MOFO
NEW YORK TAX INSIGHTS

Volume 9, Issue 5 | May 2018

IN THIS ISSUE

CITY UTILITY TAX NOT APPLICABLE TO FIXED CHARGES RELATED TO LONG-DISTANCE TELEPHONE SERVICES
Page 1

TRIBUNAL REMANDS QEZE CASE FOR RECONSIDERATION OF RETROACTIVITY ISSUE
Page 3

FINAL 2018-19 NYS BUDGET BILL ENACTED, INCLUDING OPTIONAL PAYROLL TAX
Page 4

NEW YORK STATE ALJ DENIES VERIZON'S $20 MILLION SALES TAX REFUND
Page 6

NYS AND NYC ANNOUNCE LIMITED TIME WITHDRAWAL OF CORPORATE TAX COMMONLY OWNED GROUP ELECTION
Page 7

NYS AND NYC ISSUE GUIDANCE ON INCLUSION OF IRC § 965 DEEMED REPATRIATION INCOME FOR TAXPAYERS OTHER THAN C CORPORATIONS
Page 8

INSIGHTS IN BRIEF
Page 9

EDITORS

Hollis L. Hyans
hhyans@mofo.com

Irwin M. Slomka
islomka@mofo.com

NEW YORK STATE + LOCAL TAX GROUP

Craig B. Fields
cfields@mofo.com

Hollis L. Hyans
hhyans@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

Michael J. Hilkin
mhilkin@mofo.com

Nicole L. Johnson
njohnson@mofo.com

Kara M. Kraman
kkraman@mofo.com

Eva Y. Niedbala
eniedbala@mofo.com

Michael P. Penza
mpenza@mofo.com

MORRISON FOERSTER

CITY UTILITY TAX NOT APPLICABLE TO FIXED CHARGES RELATED TO LONG-DISTANCE TELEPHONE SERVICES

By Michael J. Hilkin

The New York City Tax Appeals Tribunal upheld an Administrative Law Judge determination that income from fixed charges that were imposed by a long-distance telephone service provider each month whether or not a customer made any long-distance calls were not subject to the New York City utility tax because they related to transactions that "originat[ed] or consummated outside the territorial limits" of New York City. *Matter of U.S. Sprint Communications Company, LP*, TAT(H)14-12(UT) *et al.* (N.Y.C. Tax App. Trib., Apr. 3, 2018).

Facts. U.S. Sprint Communications Company, LP ("Sprint") provided an assortment of telecommunication services in New York City, including long-distance telephone service. Sprint's long-distance telephone service involved calls that either were initiated from the City and received outside of the City, or initiated outside of the City and received within the City.

Sprint owned no local telephone equipment within New York City, but maintained a physical point of presence, described in the opinion as a "long-distance switch," within the City for purposes of providing its long-distance telephone services. Sprint also paid access charges to use the facilities of a New York City local exchange carrier ("LEC") to bring long-distance calls between a New York City customer's location and Sprint's long-distance switch in the City. Access charges were imposed on a schedule set by the Federal Communications Commission. Some of the access charges were charged as a fixed monthly fee based on the number of Sprint customers located in the LEC's coverage area. In turn, Sprint imposed fixed monthly charges on each long-distance telephone service customer, even if the customer made no long-distance calls in any given month, to recover the fixed access charges Sprint paid to the LECs (the "monthly charges"). Separately, Sprint also charged a "per-minute" rate for all long-distance calls completed by such customers. Sprint did not include either the monthly charges or the per-minute charges in its utility tax gross operating income base. The New York City Department of Finance assessed Sprint for utility tax on the basis that a variety of its charges to customers, including the monthly charges, were subject to the utility tax. The Department asserted that the monthly charges represented a local charge for access to long-distance service, rather than a charge for an actual long-distance telephone call.

continued on page 2

ATTORNEY ADVERTISING

Tax Law. New York City imposes the utility tax under the authority of New York State's General City Law ("GCL") § 20-b, which enables cities to impose a utility tax on certain utility services, including telecommunication services. However, GCL § 20-b prohibits cities from imposing a utility tax on "any *transaction* originating or consummated outside of the territorial limits of any such city, notwithstanding that some act be necessarily performed with respect to *such transaction* within such limits." (Emphasis added.) Therefore, the utility tax may not be assessed on a long-distance telephone call even if some part of the call occurs within the City. However, under Administrative Code § 11-1102.c, the income of an entity subject to the utility tax is "presumed" to be "derived from business conducted wholly within" New York City, and an entity carries "the burden of proving" otherwise.

The Tribunal concluded that the services received in exchange for the monthly charges were inseparable parts of activities necessary to complete a single long-distance call.

ALJ Decision. As reported in the February 2017 issue of *New York Tax Insights*, the ALJ concluded that most of the charges that the Department included in Sprint's gross operating income, including the monthly charges, were not subject to the utility tax under GCL § 20-b. The Department filed an exception only to the ALJ's conclusion that the monthly charges were not subject to the utility tax.

Tribunal Decision. The Tribunal upheld the ALJ's conclusion that GCL § 20-b prohibited Sprint's income from the monthly charges from being subject to utility tax. The Tribunal largely focused on GCL § 20-b's prohibition of the imposition of tax on any "transaction" originated or consummated outside of New York City, and concluded that a long-distance call, rather than any discrete activities necessary to consummate the call, represents a transaction for purposes of GCL § 20-b.

The Tribunal first established that GCL § 20-b was an "imposition" statute that contained a prohibition on taxing long-distance telephone service, rather than a statute that would generally allow the imposition of a tax on long-distance telephone service while "exempting receipts from the sale of individual long distance calls." Next, the Tribunal determined that Sprint had rebutted the statutory presumption that the monthly charges related to activities wholly within New York City. According to the Tribunal, "no long distance service could be provided [by Sprint] if local access" was not provided by a New York City LEC and, as such, the monthly charges related to access charges that were a necessary component of transactions "originating or consummating outside the City."

Ultimately, the Tribunal rejected the Department's argument that the monthly charges related to local transactions originating and consummating in the City that were separable from the per-minute charges for a long-distance call. Although the Department argued that the monthly charges related only to an LEC providing access to Sprint's long-distance switch within the City, the Tribunal pointed out that the Department had acknowledged in its own briefs that a long-distance call represented a "transaction" under GCL §20-b. The Tribunal concluded that the services received in exchange for the monthly charges were inseparable parts of activities necessary to complete a single long-distance call. Further, the Tribunal stated that the fact that the monthly charges were itemized and separately charged on a customer's bill did not change the conclusion.

ADDITIONAL INSIGHTS

State and City Tax Departments often interpret statutory exemptions or exclusions from a tax very narrowly. In this case, the Department's attempt to narrowly interpret the exclusionary language of GCL § 20-b was supported by a New York City Administrative Code provision that explicitly placed the burden on the taxpayer to prove that certain items of income were not subject to utility tax.

Nevertheless, before analyzing this statutory burden, the Tribunal's opinion stated that GCL § 20-b was an imposition statute containing exclusionary language limiting its application, rather than an exemption statute. Under New York case law, a statutory exclusion contained in a tax imposition statute is construed in favor of the taxpayer and against the taxing authority. *See, e.g., Grace v. New York State Tax Comm'n*, 37 N.Y.2d 193 (1975). While the Tribunal did not cite this case law, the burden placed upon Sprint may have effectively been lowered by the Tribunal's conclusion that GCL § 20-b was not an exemption statute.

continued on page 3

TRIBUNAL REMANDS QEZE CASE FOR RECONSIDERATION OF RETROACTIVITY ISSUE

By Hollis L. Hyans

The New York State Tax Appeals Tribunal reversed the decision of an Administrative Law Judge denying a Qualified Empire Zone Enterprise ("QEZE") tax credit, finding that statutory amendments that restricted the credit had been retroactively applied, and that further consideration of the retroactivity issue was required. *Matter of NRG Energy, Inc.*, DTA No. 826921 (N.Y.S. Tax App. Trib., Mar. 14, 2018). The Tribunal remanded the case to the ALJ to consider whether the retroactive application of statutory amendments enacted in April 2009 to the year beginning January 1, 2009, was a violation of the petitioner's rights under the Due Process Clause of the U.S. Constitution.

Facts. NRG Energy, Inc. ("NRG") owns and operates power plants that generate power from various fuel sources, including coal, natural gas, solar, and wind. NRG is the sole owner and member of Oswego Harbor Power LLC, which owns and operates the Oswego Generating Station in Oswego County, New York (the "Plant"). NRG and Oswego Harbor Power LLC originally were certified as eligible under the New York State Empire Zones Act for the Plant effective in 2002. As an eligible participant in the Empire Zones Program, NRG was entitled to apply for QEZE credits against its New York State corporate franchise taxes, including a refundable credit for real property taxes.

On April 7, 2009, the Empire Zones Act was amended to impose new criteria for continued certification under the Empire Zones Program. In 2010, the statute was further amended to explicitly provide that the 2009 changes were retroactive to years beginning on or after January 1, 2008. On or about June 29, 2009, the Department of Economic Development ("DED"), which administers the Empire Zones Program, notified NRG and Oswego Harbor Power LLP that their certifications were being revoked, effective January 1, 2008, for failure to meet the new criteria.

Litigation brought by other taxpayers challenged the retroactive application of the 2009 amendments, and in 2013, the New York Court of Appeals held that retroactive application of the 2009 amendments to the year beginning January 1, 2008, violated the Due Process Clause and was unconstitutional. *James Square Assocs. LP, et al. v. Mullen*, 21 N.Y.3d 233 (2013). Applying a three-factor test, the Court of Appeals found that the taxpayers had not been forewarned of the legislative change, but were instead being "punished . . . more harshly for behavior that already occurred and that they could not alter"; that the period of retroactivity was excessive; and that the retroactive application did not serve an important public purpose, since "raising money for the state budget is not a particularly compelling justification." *Id.* at 250.

In August 2013, after the decision in *James Square*, the Department of Taxation and Finance issued a refund to NRG for the claimed 2008 QEZE tax credits.

NRG's original 2009 tax return claimed QEZE credits with regard to different facilities, located in the Town of Tonawanda Empire Zone and the Sheridan Empire Zone, and NRG received those refunds of approximately $24 million. In August 2013, NRG filed an amended 2009 return claiming an additional credit of approximately $5.8 million for the Plant in the Oswego County Empire Zone. The Department denied the credit because the certificate of eligibility for the Plant had been revoked, in reliance on the 2009 amendments to the statute. NRG challenged the denial, arguing that the retroactive application of the 2009 amendments was impermissible under *James Square*, and that the Department's "selective enforcement" of the statute violates its rights to Equal Protection under the Constitution.

> [T]he Tribunal found that "there is no rule" that a statute adopted during an open tax year and made effective as of the beginning of the year "automatically is determined not to have a retroactive effect."

ALJ Determination. The ALJ rejected NRG's arguments, finding that application of amendments enacted in 2009 to the 2009 tax year itself was not retroactive application of the law. The ALJ also rejected NRG's argument that there was any violation of NRG's equal protection rights, finding that NRG had failed to demonstrate any "selectivity of enforcement" arising from "'an intentional invidious plan of discrimination'" on the part of the Department, as required by previous Tribunal decisions, such as *Matter of Goetz Energy Corp.*, DTA No. 815558 (N.Y.S. Tax App. Trib., Nov. 18, 1999).

Tribunal Decision. The Tribunal reversed the ALJ's determination that no retroactive application of a statute had occurred. While seeing the "common sense" in the

continued on page 4

ALJ's conclusion, the Tribunal found that "there is no rule" that a statute adopted during an open tax year and made effective as of the beginning of the year "automatically is determined not to have a retroactive effect." Here, the application of the new amendments rendered NRG unqualified to participate in the QEZE program as of January 1, 2009, based upon program requirements that were not in effect until April of that year. Therefore, the Tribunal found that application of the amendments attached "new legal consequences" to events that had occurred prior to their enactment, and were therefore retroactive in application, citing *Landgraf v. USI Film Prod.*, 511 U.S. 244 (1994).

After determining that the application of the amendments was indeed retroactive, the Tribunal turned to the question of whether that retroactive application was constitutional, under the factors set forth, most recently in *James Square*, 21 N.Y.3d at 246, and in *Matter of Replan Development v. Department of Housing Preservation & Development*, 70 N.Y.2d 451, 456 (1987). However, this issue had not been reached by the ALJ, because she had found that there was no retroactive application at all. The Tribunal therefore remanded the case to the ALJ for consideration of this issue, which had already been the subject of evidence and argument.

ADDITIONAL INSIGHTS

Retroactive application of statutory amendments continues to be a contentious issue in the state tax area. In *James Square*, New York's highest court did find the retroactive application unconstitutional, but in *Burton v. New York State Department of Taxation & Finance et al.*, 25 N.Y.3d 732 (2015), and *Caprio v. New York State Department of Taxation & Finance et al.*, 25 N.Y.3d 744 (2015), the Court of Appeals rejected challenges to the validity of a 2010 statutory amendment that changed the treatment of gains recognized by a nonresident on the sale of S corporation stock. The Court of Appeals in *James Square* has already found that application of these exact 2009 amendments to the 2008 year was unconstitutional, rejecting the Department's arguments that the change, for example, served an important public purpose, and determining that the taxpayers were "being punished" for behavior that had already occurred and they could not alter. The only new consideration is whether the shorter period of retroactive application—which had been over a year in *James Square*, but in *NRG* is only a little more than three months—will lead to a different determination on constitutionality.

FINAL 2018-19 NYS BUDGET BILL ENACTED, INCLUDING OPTIONAL PAYROLL TAX

By Irwin M. Slomka

On April 12, 2018, Governor Andrew M. Cuomo signed into law the New York State Budget Bill passed by the State Legislature for the State's 2018-19 fiscal year. Among the more significant tax provisions adopted (in bill S. 7509-C/A. 9509-C) are the following.

- *Creates an Optional Employer Payroll Tax* (Part MM). New York State became the first state to enact legislation as a workaround to the $10,000 federal limitation for state and local tax deductions, creating a new "Employer Compensation Expense Program" proposed by the Governor: an annual election, to be made by December 1 of each calendar year for the succeeding year, giving employers in New York the option to become subject to a new payroll tax for tax years beginning after 2018. The elective tax would be imposed on the employer's annual payroll expenses in excess of $40,000 per covered employee at the rate of 1.5% in 2019, and rising to 5% when fully phased in starting in 2021. The payroll tax is expected to be deductible by the employer for federal income tax purposes. Covered employees would be allowed a credit against their New York State personal income tax for equivalent amounts.

  In considering whether to make the New York payroll tax election, businesses will need to consider whether they intend to offset the new payroll tax cost by adjusting employee compensation as well as the additional cost of compliance, factors that could deter businesses from making the election.

- *Authorizes State-Operated Charitable Funds* (Part LL). The legislation adopts the Governor's proposal to establish two State-operated charitable funds, relating to health care and education, to which individuals can make donations and claim a New York State tax credit of 85% of the donation amount contributed in the immediately preceding year, for tax years beginning after 2018. An earlier press release from the Governor stated that these donations may be claimed as federal and State itemized deductions by individuals who itemize, but there remain considerable doubts that the IRS will permit charitable deductions for federal income tax purposes

continued on page 5

since taxpayers will receive a State tax credit in exchange for the contribution.

- *Confirms Exemption for One-Time Repatriated Foreign Income* (Part KK). The Budget Bill makes explicit that the one-time inclusion in a corporation's federal taxable income of repatriated foreign income under I.R.C. § 951, received from a corporation not included in the taxpayer's Article 9-A combined return, qualifies as "exempt CFC income" and therefore is not subject to New York State corporate tax. Taxpayers must, however, add back the partial federal deduction allowed for repatriated foreign income. Left in place is the provision for the direct or indirect attribution of the taxpayer's interest deductions to such exempt income, and the election allowing the taxpayer to reduce its total exempt income by 40% in lieu of such expense attribution, which will have the effect of reducing the benefits of the exempt CFC income exemption. Conforming legislation was passed with respect to the New York City corporate tax. (Note that a State Senate proposal to similarly exempt federal Global Intangible Low-Taxed Income ("GILTI income") under IRC § 951A was not enacted.)

- *Decouples from Federal PIT Deduction Limitations* (Part JJ). New York residents will be entitled to claim itemized deductions for New York State and City personal income tax purposes as the law existed immediately prior to the enactment of federal tax reform (*i.e.*, allowing without limitation deductions for local *real property* taxes, but not state and local *income* taxes) beginning in 2018. The Budget Bill also now permits itemized deductions to be claimed for State and City purposes even for individuals who claim the standard deduction for federal tax purposes.

- *Extends Statute of Limitations for NYS and NYC Tax Departments to Assess Additional Tax on Amended Returns* (Part H). Proposed as an "anti-abuse" provision, the legislation will permit the New York State and New York City tax departments to assess additional corporate or personal income tax, including recovery of a previously paid refund, within one year after an amended return is filed. Previously, an amended return did not generally extend the limitation period for the tax departments to assess additional tax. The extended limitation period applies to tax "attributable to a change or correction on the amended return," a phrase that will likely require clarification by regulation. The change applies to amended returns filed on or after the effective date of the Budget Bill. The Tax Department continues to have two years to assess tax arising out of the payment of an "erroneous refund" resulting from a mathematical or clerical error by the department.

- *Clarifies New York Statutory Residency Requirements for Individuals* (Part O). The Budget Bill adopts the Tax Department's interpretation of the term "resident" for personal income tax purposes whereby in determining whether an individual is a "statutory resident"—an individual who is in the State for more than 183 days in a year and who maintains a permanent place of abode here—days present in the State during a portion of the year when the individual was a New York domiciliary will count toward the "more than 183 day[]" requirement. This was proposed by the Governor in light of *Matter of Sobotka*, DTA No. 826286 (N.Y.S. Div. of Tax App, Aug. 20, 2015), a non-precedential Administrative Law Judge decision holding that days spent in New York during the portion of the year when the individual was domiciled in the State cannot be counted toward the 183-day test for determining statutory residency. While the Governor sought to make the legislation retroactive, the enacted legislation applies only to taxable years commencing on or after the effective date of the legislation.

- *Codifies Partial Responsible Person Sales Tax Relief for Certain LLC Members and Limited Partners* (Part X). The legislation codifies existing Tax Department policy contained in a 2011 Technical Memorandum that provides some relief from absolute liability for sales tax owed by a partnership or limited liability company for limited partners and members of such entities. Under the provision, limited partners and members who, among other things, have not acted on behalf of the partnership or LLC in complying with the sales tax laws, may satisfy their sales tax liability on behalf of the entity by paying a percentage of the tax (plus interest) equivalent to their ownership percentages, but only if the limited partners or members (i) have a less than 50% interest in the entity and (ii) were not under a "duty to act" in complying with the sales tax law. The "absolute liability" provisions in the Tax Law for partners and members, regardless of their involvement in the financial affairs of the business, remain in place.

- *Permits Sale for Resale Treatment for Purchases of Prepared Foods by Restaurants* (Part J). Prepared food purchased on or after June 1, 2018, by restaurants, taverns, cafeterias, caterers, and other establishments will qualify as nontaxable purchases where a properly completed resale certificate is

continued on page 6

furnished to the seller. Previously, no resale exclusion could be claimed, and restaurants and other food establishments had to pay the sales tax and claim a credit.

Several of the Governor's proposals were *not* passed by the Legislature, including: (i) the imposition of an "Internet Fairness Conformity Tax" that would have required Internet "marketplace providers" that "facilitate" sales of tangible personal property on behalf of sellers to collect New York sales tax on those transactions; (ii) a 14% "Healthcare Insurance Windfall Profit Fee" imposed on net underwriting gains from health insurance sales to New York customers; (iii) a proposal that would have treated carried interests earned by promoters as income from a trade or business (subjecting nonresident individuals to tax on those amounts), and would have imposed a 17% "carried interest fairness fee," but only if substantially similar legislation was enacted by several nearby states; (iv) the deferral of certain business tax credits aggregating in excess of $2 million annually for the years 2018 through 2020; and (v) affording the New York State Tax Department the right to appeal adverse decisions of the Tax Appeals Tribunal to the New York courts.

NEW YORK STATE ALJ DENIES VERIZON'S $20 MILLION SALES TAX REFUND

By Kara M. Kraman

A New York State Administrative Law Judge (ALJ) rejected a nearly $20 million sales tax refund claim for sales tax paid on hardware and software purchased by Verizon Wireless to upgrade its Orangeburg, New York data center. *Matter of Cellco Partnership d/b/a Verizon Wireless*, DTA No. 827179 (N.Y.S. Div. of Tax App., Apr. 12, 2018). The ALJ held that the purchased property did not qualify for the exemption from sales tax for property used to process and transmit telecommunications services because the property was used to upgrade Verizon Wireless' customer care and data center and not its transmission equipment.

Verizon Wireless maintains a data center located in Orangeburg, New York, which is primarily dedicated to hosting its Virtual Information System Integrated Online Network (VISION). Verizon Wireless uses the VISION system to add new customers to its network, to change an existing customer's service plan, and for customer billing. While a cellular device would not work on Verizon Wireless' network until it was added by VISION, if the VISION system were not working for a month, an active customer would still be able to make phone calls.

In 2009, Verizon Wireless acquired Alltel Corporation, a cellular provider, and as a result, added more than 10 million new customers to its network. Due to the large influx of new users, Verizon Wireless had to make significant upgrades to the hardware and software in Orangeburg that hosted the VISION application. As part of this upgrade, Verizon Wireless made extensive purchases of server, disk, tape, memory, and other mainframe component upgrades from various vendors. It paid sales tax on these purchases.

Verizon Wireless subsequently filed a refund claim in the amount of $19,184,576 on the grounds that the purchased property was exempt from sales tax under Tax Law § 1115(a)(12-a), which provides an exemption from sales tax for:

> Tangible personal property for use or consumption directly and predominantly in the receiving, initiating, amplifying, processing, transmitting, retransmitting, switching or monitoring of switching of telecommunications services for sale or internet access services [including tangible personal property used or consumed to upgrade such processing and transmittal systems.]

Verizon Wireless took the position that the purchased property was essential to its business operations, and should be exempt despite the fact that it was not used to process or transmit telecommunications services, citing *Matter of Peoples Telephone Company, Inc.*, DTA No. 816253 (N.Y.S. Tax App. Trib., Jan. 16, 2001). The Department approved $49,553 of Verizon Wireless' refund claim, but denied the balance of $19,135,023, finding that the vast majority of the purchases were "[n]ot used in transmitting telecom," as required under the statute.

ALJ Determination. The ALJ found that the question to be resolved was straightforward: whether the purchased tangible personal property, which was used to upgrade Verizon's VISION system, was used or consumed directly and predominantly in the receiving, initiating, amplifying, processing, transmitting, retransmitting, switching, or monitoring of switching of telecommunications services for sale or internet access services for sale. The ALJ held that it was not.

While the ALJ acknowledged that the property used to upgrade Verizon's VISION system was "mission critical" to Verizon's operations in providing cellular telecommunications services, he held that the exemption did not apply because the hardware and software were "not

continued on page 7

necessary nor used to receive, initiate, amplify, process, transmit, retransmit, switch or monitor switching of telecommunications services." The ALJ noted that this was evidenced by the fact that cellular communications could still occur if the VISION system was not operational.

ADDITIONAL INSIGHTS

This case is a reminder that exemption statutes are narrowly construed. Accordingly, the ALJ declined to expand the exemption under Tax Law § 1115(a)(12-a) for tangible personal property "directly and predominately used" in initiating, transmitting, and receiving telecommunications services to include tangible personal property that is essential to Verizon's business operations, but is not necessary or used for the actual transmission of telecommunications services. In so doing, the ALJ distinguished *Matter of Peoples Telephone*, in which the Tribunal held that payphone pedestals and enclosures were directly and predominately used in the initiating and receiving of telecommunications services, because in that case there would be no meaningful reception or initiation of telephone communications at payphone locations without the pedestals or enclosures.

NYS AND NYC ANNOUNCE LIMITED TIME WITHDRAWAL OF CORPORATE TAX COMMONLY OWNED GROUP ELECTION

By Irwin M. Slomka

The New York State Department of Taxation and Finance has issued a Technical Memorandum that provides a procedure to allow taxpayers to withdraw from the commonly owned group election made on their 2015 and 2016 Article 9-A combined returns. *Technical Memorandum*, "June 1, 2018 Deadline for Withdrawal (in certain circumstances) of the Commonly Owned Group Election made on a 2015 or 2016 Combined Return," TSB-M-18(1)C (N.Y.S. Dep't of Taxation & Fin., Mar. 22, 2018).

Under the election, all corporations that meet the more-than-50% ownership requirements for combination with any taxpayer in the group are included in the Article 9-A combined return, regardless of whether they are engaged in a unitary business. The election is made by the group's "designated agent" on an original timely filed return and, under the Tax Law, is irrevocable and binding for seven years. Otherwise, under New York State corporate tax reform, only corporations that meet both the more-than-50% stock ownership and unitary business requirements are included in an Article 9-A combined return.

Since the commonly owned election was generally perceived as a means of simplifying the filing of returns, it is perhaps understandable that some taxpayers may have mistakenly viewed such simplification as meaning conformity to the federal consolidated group.

As background for the new one-time withdrawal procedure, the Technical Memorandum notes that there have been several instances where the commonly owned group election was made but not all corporations that met the ownership requirements were included in the taxpayer's Article 9-A combined return. Rather, the combined return that was filed included only those corporations that were included in the designated agent's federal consolidated return. Earlier this year, the Department issued an FAQ reminding taxpayers that the commonly owned group Article 9-A return *is not* limited to entities included in the federal consolidated return under IRC § 1504—which is generally based on 80% or more common ownership—and can require the inclusion of corporations that file as part of a different federal affiliated group return.

The Department has concluded that some taxpayers misunderstood the commonly owned group election filing requirement and made the election based on that misunderstanding, possibly resulting in a substantial tax change. The Department views this as a transitional issue regarding a new provision of law and has decided to "administratively permit" the designated agent to withdraw the election for the years 2015 and 2016, but only where the corporations included in the Article 9-A combined returns identically matched those that were included in the designated agent's federal consolidated return, and did not include any other corporations that met the Article 9-A combined filing ownership requirements.

The Technical Memorandum sets out a limited time withdrawal procedure under which, no later than June 1, 2018, the designated agent must, among other things, file amended Article 9-A combined returns for the first year the election was made, including only those corporations that meet the ownership and unitary business requirements for combination. Taxpayers are instructed not to mark the box

continued on page 8

for making an "irrevocable election" and must include a statement that the election is being withdrawn based on the Technical Memorandum. If by the time of filing of the amended 2015 Article 9-A combined return the 2016 combined return has ready been filed, the 2016 return must also be amended by June 1, 2018.

The New York City Department of Finance has issued similar guidance under the business corporation tax. Finance Memorandum 18-3, "June 1, 2018 Deadline for Limited Withdrawal of the Commonly Owned Group Election Made on a Tax Year 2015 or 2016 Combined Return" (N.Y.C. Dep't of Fin., Mar. 29, 2018).

ADDITIONAL INSIGHTS

The New York State and City Tax Departments have taken the highly commendable approach of permitting the commonly owned election to be withdrawn under the narrowly defined criteria set out in the Technical Memorandum. Although the State and City statutes make the election "irrevocable," there is some authority (federally and in other states) for a taxpayer to withdraw from a consolidated or combined return election for "good cause." Since the commonly owned election was generally perceived as a means of simplifying the filing of returns, it is perhaps understandable that some taxpayers may have mistakenly viewed such simplification as meaning conformity to the federal consolidated group. The State and City approach is welcome recognition that a strict interpretation of the new election can have harsh consequences and that there should be an opportunity for taxpayers to avoid those consequences by correcting the election under this limited time procedure.

NYS AND NYC ISSUE GUIDANCE ON INCLUSION OF IRC § 965 DEEMED REPATRIATION INCOME FOR TAXPAYERS OTHER THAN C CORPORATIONS

By Kara M. Kraman

The New York State and New York City Tax Departments have each issued pronouncements on the effects of IRC § 965 deemed repatriation income for taxpayers other than *C corporations*. (See page 5 for effects on Article 9-A and City corporate business tax.)

New York State. The New York State Department of Taxation and Finance has issued a Notice addressing the treatment of deemed repatriation income under IRC § 965 by individuals (including shareholders of S corporations). *Important Notice N-18-4* (N.Y.S. Dep't of Taxation & Fin., Apr. 2018). For federal income tax purposes, IRC § 965 requires that a U.S. shareholder owning at least 10% of a foreign subsidiary must include as Subpart F income its pro rata share of the accumulated earnings and profits of its foreign subsidiary. The income recognition is a one-time event, for the last taxable year beginning before January 1, 2018, and the taxpayer has the option to pay the resulting tax liability over eight years.

[T]he Notice concludes that the enactment of the Tax Cuts and Jobs Act (Public Law 115-97) so late in 2017 (December 22, 2017) constitutes reasonable cause for resulting underpayments of New York State tax attributable to § 965, which may be substantial.

The Notice advises individuals that amounts required to be included in the individual's 2017 federal adjusted gross income under § 965 will consequently be includable in the individual's 2017 New York taxable income, and confirms that there is no deduction or exemption for this amount for personal income tax purposes. The Notice also notes that New York law does not provide an option to pay the resulting tax liability over eight years. Instead, the additional tax generated by the § 965 tax liability must be paid in the same year it is recognized and included in federal adjusted gross income.

Finally, the Notice concludes that the enactment of the *Tax Cuts* and *Jobs Act* (Public Law 115-97) so late in 2017 (December 22, 2017) constitutes reasonable cause for resulting underpayments of New York State tax attributable to § 965, which may be substantial. Accordingly, a taxpayer that is assessed a late payment penalty attributable to this amount may request a waiver of the penalty and must include a copy of its federal *IRC 965 Transition Tax Statement* with the penalty waiver request. If the taxpayer provides this information and either pays the remaining tax and interest, or enters into an installment payment plan to pay the same, the Department may waive the penalty.

New York City. The New York City Department of Finance has issued a Finance Memorandum also addressing the treatment of IRC § 965 deemed repatriation income under the General Corporation Tax (GCT), the Banking

continued on page 9

Corporation Tax (BTX), and the Unincorporated Business Tax (UBT). *Finance Memorandum 18-4* (N.Y.C. Dep't of Fin., Apr. 20, 2018). (Note: For tax years commencing on or after January 1, 2015, the GCT and BTX are only applicable to S corporations.) The Memorandum advises taxpayers that there are no specific modifications under the GCT, BTX, and UBT to the amount of § 965 income included for federal tax purposes. Instead, the § 965 income must be classified as business income, investment income, or income from subsidiary capital, to the extent applicable, and deductions must be attributed to that income, including the taxpayer's deduction from § 965 income under § 965(c) for federal income tax purposes. The net income after expense attribution must then be allocated (or in the case of subsidiary capital, excluded) in accordance with the applicable law.

The Memorandum also clarifies that unlike under federal law, taxpayers do not have the option to pay the tax liability over eight years, regardless of whether the taxpayer's owners deferred the tax liability for federal income tax purposes. However, like the State Notice, the Memorandum recognizes that the enactment of the *Tax Cuts* and *Jobs Act* so late in 2017 constitutes reasonable cause for taxpayers under the GCT, BTX, and UBT to underpay a portion of what may be a significant New York City tax liability for the 2017 tax year. Accordingly, a taxpayer that is assessed a late payment penalty attributable to the § 965 income may request a waiver of the penalty, which request must also include a federal *IRC 965 Transition Tax Statement*. If the taxpayer provides this information and, by October 15, 2018, either pays the remaining tax and interest or enters into an installment agreement to pay the same, the Department will waive the penalty.

INSIGHTS IN BRIEF

TAX PREPARER OBTAINS PARTIAL WAIVER OF PENALTIES FOR FAILURE TO FILE NYS RETURNS ELECTRONICALLY

A New York State Administrative Law Judge rejected a tax preparer's request for waiver of the $50 per tax document penalty for failure to file New York State corporate and individual income tax returns electronically on behalf of clients. *Matter of John J. Petito, CPA, PLLC*, DTA No. 827385 (N.Y.S. Div. of Tax App., Apr. 5, 2018). The preparer failed to establish reasonable cause applicable to the 2013 tax year, and while he claimed that the IRS had granted him a hardship waiver under a similar federal law, the evidence only indicated that the IRS granted a hardship waiver for 2011. The ALJ also rejected the preparer's claim that the notices were invalid because they referenced corporate tax at the top right, even though the preparer was not a corporation. However, in a companion case involving the same preparer for the 2012 tax year, the same ALJ granted the penalty waiver, concluding that the destruction caused by Hurricane Sandy in October 2012 to the preparer's home office in Long Island, which did not return to full functionality for more than a year, constituted reasonable cause justifying the abatement of the penalty for 2012. *Matter of John J. Petito, CPA, PLLC*, DTA No. 827055 (N.Y.S. Div. of Tax App., Apr. 5, 2018).

CORPORATION HELD NOT ENTITLED TO NYC CORPORATE TAX DEDUCTION FOR EXCESS FICA TAXES CLAIMED AS A CREDIT FOR FEDERAL PURPOSES

The Department of Finance has been granted summary determination upholding a general corporation tax ("GCT") deficiency against the operator of restaurants in New York City that claimed a deduction from entire net income under the GCT for its excess FICA taxes, which it claimed as credits for federal income tax purposes rather than as business expense deductions under IRC § 162. *Matter of ARK Restaurants Corp.*, TAT (H) 16-18 (GC) (N.Y.C. Tax App. Trib., Admin. Law Judge Div., Mar. 6, 2018). The Chief Administrative Law Judge granted the Department's motion, concluding that there were no triable issues of fact and noting that the taxpayer did not present evidence to support its claim that the Department had permitted similarly situated taxpayers to claim deductions. Therefore, she concluded that once the taxpayer chose to claim a federal tax credit for the excess FICA taxes, there was no longer a deduction "allowable" for federal purposes and no "allowable" business expense available as a GCT deduction.

COSTS AWARDED TO TAXPAYER AFTER NOTICES WERE CANCELLED BY DEPARTMENT

A New York State Administrative Law Judge has allowed the recovery of costs by a taxpayer who had been issued 12 estimated notices and notices and demands for payment of the fifty-cent tax per taxicab trip imposed on taxicab owners under Tax Law § 1281 that were later cancelled by the Department. *Matter of Jean Lys Jean Phito*, DTA No. 828233 (N.Y.S. Div. of Tax App., Apr. 5, 2018). While the ALJ found that the Department had been substantially justified in issuing the notices, since the petitioner remained liable for the tax despite having leased the taxicab to an agent, the Department had not been substantially justified in sending those notices to an address in Woodside, New York, that was not the petitioner's home or business address in Brooklyn, which he had used for filing resident income tax returns. The ALJ found that the Department had presented no evidence supporting the Woodside address, and had not explained how the "taxpayer information profile" that contained the Woodside address had been created by the Department, or what information had been relied upon in setting it up.

continued on page 10

REFUND CLAIM FOR FILM PRODUCTION CREDIT DENIED AS UNTIMELY

Rejecting several alternative arguments made by the petitioner, a New York State Administrative Law Judge has sustained the Department's denial of a refund of an Empire State film production credit for a film, "The Accidental Husband," that was filmed in New York City in 2007, on the ground that the refund claim contained in an amended return received by the Department on June 18, 2012, was not timely filed. *Matter of Accidental Husband Intermediary, Inc.*, DTA No. 827186 (N.Y.S. Div. of Tax App., Mar. 15, 2018). The ALJ rejected the petitioner's claim that an amended return had been filed on January 22, 2009, finding that an affidavit from the petitioner's Secretary/Vice President that he received the return from the tax preparer and mailed it that day was insufficient, since the Tax Appeals Tribunal has consistently held that proof of ordinary mailing is legally insufficient to establish timely filing. The ALJ also rejected arguments that a 2008 New York State tax return should be considered an informal refund claim for the 2007 year, since the 2008 return did not contain any indication that it was requesting a refund for 2007, which was not even referenced, and found that the situation did not qualify for the "special refund authority" provided by Tax Law § 1097(d), since there was no question of fact or law in issue, but simply a late filing of an amended return.

U.S. News – Best Lawyers® BEST LAW FIRMS 2018

- Nationwide: Tax Law (Tier 1)
- New York: Tax Law (Tier 1)
- San Francisco: Tax Law (Tier 1)
- Washington, D.C.: Tax Law (Tier 1)

Chambers USA 2017

- California: Tax
- Nationwide: Tax Controversy
- New York: Tax

Legal 500 US 2017

- U.S. Taxes: Contentious
- U.S. Taxes: Non-Contentious

U.S. News – Best Lawyers® BEST LAW FIRMS 2016

- Law Firm of the Year: Litigation – Tax

Chambers USA 2017

"THEY ARE ALWAYS AVAILABLE AND RESPONSIVE TO OUR NEEDS AND REQUESTS, AND PROVIDE OUTSTANDING ANALYTICS BEHIND THE ISSUES AND VERY GOOD SOLUTIONS."

"THEY PROVIDE OUTSTANDING CLIENT SERVICE AND GOOD VALUE FOR FEES."

"THEY ARE PARTICULARLY GOOD AT GUIDING AND ORGANIZING DISCOVERY AND DEVELOPING CASE STRATEGY."

Legal 500 US 2017

"'OUTSTANDING' DEDICATED SALT PRACTICE."

"SOLID EXPERTISE IN DEVELOPING AND IMPLEMENTING COMPREHENSIVE AND INNOVATIVE SOLUTIONS."

Chambers USA 2016

"VERY GOOD HANDLING, I VIEW THEM AS THE TOP STATE AND LOCAL TAX FIRM IN THE USA."

"THEY HAD THE EXPERTISE I NEEDED AND I RECEIVED EXCELLENT CLIENT SERVICE."

Legal 500 US 2016

"VAST KNOWLEDGE OF THE TAX ISSUES AND EXPERIENCE WITH OPPOSING ATTORNEYS."

"VERY HIGH COMFORT LEVEL ON THE BIG-DOLLAR, HIGH-RISK ISSUES."

"PUT THEIR CLIENTS FIRST AND ARE ALWAYS AVAILABLE WHEN NEEDED."

To ensure compliance with requirements imposed by the IRS, Morrison & Foerster LLP informs you that this publication has been prepared for general informational purposes only. None of the statements made herein constitute financial, accounting, tax or other professional advice of any kind. Please consult with your own advisors to discuss matters relevant to your specific situation. If you wish to change an address, add a subscriber, or comment on this newsletter, please email Hollis L. Hyans at hhyans@mofo.com, or Irwin M. Slomka at islomka@mofo.com, or write to them at Morrison & Foerster LLP, 250 West 55th Street, New York, New York 10019-9601.

© 2018 Morrison & Foerster LLP

MORRISON
FOERSTER

STATE + LOCAL TAX

WHAT SEPARATES US FROM THE REST?

OUR EXPERIENCE. We've been doing it longer, have more experience and published decisions, and have obtained a greater number of favorable settlements for our clients than the rest.

OUR TRACK RECORD OF PROVEN SUCCESS. We've successfully litigated matters in nearly every state, and have resolved the vast majority of matters without the necessity of trial.

OUR NATIONAL PERSPECTIVE. We approach state and local tax issues from a nationwide perspective, taking into account the similarities and differences of SALT systems throughout the United States.

OUR DEPTH. Our team is comprised of a unique blend of public and private backgrounds with experience spanning various industries. We're nationally recognized as a leading practice for tax law and tax controversy by *Chambers*, *Legal 500* and *Law360*. In fact, we've been referred to as "one of the best national firms in the area of state income taxation" by *Legal 500 US* and were rated Law Firm of the Year for Litigation – Tax by the 2016 "Best Law Firms" Edition of *U.S. News & World Report – Best Lawyers*.

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.

© 2018 Morrison & Foerster LLP