YEAR IT WAS TAXED ON NON-INCOME BASE

By Kara M. Kraman

The Appellate Division has held that a taxpayer was required to use its net operating loss ("NOL") carryforward to decrease its entire net income ("ENI") in a year in which its bank tax liability was not measured by its ENI under former Article 32. *Toronto Dominion Holdings (U.S.A.), Inc. v. Tax Appeals Trib.* No. 523475, 2018 NY Slip Op. 04402 (3d Dep't, June 14, 2018). The decision affirms the holding of the New York State Tax Appeals Tribunal, which had overturned a determination of the ALJ, who had held that the taxpayer was not required to use any portion of its NOL to reduce its income if its income was already low enough to cause it to be subject to taxation on an alternative base.

During tax years 2005 through 2007, Toronto Dominion Holdings (U.S.A.), Inc., successor-in-interest to TD Holdings II, Inc., ("TD Holdings"), was subject to the New York State bank tax under former Article 32 and filed New York bank tax returns. In 2005, TD Holdings reported a loss of approximately $12 million for federal income tax purposes and a loss of approximately $9 million for New York bank tax purposes. In 2006, TD Holdings claimed almost $4 million of its 2005 federal NOL carryforward on its federal return, but did not claim any of its 2005 New York NOL for bank tax purposes, because its 2006 ENI was low enough that the alternative tax on assets was the applicable tax base. In 2007, TD Holdings claimed the remainder of its 2005 federal NOL carryforward on its federal return and claimed the remainder of its 2005 New York NOL carryforward on its New York bank tax return. On audit, the Department required TD Holdings to use its available New York NOL carryforward to offset its ENI in 2006 even though it was not taxed on the ENI base in that year.

During the years at issue, the New York bank tax under former Article 32 was imposed on one of four alternate bases, whichever resulted in the highest tax: (i) entire net income; (ii) taxable assets; (iii) alternative entire net income; or (iv) a minimum tax. Tax Law former § 1455. The Tax Law also provided that the allowable New York NOL deduction was "presumably the same" as the federal NOL deduction claimed in the same year, and the New York NOL deduction could not exceed the maximum federal NOL deduction allowed for the same year. Tax Law former § 1453(k-1).

TD Holdings argued that nothing in Tax Law former § 1453(k-1) prohibited it from using a New York NOL deduction that was less than its federal NOL deduction, or not using a New York NOL deduction at all, when its

continued on page 2

bank tax liability was computed on a non-income base and it therefore had no taxable income to offset. The ALJ agreed, but the Tribunal reversed.

[N]othing in the language of Tax Law former § 1453(k-1) . . . provided a banking corporation with the option to forego deducting its available New York NOL in a year in which it has positive ENI solely because its bank tax liability for that year was calculated using an alternative base.

In affirming the decision of the Tribunal, the Appellate Division noted at the outset that tax deduction statutes are strictly construed against the taxpayer and that the Department's interpretation of the statute will be upheld unless the taxpayer can demonstrate its "irrationality or unreasonableness" (Citation omitted). The court also noted the limited scope of its review of the Tribunal's decision, so as long as the Tribunal's decision is "rationally based and is supported by substantial evidence, it must be confirmed, even if a different conclusion would not have been unreasonable."

The Appellate Division then held that the Tribunal's decision requiring the use of TD Holdings' New York NOL in 2006, even though it was taxed on an alternative base, did not constitute an error of law and was not irrational. Like the Tribunal, the Appellate Division found nothing in the language of Tax Law former § 1453(k-1) that provided a banking corporation with the option to forego deducting its available New York NOL in a year in which it has positive ENI solely because its bank tax liability for that year was calculated using an alternative base.

Also like the Tribunal, the Appellate Division found that *Matter of Brooke-Bond Group (U.S.), Inc.*, DTA No. 810951 (N.Y.S. Tax App. Trib., Dec. 28, 1995), did not mandate a different result. In *Brooke-Bond*, the Tribunal held that where requiring a taxpayer's New York NOL deduction to be equal to its federal NOL deduction would result in a taxpayer having negative ENI for a given year, the taxpayer only had to claim enough of its New York NOL deduction to reduce its ENI to zero. The Appellate Division noted that unlike in *Brooke-Bond* — which was based in part upon principles of federal conformity (under IRC § 172, NOL deductions are limited to the amount necessary to bring a taxpayer's taxable income to zero) — there is no analogous federal rule that "tethers the use of an available New York NOL deduction to a taxpayer's payment of franchise tax on an alternative basis." Accordingly, the Appellate Division held that the Tribunal's decision requiring TD Holdings to utilize a portion of its 2005 New York NOL deduction equal to its federal NOL deduction in the 2006 tax year to be reasonable and not irrational.

ADDITIONAL INSIGHTS

For tax years beginning on or after January 1, 2015, the issue of NOL utilization is clearly addressed under the new corporate tax reform legislation. Since 2015, the amount of a New York NOL deduction is no longer limited to the amount of the federal deduction, and the maximum allowable amount of the deduction is "the amount that reduces the taxpayer's tax on the apportioned business income base to the higher of the tax on the capital base or the fixed dollar minimum." Tax Law § 210(1)(a)(ix). Nevertheless, the holding in this case continues to be relevant to post-2015 NOLs under Article 9-A since it impacts the computation of a corporation's prior NOL conversion subtraction (the device by which pre-2015 NOLs are calculated and carried forward for use in tax years beginning on or after January 1, 2015). It is not known at this time whether TD Holdings will seek review by the Court of Appeals.

TRIAL COURT DISMISSES ANOTHER FALSE CLAIMS ACT ACTION IN WHICH THE ATTORNEY GENERAL DECLINED TO INTERVENE

By Michael J. Hilkin

A New York State Supreme Court Judge granted a motion to dismiss an action brought under New York's False Claims Act ("FCA"), which alleged that Starbucks Corporation had failed to properly collect sales tax on many in-store sales of pastries. *People ex rel. Hunter v. Starbucks Corp.*, No. 101069/2015, 2018 NY Slip Op. 28123 (Sup. Ct. N.Y. Cty., Apr. 6, 2018). Starbucks brought the motion to dismiss after the New York State Attorney General's Office ("Attorney General") declined to intervene in the action prior to its dismissal.

Background. James A. Hunter and Keenan D. Kmiec (the "Relators") are partners in the law firm Hunter & Kmiec. They devised and conducted an informal survey of approximately 80 Starbucks stores located in New York State from November 2013 through September 2014,

continued on page 3

focusing on whether and to what extent the stores collected New York sales tax on purchases of pastry products.

Under New York Tax Law as interpreted by the New York State Department of Taxation and Finance, sales tax must be collected on sales of food products when, among other things: (1) the food product is intended "for consumption on the premises where sold"; (2) the food product is heated by the vendor; or (3) the food product is sold by a restaurant "to-go," unless the food is sold unheated and is being sold in the same way as it would in a supermarket or grocery store. Tax Law § 1105(d)(i); *Tax Bulletin*, TB-ST-806 (N.Y.S. Dep't of Taxation & Fin., Apr. 13, 2011).

The stores surveyed by the Relators were not chosen through the use of any statistical sampling method. Instead, Starbucks stores were included in the Relators' survey primarily based on their proximity to locations in New York that the Relators were visiting.

The judge sustained Starbucks' motion to dismiss on the basis that the facts presented by the Relators, even if true, did not permit a reasonable inference that Starbucks as a company had actual knowledge of, or acted in deliberate ignorance or reckless disregard of, its employees' alleged noncompliance with the Tax Law.

According to the Relators, all of the pastries purchased during their survey were provided either on ceramic plates or in a wax or tissue paper warming sleeve, which they claimed was inconsistent with the manner in which pastries would normally be sold in a grocery store. Thus, according to the Relators, *all* of their sample pastry purchases were subject to sales tax. However, the Starbucks stores did not collect sales tax on the "vast majority" of the total of $208.25 of pastry purchases made for purposes of the survey. While Starbucks' computer register system in its stores apparently provides for the collection of sales tax on purchases for on-premises consumption, on four occasions Starbucks employees acknowledged that they typically do not collect the sales tax for eating in, either by entering the order as an order "to go" or manually removing the tax. Although their survey only covered an 11-month period, the Relators asserted that Starbucks had "likely" failed to properly collect sales tax on pastry purchases at all times during the FCA's 10-year statute of limitations period.

While the Relators' survey focused on Starbucks' collection of New York sales tax on the purchase of pastries, the judge noted that the purchases used to generate their survey included purchases of beverages and other food items, and the Relators conceded that Starbucks' sales tax collection practices regarding those other items "substantially complied with the Tax Law."

The Relators originally filed their FCA case against Starbucks under seal in 2015, at which point the Attorney General had the opportunity to review the case and determine whether he would take over, or "intervene" in, the case. In March 2017, the Attorney General declined to intervene. Thereafter, the Relators decided to bring the case on the State of New York's behalf and, as the law allows, served Starbucks with a complaint seeking: (1) $10 million in allegedly unpaid sales tax (based on their own estimates and calculations of Starbucks' revenue from the sale of pastries in New York stores from 2005 through 2014); (2) treble damages and civil penalties; and (3) costs and attorney's fees. Further, the Relators sought to collect, on their own behalf, a statutory 25-30% share of the amount recovered in the action.

The FCA Statutes. The FCA imposes liability on "any person who . . . knowingly makes, uses, or causes to be made or used, a false record or statement material to an obligation to pay or transmit money or property to the state or a local government." State Fin. Law § 189(1)(g). In order to be liable under the FCA, a defendant "must knowingly make a false statement or knowingly file a false record." *People v. Sprint Nextel Corp.*, 26 N.Y.3d 98, 112 (2015). "Knowingly" is defined for FCA purposes as (1) having actual knowledge of the relevant information; (2) acting in deliberate ignorance of the truth or falsity of the information; or (3) acting in reckless disregard of the truth or falsity of the information. State Fin. Law §188(3)(a)(i)-(iii). On the other hand, "acts occurring by mistake or as a result of mere negligence are not covered" by the FCA. State Fin. Law § 188(3)(b).

Decision. The judge sustained Starbucks' motion to dismiss on the basis that the facts presented by the Relators, even if true, did not permit a reasonable inference that Starbucks as a company had actual knowledge of, or acted in deliberate ignorance or reckless disregard of, its employees' alleged noncompliance with the Tax Law. Further, the judge concluded that the allegations also do not permit a reasonable inference that Starbucks failed to properly collect sales tax on pastry sales during the entire 10-year period preceding the commencement of the Relators' FCA case. In support of his conclusion, the judge pointed out that Starbucks had cooperated with repeated sales tax audits in New York and had sought guidance from the

continued on page 4

Department regarding its "to-go" sales, and was told by an auditor that such sales are not taxable in New York.

Additionally, the judge found that the Relators' admission that Starbucks had substantially complied with its sales tax collection responsibilities on sales of items other than pastries supported the conclusion that the allegations, at most, demonstrate negligence or carelessness with respect to pastry sales, rather than an attempt to conceal, reduce, or avoid an obligation to collect and pay sales tax. The judge also determined that the Relators' survey, which "lack[ed] . . . the use of any plausible scientific methodology," did not constitute sufficient evidence to bring an FCA claim.

ADDITIONAL INSIGHTS

Some companies that have defended FCA cases after the Attorney General has declined to intervene have been quite successful in the New York trial courts. For example, the Attorney General declined to intervene in separate FCA tax cases brought against Citigroup Inc. and Vanguard Group, Inc., and trial court judges subsequently granted motions to dismiss in both of those cases (see the Summer 2017 issue of *MoFo State + Local Tax Insights* for further discussion, and note that the *Citigroup* decision was recently affirmed on appeal). While each of these cases involves very different fact patterns, companies facing FCA claims should carefully consider whether a particular suit might be vulnerable to a quick motion to dismiss, as was successful here.

JUDGE DISMISSES DECLARATORY JUDGMENT ACTION ON TAXABILITY OF CHARGES FOR INDOOR CYCLING SESSIONS

By Irwin M. Slomka

A recent decision by a New York Supreme Court judge raises important questions as to when a declaratory judgment action may be brought to challenge the applicability of a sales tax provision to a taxpayer's charges. The court was presented with the legal question of whether the sales tax statute applied to the taxpayer's charges for indoor cycling classes, but it declined to rule on the question, holding that the taxpayer must first exhaust its administrative remedies. *Flywheel Sports, Inc. v. N.Y.S. Dep't of Taxation & Fin.*, No. 155110/16, 2018 NY Slip Op. 50897(U) (Sup. Ct. N.Y. Cty., June 14, 2018).

Background. New York City sales tax — which is administered by the New York State Department of Taxation and Finance — is imposed on the furnishing of services by "weight control salons, health salons, gymnasiums . . . and similar establishments and every charge for the use of such facilities." Admin. Code § 11-2002(a). If a facility provides access to participant sporting activities and facilities, such as a swimming pool or racquetball courts, the facility is not considered a "gymnasium[] [or] similar establishment[]." *Tax Bulletin*, TB-ST-329 (N.Y.S. Dep't of Taxation & Fin., June 1, 2014).

Finding the issue of whether the cycling sessions were exempt to be "clearly a matter for the Tax Department to determine on a factual basis," and concluding that Flywheel must first exhaust its administrative remedies, the court dismissed Flywheel's action.

Flywheel Sports, Inc. ("Flywheel") operates indoor cycling studios in New York City and at various locations nationwide. Although it registered as a New York sales tax vendor and collected and remitted sales tax on certain of its charges, it did not collect sales tax on its charges for cycling classes. In April 2016, following a sales tax audit for the period March 1, 2012, through February 28, 2015, the Department sent Flywheel a letter recommending that it begin collecting and remitting sales tax on the cycling charges, in exchange for which sales tax on those charges would not be imposed for the audit period. The Department did not issue a Notice of Determination at that time. Two months later, in June 2016, Flywheel filed this declaratory judgment action with the New York County Supreme Court seeking an order that the sales tax did not apply to its charges for indoor cycling sessions, claiming they were excludable charges for "participant sporting activities."

Flywheel argued that the cycling sessions are "competitive" — riders can compare their results against other riders through a digital display — and therefore are nontaxable "participatory sporting events." The Department, while indicating that it had not reached a final decision on whether the charges were taxable, maintained that the declaratory judgment action was premature because a Notice of Determination had not yet been issued and because Flywheel had not yet exhausted its administrative remedies, which only arise after a Notice is issued. The Department sought dismissal of the action.

continued on page 5

Decision. The judge agreed with the Department and dismissed Flywheel's declaratory judgment action. Since Flywheel was not challenging the constitutionality of the statute, the judge found that the only remaining grounds for proceeding as a declaratory judgment action was if the sales tax was "wholly inapplicable" to Flywheel. According to the judge, this meant that Flywheel must establish "that the Tax Department ha[s] no jurisdiction over [Flywheel] or the matter that was taxed." Finding the issue of whether the cycling sessions were exempt to be "clearly a matter for the Tax Department to determine on a factual basis," and concluding that Flywheel must first exhaust its administrative remedies, the court dismissed Flywheel's action.

ADDITIONAL INSIGHTS

By declining to rule on the merits, the decision does not address the underlying legal question of whether a business that furnishes cycling services — which does not appear to be a taxable "gymnasium [or] similar establishment" — must charge New York City sales tax on its cycling charges. As to whether this question may properly be the subject of a declaratory judgment action, the judge ruled that it may not, but his reasoning is not entirely clear. His holding seems to be that since the Department "has jurisdiction" over Flywheel and "over the [legal] issue," and since Flywheel already pays sales tax on certain other charges, Flywheel's only recourse is through the administrative process. Yet the New York courts have accepted a declaratory judgment action brought by a tenant on whether its payments to its landlord for overtime HVAC services were subject to sales tax, a question over which the Department certainly "had jurisdiction" but that the court nonetheless accepted. *Debevoise & Plimpton v. N.Y.S. Dep't of Taxation & Fin.* 80 N.Y. 2d 657 (1993).

It is somewhat curious that it took over two years from the commencement of the declaratory judgment action — for which the underlying facts do not appear to have been in dispute — for the judge to issue his ruling dismissing the case. The decision does not indicate whether the Department eventually issued a Notice of Determination assessing sales tax on the charges.

INSIGHTS IN BRIEF

THIRD DEPARTMENT HOLDS THAT SALES TAX CANNOT BE REDUCED BY RETROACTIVE VOLUME DISCOUNTS

Confirming a decision of the New York State Tax Appeals Tribunal, the Appellate Division, Third Department, has held that a vendor cannot reduce the sales tax due on prior sales to account for a volume discount later provided to customers. *Prima Asphalt Concrete, Inc. v. N.Y.S. Tax Appeals Trib.*, No. 525082, 2018 NY Slip Op. 04411 (3d Dep't, June 14, 2018). Prima Asphalt Concrete offered volume discounts that were applied to customers' orders after they met particular volume goals, which could take one or more years for larger orders, and invoiced customers based on the full prices without discounts; if discounts were later earned, customers were issued "credit memos" reflecting the discounted sales price and reduced sales tax. The Third Department held that, since the discount was not provided at the time of sale and depended upon future events, sales tax must be applied to the original undiscounted price, and rejected the vendor's argument that the retroactive discount should be treated as a "continuing transaction," finding that New York law treats sales tax as transactional "and not necessarily tied to the ultimate price paid" by the customer.

ADULT CLUB SCRIP CHARGES AGAIN FOUND SUBJECT TO SALES TAX

An Administrative Law Judge has held that charges for scrip used for personal dances and tipping dancers at an adult entertainment club are subject to sales tax. *Matter of The Executive Club LLC et al.*, DTA Nos. 827313 – 827318 (N.Y.S. Div. of Tax App., May 24, 2018). While rejecting the Department's argument that the doctrine of issue preclusion prevented the club from relitigating issues that had been decided against it by the Tax Appeals Tribunal for an earlier period — since each tax period must receive separate consideration — the ALJ found that the parties were bound by the "prior controlling precedent" established in an earlier Tribunal decision involving the same club, as well as in other decisions involving the same issue for unrelated adult clubs. The ALJ found that the exact same arguments raised by the club, including that the sale of the scrip does not constitute a taxable admission charge under the Tax Law, and that the sale of scrip was akin to sale of a gift card and not a taxable event, had been rejected by the Tribunal.

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