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MoFo New York Tax Insights

Divided Appellate Division Affirms Tribunal's *Gaied* "Permanent Place of Abode" Decision

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By Kara M. Kraman

A divided Appellate Division has affirmed a controversial Tax Appeals Tribunal decision holding that Staten Island residential property owned by a New Jersey resident and occupied by his parents constituted his "permanent place of abode," and made him a "statutory resident" of New York. *Matter of John Gaied v. Tax App. Trib.*, 2012 NY Slip Op. 9108 (3d Dep't, Dec. 27, 2012).

After initially holding that the multifamily residence owned by Mr Gaied and occupied by his parents (and also partially leased to tenants) was not occupied by Mr. Gaied, and therefore was not his permanent place of abode, the Tribunal granted the Department's motion for reargument. Following reargument, the Tribunal reversed its earlier decision, and held that the Staten Island property was the individual's permanent place of abode. *Matter of John Gaied*, DTA No. 821727 (N.Y.S. Tax App. Trib., June 16, 2011). The Tribunal concluded that its earlier decision was in error because "where a taxpayer has a property right to the subject premises, it is neither necessary nor appropriate to look beyond the physical aspects of the dwelling place to inquire into the taxpayer's subjective use of the premises." The Tribunal's decision seemed to hold that as long as the taxpayer owns and maintains the property, it is not necessary to examine any other factors.

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Appellate Division Affirms *Gaied* Decision

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The Appellate Division upheld the Tribunal decision, but did not adopt the Tribunal's conclusion that ownership and maintenance of a dwelling alone is determinative of a permanent place of abode. Citing to Third Department precedent, the Appellate Division held that in determining whether a taxpayer maintains a permanent place of abode, a variety of factors and circumstances may be relevant, including, but not limited to, whether the taxpayer: (i) had free and continuous access to the dwelling; (ii) received visitors there; (iii) kept clothing and other personal belongings there; and (iv) used the premises for convenient access to and from a place of employment. Although the Appellate Division cited a number of factors that the Tribunal did not give weight to, the court nevertheless held that the Tribunal's findings of fact were supported by substantial evidence in the record. However, even in upholding the Tribunal, the court noted that "a contrary conclusion would have been reasonable based upon the evidence presented."

Two of the five justices dissented, finding that "the record clearly establishe[d] that petitioner purchased the property . . . as both a place for his parents to live and as an investment" and therefore the Tribunal's determination was "irrational and unreasonable." The dissent observed that the case law makes clear that the purpose of the statutory residence rule is to tax those who really and for all intents and purposes are residents of the State, citing *Matter of Tamagni v. Tax App. Trib.*, 91 N.Y.2d 530 (1998), *cert. denied*, 525 U.S. 931 (1998), and found there was clear and convincing evidence that Mr. Gaied did not live in the dwelling nor have any personal residential interest in the property. The dissent also noted that the court did not need to defer to the Tribunal's decision because "the statutory language is neither special nor technical."

Additional Insights. While the Appellate Division decision upheld the Tribunal's decision, the dissent by two Appellate Division justices is significant. Under C.P.L.R. § 5601(a), the dissent by two justices enables the taxpayer to appeal to the New York Court of Appeals *as of right*. Assuming the decision is appealed, the Court of Appeals will have the opportunity to address some of the well-known inequities of the permanent place of abode rule and provide more clarity on this issue.

Combined Reporting Permitted by ALJ Despite Absence of Substantial Intercorporate Transactions

By Hollis L. Hyans

In *Matter of IT USA, Inc.*, DTA Nos. 823780 & 823781 (N.Y.S. Div. of Tax App., Dec. 20, 2012), a New York State Administrative Law Judge found that two New York taxpayer corporations should have been permitted to file a combined Article 9-A return, also including their parent holding company, because they established the existence of a unitary relationship without arm's length pricing.

Facts. IT USA, Inc. ("IT USA") is a United States subsidiary of an Italian clothing company based in Milan, Italy. In 2001, a new corporation, IT Holding USA, Inc. ("IT Holding"), was formed to centralize the operations of IT USA and another affiliate, Manifatture Associate Cashmere USA, Inc. ("MAC"), acquired by the Italian parent in 1999. Employees of IT USA who had also performed administrative services for MAC were transferred to IT Holding. They continued to perform services for both IT USA and MAC from IT Holding's commercial domicile in New York City, including all logistical functions, such as ordering inventory from Italy and having it shipped to U.S. customers, and all such day-to-day functions as performing credit checks, collection activity, advertising and public relations. IT USA and MAC employed only sales personnel, and did not have their own management or administrative employees.

IT Holding used sophisticated software to track shipments and orders from IT USA and MAC, and to monitor outstanding receivables for their customers. IT Holding paid a third party a license fee for the software, and did not receive reimbursement from IT USA or MAC. IT Holding rented a warehouse to store certain IT USA and MAC merchandise, and organized fashion shows to display IT USA and MAC luxury clothing. IT Holding was not reimbursed for the use of the warehouse or the fashion shows. There was no management services agreement, although a management fee schedule was prepared to allocate compensation paid to IT Holding employees among the companies based on estimated hours spent on each. However, no time records were kept, and the methodology was based on

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Combined Reporting Permitted by ALJ

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cost, with no markup. The management fees were never actually paid, and IT Holding was intended to recognize no gain or loss for tax and financial accounting purposes.

MAC owned a co-op on Fifth Avenue in New York City where a showroom was maintained. IT USA and other related companies occupied the co-op without paying rent, although rent expenses were allocated for financial accounting purposes. MAC continually had a negative cash flow, and received money from IT USA to fund its operations. No formal loan documents or other evidence of indebtedness were created, no interest was paid, and the principal was never repaid. All three companies had the same president, who oversaw all aspects of IT Holding's departments, and was in total and sole control of IT USA and MAC, including making all the sales decisions. Certified financial statements included a disclosure that IT USA and Mac were economically dependent on IT Holding.

Filing of combined reports. IT Holding, IT USA and MAC filed combined reports for 2003 through 2004, and on audit the Department of Taxation and Finance determined that they should have filed as separate entities because they did not establish the existence of substantial intercorporate transactions, or provide documentation supporting a schedule the companies had submitted showing percentages and dollar amounts of management fees.

The standard for combined reporting. For the years in issue, combined reporting was required or permitted under the statute and the regulations when three requirements were met: (1) ownership of substantially all stock; (2) a unitary business; and (3) distortion on separate returns, which was presumed to exist when there were substantial intercorporate transactions.

Here, the Department agreed that the ownership requirements were met, and appears to have also agreed that a unitary business existed, but contended that the "distortion" requirement was not met, relying heavily on the absence of substantial intercorporate transactions as its basis for denying combined filing status.

The ALJ Decision. The ALJ focused on the relationship between the unitary business requirement and the distortion requirement. After reviewing federal and state cases on the unitary business test, including *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992), and *Matter of British Land (Md.) v. Tax Appeals Tribunal*, 85 N.Y.2d 139 (1995), the ALJ found that the companies were engaged in a unitary business, noting that they were in the same or related lines of business, they conducted related activities, and that IT Holding sold no product of its own but only provided services to IT USA and MAC. He focused on the "flow of value" among the companies as being "the key to a finding of a unitary business," and found a flow of value in numerous areas. He also relied on the cash management system, which transferred funds between the companies; on the overall control that was exercised by one person over all three companies; and on the fact that MAC continually received money from IT USA to stay solvent and fund its operation. The ALJ particularly noted that, "[a]lthough treated as loans for accounting purposes, no formal notes were created and the principal of the loans and the interest accrued on the books of the corporations were never paid."

The ALJ also concluded that distortion existed, finding that "the unitary business test and the distortion of income test are considered interrelated factors," as found in *Matter of Heidelberg Eastern, Inc.*, DTA Nos. 806890 & 807829 (N.Y.S. Tax App. Trib., May 5, 1994). Since the companies were not claiming that substantial intercorporate transactions existed, and therefore did not meet the presumption of distortion provided by the regulations, they had the burden of otherwise establishing that distortion existed, which the ALJ held they could do by establishing that the three companies "were not conducting their unitary business on arm's-length terms." The ALJ found they met this burden, and relied particularly on the cash management system, which shifted money between accounts on an as-needed basis at the discretion of the president; unreimbursed loans, services and funding; and unreimbursed use of office and fashion show space.

THE ALJ . . . CONCLUDED THAT DISTORTION EXISTED, FINDING THAT "THE UNITARY BUSINESS TEST AND THE DISTORTION OF INCOME TEST ARE CONSIDERED INTERRELATED FACTORS."

Additional Insights. For many years, most of the audits and decisions involving combined reporting in New York focused on efforts by the Department to force the filing of combined reports. Taxpayers were often, but not always, able to successfully contest these efforts, despite the presumption of distortion that arose from substantial intercorporate transactions, by demonstrating that all such intercorporate transactions were at arm's length prices. *See, e.g., Matter of Hallmark Marketing Corp.*, DTA No. 819956 (N.Y.S. Tax App. Trib., July 19, 2007); *Matter of Sears, Roebuck and Co.*, DTA No. 801732 (N.Y.S. Tax App. Trib. Apr. 28, 1994); *cf., Matter of The Talbots, Inc.*, DTA No. 820168 (N.Y.S. Tax App. Trib., Sept. 8, 2008).

In recent years, the Department's audit efforts appear to have focused more on seeking to *decombine* groups of companies,

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whenever the Department finds that substantial intercorporate transactions do not exist (and particularly where decombination would result in higher tax due). As in *IT USA*, the Department's auditors seem narrowly focused only on the existence of substantial intercorporate transactions, when all that the regulations actually provide is that substantial intercorporate transactions give rise to a presumption of distortion. The existence of distortion on separate returns is the critical element, just as in the cases in which the Department was trying to force combination and taxpayers were able to establish the absence of distortion due to arm's length pricing. The same standard applies in cases where taxpayers seek combination, as was found by the Tax Appeals Tribunal in *Heidelberg Eastern*. Whenever a group of taxpayers meets the ownership requirements and can demonstrate that the group was conducting a unitary business without arm's length charges, combination should be permitted.

As of January 1, 2007, the statute changed, and now the existence of substantial intercorporate transactions means that combination will be required, whether or not arm's length pricing is established. However, the distortion requirement remains in full force, and combination can still also be required or permitted if distortion arises from separate returns, even if no substantial intercorporate transactions exist. Therefore, taxpayers who believe they meet the standards for combination – whether or not they have substantial intercorporate transactions – can still file combined reports, in reliance on the same precedent cited in *IT USA* (such as *Heidelberg Eastern*), although not yet on *IT USA* itself, an ALJ decision with no precedential value unless it is appealed and the Tribunal issues a decision. As of this writing, the Department has been granted an extension of time to file an exception to the ALJ's decision.

Commissions Paid to Real Estate Brokers Held Subject to UBT Addback

By Irwin M. Slomka

The New York City unincorporated business tax ("UBT") addback for payments to partners continues to present a vexing problem. In a decision issued in October 2012, but only recently released, the Chief Administrative Law Judge for the New York City Tax Appeals Tribunal held that a real estate brokerage firm must add back commissions paid to its member-partners for UBT purposes, whether or not the payments qualified under IRC § 707(a) as payments made to persons other than in their capacity as partners. *Matter of Massey Knakal Realty Services of Manhattan, LLC*, TAT(H) 09-37(UB) (N.Y.C. Tax App. Trib., Admin. Law Judge Div., Oct. 22, 2012).

Massey Knakal, an LLC taxable as a partnership, is a licensed real estate brokerage firm located in New York City and is subject to the UBT. Its member-partners each entered into a separate independent contractor brokerage agreement with the firm for the performance of brokerage services, pursuant to which the member-partners received commissions. Thus, when real property was sold, the client paid Massey Knakal a commission, and Massey Knakal in turn paid a share of the commission to the broker. Form 1099s were issued to report the commissions paid to the member-partners, separate from the Form K-1s reflecting each member's distributive share of the firm's profits, and the commissions were deducted by the firm on its federal Form 1065.

WHILE THE PARTIES DISAGREED WHETHER THE PAYMENTS . . . ACTUALLY QUALIFIED UNDER IRC § 707(a) AS PAYMENTS MADE TO PARTNERS OTHER THAN IN THEIR CAPACITY AS PARTNERS, IT WAS NOT NECESSARY TO MAKE THAT DETERMINATION SINCE "THE RECIPIENTS OF THE PAYMENTS WERE STILL MEMBERS AND THE PAYMENTS WERE STILL FOR THEIR SERVICES."

In its UBT returns, and consistent with its Form 1065, Massey Knakal deducted the commissions paid to its member-partners. The Department of Finance disallowed the deductions as "amounts paid to a partner for services" under Administrative Code § 11-507(3). The firm argued that the commissions were payments occurring between a partnership and one who is not a partner under IRC § 707(a), and therefore were not "payments to partners" subject to addback under the UBT. The firm urged the ALJ to "revisit" the New York City Tax Appeals Tribunal decision in *Miller Tabak Hirsch & Co.* (TAT(E) 94-173(UB) (N.Y.C. Tax App. Trib., Mar. 30, 1999)). In *Miller Tabak*, the City Tribunal held that a partnership's payments to limited partners who were also employees of the partnership were nonetheless subject to the UBT addback as nondeductible "payments to partners."

The ALJ, declining to revisit *Miller Tabak*, held that since they were paid to individuals who were considered "partners," the commissions were non-deductible payments to partners for

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Commisions Held Subject to UBT Addback

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services. The ALJ noted that while the parties disagreed whether the payments in question actually qualified under IRC § 707(a) as payments made to partners other than in their capacity as partners, it was not necessary to make that determination since "the recipients of the payments were still members and the payments were still for their services." The ALJ also upheld the validity of 19 RCNY § 28-06(d)(1)(ii)(A), which specifically provides that "the fact that the individual [partner] is providing such services not in his capacity as a partner within the provisions of [IRC § 707(a)] will not change the result."

Additional Insights. Given the precedent, this decision upholding the addback of the commissions paid to member-partners is not surprising. It should be noted that the Department's regulations do *not* require the addback of a partnership's payments to the partnership's *corporate* partners, to the extent the payments represent the value of services furnished by the corporate partners' employees and would otherwise constitute allowable business deductions of the partnership. 19 RCNY § 28-06(d)(1)(ii)(C).

Costs Denied to Two Victorious Taxpayers

By Hollis L. Hyans

Two different New York State Administrative Law Judges, in two cases involving different taxes, have denied administrative and litigation costs to the taxpayers who successfully challenged assessments, finding in both cases that the Department of Taxation and Finance was "substantially justified" in bringing the actions. *Matter of Ward Lumber, Co., Inc.*, DTA Nos. 823209 & 823163 (N.Y.S. Div. of Tax App., Dec. 13, 2012); *Richmond Deli & Bagels, Inc., and Nabila Hussain*, DTA Nos. 823244 & 823250 (N.Y.S. Div. of Tax App., Dec. 20, 2012).

In both of these cases, the taxpayers emerged victorious, one at the ALJ level and the other only after review by the Tax Appeals Tribunal. In *Ward Lumber* (covered in the September 2012 issue of *New York Tax Insights*), which involved claims for Qualified Empire Zone Enterprise ("QEZE") credits, the Tax Appeals Tribunal reversed the decision of the ALJ and found that Ward Lumber had established a valid business purpose for restructuring its business other than to obtain tax credits. *Matter of Ward Lumber, Co., Inc.*, DTA Nos. 823209 & 823163 (N.Y.S. Tax App. Trib., July 10, 2012). The Tribunal had also explicitly noted that, in light of the legislative purpose of the Empire Zones Program to stimulate investment and job creation, and the fact that the result in this case was the creation of a new business that saved a significant number of jobs in the specified region, it found "the position of the Division and the pursuit of this case by its Audit Department to be inappropriate."

In *Richmond Deli & Bagels* (covered in the August 2012 issue of *New York Tax Insights*), a sales tax audit in which the taxpayer's records were found inadequate, the ALJ rejected the Department's reliance on an audit methodology used to estimate total sales based on prepaid cigarette credits. The ALJ found that the auditor had not observed the taxpayer's business, or even a similar business, but was merely relying on ratios derived from audits of similar establishments, and the Department did not offer any evidence concerning the facts of those other audits. Therefore, the assessments were found to derive from a method that lacked a rational basis and were cancelled.

Despite these victories, neither successful taxpayer was able to obtain costs.

ALTHOUGH THE ALJ SPECIFICALLY ACKNOWLEDGED THAT THE AUDIT METHODOLOGY "DID NOT RESULT IN A REASONABLE CALCULATION OF PETITIONERS' TAX LIABILITY" AND DEMONSTRATED A "FAILURE TO USE COMMON SENSE," THE POSITION OF THE DEPARTMENT WAS NONETHELESS HELD TO BE "SUBSTANTIALLY JUSTIFIED"

The standard for obtaining costs. New York State law, similar to federal law, provides that a "prevailing party" before the Division of Tax Appeals can obtain administrative costs and reasonable litigation costs. In order to be a "prevailing party" under N.Y. Tax Law § 3030[c][5], a party must have "substantially prevailed" on the issue, but nonetheless will not be treated as a "prevailing party" if the position of the commissioner "was substantially justified." A motion to obtain such costs must be filed with the Divison of Tax Appeals, which was done in each of these cases.

The Decisions. In *Ward Lumber*, the ALJ found that the Department's position was substantially justified, despite the strong language from the Tribunal finding the audit position "inappropriate" in light of the statutory purpose of allowing credits to businesses that increase employment in disadvantaged neighborhoods. The ALJ noted that the Department is

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Costs Denied to Two Victorious Taxpayers

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substantially justified when it "pursues litigation in close legal questions presented on novel issues," citing federal authority, and that the factors to consider in granting QEZE credits had not been fully addressed by the Tax Appeals Tribunal until the more recent decisions in *Matter of Graphite Metallizing Holdings, Inc.*, DTA No. 822416 (N.Y.S. Tax App. Trib. July 7, 2011), *Matter of Dunk & Bright Furniture Co., Inc.,* DTA Nos. 823026 & 822710 (N.Y.S. Tax App. Trib., June 28, 2012), and in *Ward Lumber* itself.

Similarly, in *Richmond Deli*, the ALJ concluded that the auditors' position was substantially justified because the business had failed to keep adequate books and records, and the method used – reliance on cigarette credits to estimate sales – had been found rational in other cases. Although the ALJ specifically acknowledged that the audit methodology "did not result in a reasonable calculation of petitioners' tax liability" and demonstrated a "failure to use common sense," the position of the Department was nonetheless held to be "substantially justified" because there was no evidence that it tried to extract excessive tax revenue or acted for purposes of harassment or embarrassment or out of political motivations.

Additional Insights. These cases demonstrate how difficult it is for a successful party to obtain an award of costs. In both cases, the Department's audit position was clearly rejected – and in *Ward Lumber*, by the Tribunal in a precedential decision -- with some strong language in each decision indicating disagreement with the method and position taken during audit. If audit methodologies found to lack a "rational basis" and be "inappropriate" do not result in awards of costs, it is hard to imagine when costs would be permitted.

Also, in its discussion of the Tribunal decisions that had clarified the standards for granting QEZE credits after the time of the audit in *Ward Lumber*, the ALJ did not mention that at least one of those decisions actually enforced a higher standard than the taxpayers in the cases had been asking for. *See Dunk & Bright* (Tribunal held that a taxpayer must prove that it was formed for valid business purposes, *and* that it was not formed solely to acquire Empire Zone benefits in order to qualify as a "new business" under the QEZE provisions). It is hard to understand how the Tribunal's decision, agreeing with the Department's position that a two-part standard should be employed, amounts to a relevant change in the law that the Department would not have known about at the time it set up an assessment in *Ward Lumber*. And, in *Graphite Metallizing*, the Tribunal rejected the Department's argument that evidence of the company's initial motivation and later effectuation of its reorganization plan should be disregarded, arguments that were not made in *Ward Lumber* and seem to have no bearing on the Tribunal's decision on the merits.

Department Adopts Amendments to Combined Return Regulations

By Irwin M. Slomka

The Department of Taxation and Finance has now offically adopted amendments to its combined return regulations under Article 9-A. Notice of Adoption, N.Y.S. Register, Vol. XXXV, Issue 1, pp. 3336 (Jan. 2, 2013). The amendments reflect changes to combined reporting enacted by 2007 legislation, which imposed mandatory combined reporting between "related corporations" having "substantial intercorporate transactions." As more fully discussed in the October 2012 issue of *New York Tax Insights*, when these amendments were published for official comment, the amendments principally clarify the statutory term "substantial intercorporate transactions." They set forth two alternative tests for finding the existence of substantial intercorporate transactions in a tax year, a 50% or more "receipts or expenditures test" and a 20% or more "asset transfer test." Meeting either test establishes that substantial intercorporate transactions exist for the year, resulting in mandatory combination under Article 9-A.

In response to comments received following publication of the proposed amendments in September 2012, the Department has made a few additional changes. The changes stem from comments and questions regarding the relationship of two provisions in the proposed amendments involving the calculation of substantial intercorporate transactions: that "expenses that benefit, directly or indirectly, one or more related corporations" are included in the calculation, but that "[i]ntercorporate cost allocations" are not. The adopted amendments now provide that where a corporation incurs expenditures that benefit one or more related corporations "and allocates those costs to the related corporation[s]," those cost allocations are not considered in determining whether there are substantial intercorporate transactions. The Department has also added language that expenditures for service functions, such as payroll processing and personnel services, are not considered expenditures that benefit related corporation(s), and therefore are not included in substantial intercorporate transactions.

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Combined Return Regulations Amendments Adopted

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In response to a public comment requesting that the amendments expressly permit taxpayers to rely on the Department's prior guidance set forth in TSB-M-08(2)C (N.Y.S. Dep't of Taxation & Fin., Mar. 3, 2008) — which was substantially codified in these amendments — the Department now states that since some of the amendments represent a departure from the TSB-M, the amendments expressly apply to taxable years beginning on or after January 1, 2013. That statement is somewhat confusing since most of the amendments do reflect policies that have been in place since the TSB-M was issued, and presumably will continue to apply for tax years prior to 2013.

Insights in Brief

Department Issues Guidance on Reduced Tax Rates for Eligible Qualified New York Manufacturers

Chapter 56 of the laws of 2011 reduced the Article 9-A tax rates for "eligible qualified New York manufacturers" for taxable years beginning on or after January 1, 2012 and before January 1, 2015. For a qualifying manufacturer, the tax rate on entire net income is reduced from 6.5% to 3.25%. The Department has now issued a Technical Memorandum setting forth the criteria for classification as an eligible qualified New York manufacturer. *Article 9-A Tax Rates for Eligible Qualified New York Manufacturers*, TSB-M-13(1)C (N.Y.S. Dep't of Taxation & Fin., Jan. 8, 2013). One of the criteria discussed is a "property test," which requires that the taxpayer have tangible property in the State principally used in the production of goods, and either (i) the adjusted basis of that property for federal income tax purposes is at least $1 million or (ii) all of the taxpayer's real and personal property is located in the State.

Denial of Interest Affirmed by Third Department

Affirming a decision by the New York State Tax Appeals Tribunal (covered in the August 2011 issue of *New York Tax Insights*), the Appellate Division, Third Department, upheld the denial of interest on an overpayment sought from the due date of the original income tax return, holding that the statute as it existed during the years in issue mandated that interest was payable only from the date of the amended return. *Matter of Michael A. Goldstein A No. 1 Trust v. Tax App. Trib.*, 2012 NY Slip Op. 9109 (3d Dep't, Dec. 27, 2012). The taxpaying trusts argued that significant inequity resulted from the fact that, because of federal changes reducing the taxable income of the trusts, the taxable income of the trusts' beneficiaries increased, and the beneficiaries were required to *pay* interest from the dates of the filing of their original returns. Nonetheless, the Third Department held that the statute clearly did not permit the payment of interest from the due date of the original return, until the statute was amended for precisely that purpose for years beginning in 1999, two years after the last of the years at issue in this case.

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