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NEW YORK TAX INSIGHTS

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Securities Rating Agency Not Entitled to Refund of Erroneously Remitted Sales Tax

By Kara M. Kraman

A New York State Administrative Law Judge upheld the denial of a securities rating agency's request for a refund of sales tax, holding that the rating agency failed to prove that it did not collect the sales tax from its customers and to prove that it had refunded such amounts to those customers. *Matter of Kroll Bond Rating Agency, Inc.*, DTA Nos. 826900 & 827411 (N.Y.S. Div. of Tax App., Oct. 5, 2017).

Facts. Kroll Bond Rating Agency, Inc. ("Kroll") is a small securities rating agency that was formed in 2010 to compete with larger rating agencies like Standard & Poor's and Fitch. Kroll negotiated its fees for its rating services individually with each customer, and memorialized those fees in an engagement agreement. Although Kroll understood that the industry practice was not to collect New York sales tax on rating services, it was nevertheless unsure whether the service it provided was properly subject to sales tax. Therefore, on March 8, 2012, it requested an Advisory Opinion from the New York State Department of Taxation and Finance.

Beginning in October 2011, and during the period when its Advisory Opinion request was pending, Kroll's invoices to customers included the statement "includes any applicable sales taxes." Kroll did not remit sales tax to the Department on the entire amount of the invoice; instead, it allocated the total invoice amount into taxable services, non-taxable services (where applicable), and sales tax. The total amount on each invoice was the amount paid by the customer, which was the same as the amount reflected in each engagement agreement.

On September 9, 2013, 18 months after its request, Kroll received the Advisory Opinion, which concluded that its securities rating service was not subject to sales tax. Kroll subsequently submitted refund claims for the portion of the New York State sales taxes it remitted on its sales of securities rating services for the period December 1, 2010, through August 31, 2013 (Kroll later filed a

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second refund claim for the New York City sales taxes it paid). The Department denied the refund claims on the grounds that Kroll had not provided any documentation indicating that it had refunded the overpaid sales tax to its customers. Kroll asserted that it did not collect any sales tax from its customers, but rather that it paid the tax on behalf of its customers.

[T]he ALJ rejected Kroll's argument that it had paid the sales tax on behalf of its customers, finding that Kroll did not demonstrate that the tax had not been collected from its customers.

Law. Tax Law § 1139(a) provides that the Department may refund any sales tax erroneously collected or paid if timely application is made, but no refund will be made of sales tax collected from customers unless the vendor "has repaid such tax to the customer." If the words "tax included" or similar words appear on a sales slip, then "the entire amount charged is deemed the sales price" subject to sales tax. 20 NYCRR § 532.1(b)(3). The taxpayer bears the burden of proof to show that it is entitled to the refund requested. 20 NYCRR § 3000.15(d)(5).

ALJ Decision. The ALJ acknowledged that the securities rating services were not subject to New York State sales tax, and that Kroll had erroneously remitted sales tax to the Department. However, the ALJ rejected Kroll's argument that it had paid the sales tax on behalf of its customers, finding that Kroll did not demonstrate that the tax had not been collected from its customers. The ALJ noted that if Kroll had paid the sales tax on behalf of its customers, the sales tax would have been due on the total invoice amount, per sales tax regulation § 532.1, and not just on the portion representing the charge for the rating services.

Instead, the ALJ found that the invoice amounts given to and paid by the customers included the sales tax, consistent with the reference to "tax included" on the face of each invoice. The ALJ therefore found Kroll's assertion that it had not collected sales tax from its customers to be "untenable." Accordingly, the ALJ held that Kroll's refund claims were properly denied because it did not demonstrate that it had refunded those amounts to its customers who paid the sales tax.

The ALJ also rejected Kroll's argument that allowing the Department to keep the erroneously paid sales tax would result in unjust enrichment. Kroll maintained that this was especially true where, as here, the Department exceeded by more than a year the four-month statutory time frame within which the Department must issue an Advisory Opinion, which Kroll claimed caused it to continue to erroneously pay sales tax while awaiting the opinion. The ALJ did not directly address Kroll's unjust enrichment claim, noting only that the Division of Tax Appeals does not have jurisdiction over the timely issuance of Advisory Opinions, and that Kroll's customers had paid the tax, not Kroll.

Additional Insights

The ALJ's decision seems to elevate form over substance. In this case, the record demonstrated that the customer paid the same price — the price set out in the engagement agreement — for Kroll's services both before *and after* Kroll started remitting sales tax. Therefore, it seems logical to conclude that it was Kroll that bore the cost of (and actually paid) the sales tax. This is true regardless of the statement on the invoice that any applicable sales tax was included, since Kroll received less money as a result of remitting sales tax while the customer remained in the same position. It is also questionable why the fact that Kroll paid sales tax on only a portion of the total invoice amount should be found to demonstrate that a portion of the amount paid by the customer represented sales tax.

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Subpoena Seeking Production of Documents by the Department Upheld in Part

By Hollis L. Hyans

A New York State Administrative Law Judge has partially granted and partially denied a motion by the Department of Taxation and Finance challenging a subpoena issued at the request of the petitioners, who were seeking documents in support of their request that the Department exercise its special refund authority in a residency matter. *Matter of Christopher Sheehan and Gunda Sabel-Sheehan*, DTA No. 827290 (N.Y.S. Div. of Tax App., Oct. 19, 2017).

Facts. The petitioners, Mr. Sheehan and Ms. Sabel-Sheehan, filed New York resident income tax returns for the years 2004 through 2012, indicating that they resided at an address in Larchmont, New York. They had formerly maintained a New York City apartment that they relinquished in 2003, and had no living quarters in New York City from 2004 through 2012. In May 2014, they filed amended resident returns for 2010 through 2012, requesting refunds of New York City personal income tax for 2010 through 2012, and these refunds were granted by the Department in September 2014, with interest. In November 2014, they filed amended New York State returns for the years 2004 through 2009, again claiming refunds of all New York City personal income tax, stating that they had mistakenly continued to pay tax as if they were residents of New York City after they ceased being New York City residents in 2003. The Department disallowed the refunds for 2004 through 2007 on the grounds that the refund claims were time-barred.

Mr. Sheehan and Ms. Sabel-Sheehan filed a petition before the Division of Tax Appeals arguing that the Department had incorrectly denied the refund claims, and that it had arbitrarily refused to exercise its special refund authority under Tax Law § 697(d), which grants the Department the power to issue refunds "without regard to any period of limitations" where there are no issues of fact or law, and where tax was erroneously or illegally collected or paid under a mistake of facts.

In preparation for a hearing, the petitioners requested that the ALJ issue a subpoena directing the Department to produce statistics regarding requests made to the Department for it to exercise its special refund authority during the last 10 years; redacted copies of applications for § 697(d) relief that were granted during the last 10 years; and copies of memoranda, legal opinions, or other correspondence referring to the Department's interpretation of § 697(d) or the scope of its authority under the statute.

[T]he ALJ found that it was the Department, as the party challenging the subpoena, that had the burden to demonstrate the utter irrelevancy of the demands, and that the Department had failed to meet that burden.

The Department moved to have the subpoena withdrawn or modified, arguing that the statistical information does not exist; that the secrecy provisions of § 697(e) bar the disclosure of other returns and opinions of counsel; and that the request for legal opinions, correspondence, and opinions of counsel is excessive, overbroad, and does not identify the requested items with sufficient specificity. The Department also requested *in camera* inspection by the ALJ of the documents if the subpoena were not withdrawn. In response, the petitioners argued that the requested documents were relevant and material to their claims.

The Decision. The ALJ found, first, that the standard for determining whether to vacate or modify a subpoena is whether the requested documents "are utterly irrelevant to any proper inquiry." With regard to the request for statistics, the ALJ found that the requested documents were not utterly irrelevant. While the Department argued that the statistics were not in any existing document, and that it was not under an obligation to create records, the ALJ found

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that no evidence had been submitted to establish that allegation, and it had only been stated in an unsworn letter. Since the documents were found to be relevant, the ALJ held that it was incumbent on the Department to either produce the records or provide an affidavit attesting the records did not exist if that were the case.

With regard to the request for copies of all applications for § 697(d) relief, redacted to remove confidential taxpayer information, the ALJ agreed with the Department that the tax secrecy provisions prohibit disclosure of such documents, since the use of taxpayers' returns or return information is strictly prohibited. Because the request did not fall under any of the exceptions from the statute, and because the ALJ determined that the statute did not allow even a redacted copy of a return to be disclosed, the part of the subpoena that requested redacted copies of applications for § 697(d) relief was withdrawn.

With regard to the portion of the subpoena requesting memoranda, legal opinions, and correspondence referring to the Department's interpretation of § 697(d), the ALJ found that it was the Department, as the party challenging the subpoena, that had the burden to demonstrate the utter irrelevancy of the demands, and that the Department had failed to meet that burden. The ALJ did agree that the request was unduly burdensome in that it did not include a time period, and therefore limited the request to the past 10 years.

Finally, with regard to the Department's arguments that any opinions of counsel are protected by secrecy laws and the attorney-client privilege, the ALJ disagreed and found, citing *People v. Sprint Communications*, 148 A.D.3d 471 (1st Dep't, 2017), that the Department's legal opinions are not shielded by the tax secrecy provisions. The ALJ also found that there was no indication that the opinions contained information from taxpayers' returns and, to the extent such information was contained, it could be redacted before production. The ALJ granted the Department's request that the documents be produced for *in camera* inspection before the hearing, and required the Department to produce a privilege log "detailing with specificity" any documents it claimed were privileged.

Additional Insights

Due to the strict requirements of taxpayer secrecy, it is very difficult to obtain documents from the Department that would reveal information concerning other taxpayers, and the ALJ's decision here reflects that strong policy to protect confidential information. However, when a subpoena requests opinions of counsel or similar documents, the concerns are different, since such opinions would not necessarily include confidential information, and the ALJ recognized that any such information could be redacted to protect the taxpayers who were involved. Here, opinions of counsel may well help to delineate the standards used by the Department in exercising its discretion under § 697(d) to determine when a refund should be permitted despite the expiration of the statute of limitations, and what criteria are used to determine if money has been erroneously or illegally collected based on a mistake of facts, which would allow relief under the statute.

New York City Adopts Major Changes to How Taxpayers Must Report Federal and New York State Adjustments

By Irwin M. Slomka

The reporting of federal or New York State changes for New York City corporate tax purposes has long been a vexing issue, and one with significant consequences inasmuch as such changes re-open an otherwise closed tax year. The New York City Department of Finance has issued a memorandum containing new rules on how taxpayers must report such final federal and State changes for tax years beginning on or after January 1, 2015, including the impact of statutory amendments regarding final New York State changes that allow the Department of Finance to adjust a taxpayer's apportionment during the re-opened tax year. *Finance Memorandum* 17-5, "Reporting Federal and New York State Changes" (N.Y.C. Dep't of Fin., Oct. 13, 2017).

Significantly, for tax years beginning on or after January 1, 2015, the Department of Finance now requires that final federal or State changes that affect a corporation's tax base be reported on amended City

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corporate tax returns, and not (as in prior tax years) on Form NYC-3360 (or Form NYC-115 for taxpayers under the UBT). The Department states that it will no longer process those forms if filed by the taxpayer to report federal or State changes for tax years beginning after 2014.

[F]or tax years beginning on or after January 1, 2015, the Department of Finance now requires that final federal or State changes that affect a corporation's tax base be reported on amended City corporate tax returns, and not (as in prior tax years) on Form NYC-3360....

The *Finance Memorandum* specifies what must be included in the report, and states that template schedules regarding those requirements will eventually be made available on the Department's website. Taxpayers that disagree with the applicability of the changes must explain why the federal or State adjustment is erroneous or inapplicable. The memorandum also allows a taxpayer to request an accelerated audit by the Department if the taxpayer cannot properly compute its corrected City tax liability (e.g., where a taxpayer reporting federal changes files its returns on a consolidated basis for federal purposes, but separately for New York City purposes).

The *Finance Memorandum* also discusses how final State adjustments affecting the taxpayer's apportionment should be reported for New York City purposes (2015 tax legislation now permits the Department to change the taxpayer's allocation during the reopened tax year stemming from the State changes, which could not be done in prior years). The memorandum contains an example involving a corporate taxpayer that elected 8% sourcing for its qualified financial instruments ("QFIs") for both State and City tax purposes, but where New York State determined on audit that certain of those instruments did not qualify, and therefore the income from those instruments was instead subject to customer-based sourcing under Article 9-A. The example instructs how the taxpayer must file an amended City return to report the State changes, and must report the impact of the changes to its City apportionment factor during the re-opened tax year using customer-based sourcing, rather than the 8% sourcing applicable to QFI income.

Additional Insights

The *Finance Memorandum*, which only applies to tax years beginning after 2014, provides important guidance, but leaves certain questions unanswered. For instance, how does a taxpayer that consents to a dollar-amount settlement with New York State report that settlement to New York City, where there is no adjustment to its income or other tax base? Where a taxpayer believes federal or State adjustments are erroneous or inapplicable for City tax purposes, how should the taxpayer file its amended City return, and in that case what exactly is the taxpayer amending? After all, a taxpayer disputing the applicability of the State changes for City purposes will report the same tax liability on its amended City return as it did on its originally filed City return.

Former Form NYC-3360, which contained columns for amounts as originally reported, modifications, and the amount of the modification agreed to, was a more logical vehicle for disputing the applicability of State changes. Representatives of the Department have noted that requiring amended City returns to report changes is consistent with Article 9-A, where Form CT-3360 was discontinued several years ago. However, federal changes to a corporation's taxable income are less likely to be inapplicable under Article 9-A than State changes are for City purposes.

Finally, fairness and efficient tax administration suggest that the Department of Finance should consider eliminating the requirement that taxpayers must report State changes where the Department has already fully audited the City tax returns for years that are the subject of the State changes, whether that can be effectuated administratively or requires remedial legislation. Indeed, the current system serves to encourage taxpayers to delay the conclusion of a New York City audit until after New York State has conducted its audit, in order to minimize the

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likelihood of multiple New York City audits for the same tax year.

INSIGHTS IN BRIEF

Appellate Division Confirms N.Y.C. Tribunal Decision That HMOs Can Be Included in Combined Return

The Appellate Division, First Department, has unanimously confirmed the decision of the New York City Tax Appeals Tribunal, which held that health maintenance organizations are not "insurance corporations" for general corporation tax purposes. Therefore, the HMOs were subject to the GCT and could be forcibly included in the combined GCT returns of their parent holding company. *Matter of Aetna, Inc. v. New York City Tax Appeals Trib.*, No. 4725 [M-45330], 2017 Slip Op. 07311 (1st Dep't, Oct. 19, 2017).

Appellate Division Upholds Application of Federal "Step Transaction" Doctrine to N.Y.C. Real Property Transfer Tax

A New York City Tribunal decision involving the real property transfer tax, holding that the Department of Finance could apply the federal "step transaction" doctrine in order to tax the transfers of minority membership interests in an entity that owned a Manhattan office building, has been confirmed by the Appellate Division, First Department. *Matter of GKK 2 Herald LLC v. The City of New York Tax Appeals Trib.*, No. 4074 OP 82/16, 2017 Slip Op. 07102 (1st Dep't, Oct. 10, 2017). The First Department also agreed with the City Tribunal that a New York State ALJ decision under the State real estate transfer tax involving the same transaction — which held that the transaction was *not* subject to the State transfer tax, and which is currently on appeal to the New York State Tax Appeals Tribunal — involved different legal issues and had no bearing on the City case. *See Matter of GKK 2 Herald LLC*, DTA No. 826402 (N.Y.S. Div. of Tax Appeals, May 26, 2016).

New York City Adopts New Power of Attorney Form

The New York City Department of Finance, following the lead of the New York State Department of Taxation and Finance, has announced that it will accept a revised power of attorney form for taxpayers to appoint representatives in tax matters, as described in *Finance Memorandum* 17-6 "Joint State/City Power of Attorney Form" (N.Y.C. Dep't of Fin., Oct. 17, 2017). The revised power of attorney is Form POA-1 (version 6/17) and is available on both the Department of Finance and Department of Taxation and Finance websites. The major changes from the previous form are that the new form does not automatically revoke previously filed powers of attorney, and it requires a signature only from the taxpayer, so that the representatives no longer need to sign.

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