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NEW YORK TAX INSIGHTS

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NYC ALJ UPHOLDS TAX ON CAPITAL GAIN BASED ON NYC PRESENCE OF INVESTMENT THAT WAS SOLD

By Hollis L. Hyans

A New York City Administrative Law Judge has upheld the Department of Finance's imposition of General Corporation Tax ("GCT") on a gain realized by a corporate taxpayer from the sale of its interest in an LLC doing business in NYC, although the corporation did not have a unitary business relationship with the LLC. *Matter of Goldman Sachs Petershill Fund Offshore Holdings (Delaware) Corp.*, TAT (H) 16-9 (GC) (N.Y.C. Tax App. Trib., Admin. Law Judge Div., Dec. 6, 2018).

Facts. The petitioner, Goldman Sachs Petershill Fund Offshore Holdings (Delaware) Corp. ("GS Offshore"), owned an 88.91% interest in an investment vehicle, the Petershill U.S. IM Master Fund LP ("Master Fund"), which had been formed to make investments in alternative investment management companies. The Master Fund was managed by a London-based investment team employed by another Goldman Sachs–related entity. In 2008, the Master Fund purchased a 9.99% interest in Claren Road Asset Management, LLC ("Claren"), which operated as an investment management company. The London-based investment team managed Master Fund's investment in Claren solely in London. Claren engaged in business in New York in 2008, 2009, and 2010.

In 2010, Master Fund sold its investment in Claren to an unrelated party, generating a capital gain of more than $54 million (the "Gain"). The sale was negotiated from London.

Neither GS Offshore, Master Fund, nor any Goldman Sachs affiliate participated in the management, control, or operation of the day-to-day business affairs of Claren. In 2010, the year in issue, neither GS Offshore nor Master Fund owned any real or tangible personal property, had any employees, or conducted any business activities in NYC, and the parties stipulated that neither Claren and Master Fund, nor Claren and GS Offshore, are part of a unitary business.

Issues and precedent. GS Offshore did not include the Gain in its entire net income for GCT purposes, arguing that Claren's NYC activities were entirely unrelated to GS Offshore's investment activities, which all occurred outside the U.S., and that, in the absence of a unitary business relationship between it and Claren, taxing the Gain violates the Due Process and Commerce Clauses of the U.S. Constitution. GS Offshore relied primarily on the U.S. Supreme Court decision in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992) ("*Allied-Signal US*"), which

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held that a unitary relationship between the taxpayer and the business it sold was required for a nondomiciliary state to tax a gain on the sale of a business. GS Offshore argued that *Allied-Signal US* effectively overruled the decision of New York's highest court in *Allied-Signal Inc. v. Commissioner of Finance*, 79 N.Y.2d 73 (1991) ("*Allied-Signal NYC*"), and that neither *Allied-Signal NYC* nor a similar case decided by New York's Appellate Division, *Allied-Signal Inc. v. Tax Appeals Trib. of the Department of Taxation & Finance*, 229 A.D.2d 759 (3d Dep't, 1996), *appeal dismissed*, 89 N.Y.2d 859 (1996) ("*Allied-Signal NYS*"), applies, because those cases involved the treatment of investment income rather than business income, and that, in both of those cases, the taxpayer itself conducted business activities in the taxing jurisdiction.

The Department of Finance argued that the lack of a unitary relationship between the taxpayer and Claren is irrelevant because Claren's NYC activities conferred sufficient nexus to allow the Gain from the sale of Claren to be taxed, and that the Gain was being apportioned according to Claren's GCT business allocation percentage. The Department also argued that a 2010 decision of the New York State Tax Appeals Tribunal, *Matter of Shell Gas Gathering Corp. #2 & Shell Gas Pipeline Corp. #2*, DTA Nos. 821569 & 821570 (N.Y.S. Tax App. Trib., Sept. 23, 2010) ("*Shell Gas*"), which GS Offshore claimed was limited to the taxability of flow-through ordinary income and did not address a gain, provided further support for the continued viability of the decisions in *Allied-Signal NYC* and *Allied-Signal NYS*.

ALJ determination. The ALJ agreed with the Department, relying on the decisions in *Allied Signal NYC*, *Allied-Signal NYS*, and *Shell Gas* to conclude that "the requisite nexus existed between [NYC] and Claren for the proper assessment of GCT on the Gain." The ALJ found that, in *Allied-Signal NYC*, the New York Court of Appeals held that the Department's power to tax need not be based on the taxpayer's own activities, but can be based on the "privileges and opportunities" that NYC provided to the taxpayer's investment. Similarly, the ALJ found that the Appellate Division decision in *Allied-Signal NYS* relied on the nexus of the business being sold to support the imposition of tax. The ALJ rejected GS Offshore's argument that *Allied-Signal NYC* and *Allied-Signal NYS* were not binding because GS Offshore, unlike the taxpayer in those cases, conducted no activity in NYC, determining that the NYS Tribunal had rejected a similar claim in *Shell Gas*. The ALJ concluded that the Court of Appeals' rationale in *Allied-Signal NYC* was that NYC provided the investment with "an environment for which it could ask something in return," and that the difference between the tax on income involved in *Shell Gas* and the tax on the Gain involved in the present case does not invalidate *Shell Gas*'s binding authority.

Next, the ALJ reviewed U.S. Supreme Court authority and concluded that, despite the language in *Allied-Signal US* and a later decision, *MeadWestvacoCorp. v. Illinois Department of Revenue*, 553 U.S. 16 (2008), that the unitary business relationship is the linchpin of apportionability, the Court has recognized that a unitary relationship between the payor and payee is not the only basis to justify apportionment. The ALJ noted that, in *MeadWestvaco*, the State of Illinois had argued that the in-state activity of the business that was sold—rather than the relationship with the taxpayer—is another basis for apportionability, and that the Court did not reject that argument but merely held that it would not address it because it had not been raised below or in the State's brief. The ALJ concluded that *MeadWestvaco* "left the door open" to a nexus standard based on the in-state connection of the investment rather than a unitary relationship with the taxpayer.

The ALJ found that, in *Allied-Signal NYC*, the New York Court of Appeals held that NYC's power to tax need not be based on the taxpayer's own activities, but can be based on the "privileges and opportunities" that the City provided to the taxpayer's investment.

The ALJ also rejected GS Offshore's alternative argument that its interest in Claren should be treated the same as stock ownership for GCT purposes, so that the nexus between Claren and the City does not flow through to it, because GS Offshore's interest in Claren is a partnership interest. The ALJ also stated that the Supreme Court's decision in *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018), provides further support for apportioning the Gain, since it found nexus sufficient when the taxpayer availed itself of the privileges and opportunities in the taxing jurisdiction, despite the absence of physical presence.

ADDITIONAL INSIGHTS

This determination is the first to address issues that have been debated in New York for some time about the continued validity of the decisions more than 20 years ago in *Allied-Signal NYC* and *Allied-Signal NYS* under more recent analyses of nexus and the breadth of the constitutional power to tax. As the ALJ noted, the issue of basing nexus not on the activities of the taxpayer but instead on the activities of the investment that was sold was raised by the Illinois Attorney General's office late in the proceedings in *MeadWestvaco*, and therefore was not addressed at all by the Supreme Court, which explicitly noted that no party had been given the opportunity to respond. This decision is

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hardly an endorsement of the theory, and since *MeadWestvaco* in 2008 there has not been any opportunity for the Supreme Court to revisit the issue. The ALJ does not cite any other state court that has premised nexus on the relationship between the investment and the taxing jurisdiction.

The ALJ's reliance on the recognition in *Allied Signal US* and in *MeadWestvaco* that a unitary business relationship between the taxpayer and the investment is not the only prerequisite to taxation seems to ignore the actual circumstances discussed in those cases by the Supreme Court where such a requirement might not apply: potential inclusion in apportionable income of interest income arising from operating funds held in a bank, despite the lack of a unitary relationship between the taxpayer and the bank. However, in those circumstances, the operating funds and the activities at issue were clearly those of the *taxpayer*, not of the third-party investment that was sold to generate income.

An exception has been filed by GS Offshore, so the NYC Tax Appeals Tribunal will be reviewing the ALJ's decision, and the case may well move from there into the courts if the Tribunal sustains the ALJ's decision.

NEW YORK STATE RELEASES GUIDANCE ON TREATMENT OF TCJA PROVISIONS RELATED TO FOREIGN INCOME

by Kara M. Kraman

The New York State Department of Taxation and Finance has released *Technical Memorandum*, "New York State Tax Treatment of Repatriation, Foreign-Derived Intangible Income Deduction, and Global Intangible Low-Taxed Income for Businesses," TSB-M-19(1)C (N.Y.S. Dep't of Taxation & Fin., Feb. 8, 2019). The *Memorandum* addresses the New York State impact of federal changes relating to mandatory deemed repatriation income, foreign-derived intangible income ("FDII"), and global intangible low-taxed income ("GILTI").

Mandatory Deemed Repatriation Income

The Tax Cuts and Jobs Act ("TCJA") required the one-time recognition of certain accumulated earnings and profits of certain foreign corporations as mandatory deemed repatriation income under IRC § 965(a) and (b) (the "IRC § 965 inclusion amount") generally for the 2017 tax year. Taxpayers may then deduct a portion of the IRC § 965 inclusion amount under IRC § 965(c), resulting in a net IRC § 965 amount. The *Memorandum* explains that New York State's treatment of deemed repatriation income under IRC § 965 varies according to the type of entity that recognizes the income.

For New York State purposes, C corporations and insurance corporations that receive IRC § 965 inclusion amounts from foreign corporations that are not included in their New York State combined returns should subtract from their entire net income the IRC § 965 inclusion amounts, but must add back interest deductions (and, in the case of insurance companies, interest and noninterest deductions) directly or indirectly attributable to that income. C corporations and insurance companies that have an underpayment of estimated tax penalty as a result of those expense addbacks may request a penalty waiver for the 2017 tax year.

The *Memorandum* further provides that, for C corporations, the IRC § 965 inclusion amount is not included in the numerator or the denominator of the corporation's apportionment factor. In addition, the IRC § 965 inclusion amount is disregarded for purposes of the "principally engaged" test used in determining eligibility for the preferential tax rates and amounts available to certain manufacturers.

S corporations must treat the net IRC § 965 amount as dividends from stock in their apportionment factor. Where the S corporation has made the 8% fixed percentage election, and the stock that generated the § 965 income is a qualified financial instrument (as defined in Tax Law § 210-A(5)(a)), the net IRC § 965 amount is included in the denominator of the factor, and 8% of such amount is included in the numerator. In all other cases, the net IRC § 965 amount is not included in either the numerator or the denominator of the factor.

Foreign-Derived Intangible Income (FDII) Deduction

The TCJA provides that a domestic C corporation can deduct a portion of its income derived from serving foreign markets. The *Memorandum* states that, for purposes of Articles 9-A and 33, the federal FDII deduction is not allowed for tax years beginning on or after January 1, 2017.

Global Intangible Low-Taxed Income (GILTI)

For federal tax purposes, under IRC § 951A, a U.S. shareholder of a controlled foreign corporation ("CFC") is required to include in gross income its GILTI inclusion amount, which generally is the excess of its net CFC tested income for the tax year over its net deemed tangible income return for the tax year.

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A domestic corporation taxed as a C corporation is allowed a deduction for a portion of its GILTI, generally at 50% of the GILTI inclusion pursuant to IRC § 250(a)(1)(B)(i) (“§ 250 deduction”). GILTI includes amounts earned directly by the U.S. shareholder, as well as distributive shares of GILTI from flow-through entities.

The *Memorandum* explains that, for C corporations, net GILTI income, which is the GILTI inclusion less the allowable § 250 deduction, is included in entire net income under Article 9-A. However, IRC § 78 dividends attributable to GILTI are not included in ENI.

Where the stock of a foreign corporation that generates GILTI is business capital, the *Memorandum* explains that net GILTI income is included in the denominator, but not the numerator, of the taxpayer’s apportionment factor to properly reflect the taxpayer’s business income and capital in the State. Where the stock of a foreign corporation that generates GILTI is investment capital, the net GILTI income may be deducted as investment income in the computation of business income, but it is not included in either the numerator or denominator of the apportionment factor. Finally, as with repatriation income, the net GILTI amount is disregarded for purposes of the “principally engaged” test used to determine a taxpayer’s eligibility for the preferential tax rates and amounts available to certain manufacturers.

For S corporations, the *Memorandum* provides that GILTI is included in the denominator, but not the numerator, of the apportionment factor in order to properly reflect the taxpayer’s business income in New York State.

The *Memorandum*’s treatment of GILTI is consistent with the treatment of GILTI contained in the Governor’s proposed 2019-20 Executive Budget, which was submitted to the New York State legislature this January.

TRIBUNAL UPHOLDS DENIAL OF SOLAR ENERGY SYSTEM TAX CREDIT

By Irwin M. Slomka

A recent decision of the Tax Appeals Tribunal regarding the somewhat arcane New York State “solar energy system equipment system credit” addresses interesting questions about the ability of a taxpayer to rely on the oral advice of Tax Department personnel and about the usefulness of legislative history on questions of statutory interpretation. *Matter of Paul J. Suozzi & Karen L. Spencer*, DTA No. 827275 (N.Y.S. Tax App. Trib, Jan. 24, 2019).

Facts. Since 2006, a tax credit of up to $5,000 has been available to individuals under the New York State personal income tax for expenditures for “qualified solar energy equipment” placed in service in a primary residence in the State. Tax Law § 606(g-1). Mr. Suozzi and Ms. Spencer (“Petitioners”) claimed the tax credit on their joint New York State tax return for 2012. That year, they purchased and had installed in their home a “geothermal heat pump and dedicated 100% domestic hot water heat pump” at a cost of $42,000. For those not familiar with the term, a geothermal heating system removes heat from the earth’s crust and transfers it into the home through a piping system using a water and antifreeze mixture to heat the home and provide hot water, and also to remove heat during the warm summer months.

Following an audit of Petitioners’ 2012 return, the Department disallowed the claimed solar energy equipment credit, stating that geothermal systems do not qualify because they “use energy stored within the earth’s core,” and assessed a tax of $5,000, plus interest. The Petitioners protested the assessment and, at the administrative hearing, presented the testimony of the mechanical engineer from the company that had designed and sold them the geothermal system. The engineer testified that he was told by someone named Ashley from the Department’s call center that the described system qualified for the credit. Before installing the system in their home, he had informed the Petitioners of his conversation with Ashley.

The mechanical engineer testified about the system installed in the Petitioners’ home, and explained the similarities and differences between a solar thermal system, which has a solar collector that is active when exposed to the sun’s rays, and a geothermal system, which utilized energy from solar radiation stored in the earth and is available 24 hours a day.

ALJ determination. An Administrative Law Judge ruled in favor of the Department, holding that the Tribunal decisions in *Matter of Kathleen Grimm*, DTA No. 826743 (N.Y.S. Tax App. Trib., Jan. 11, 2018) and *Matter of Carlos Li*, DTA No. 826508 (N.Y.S. Tax App. Trib., May 8, 2017) on the identical issue constituted binding precedent, and that a strict and narrow construction of the statute did not permit the geothermal systems to qualify for the credit.

On appeal of the ALJ determination, and in the face of adverse Tribunal precedent, the Petitioners made several arguments. Petitioners argued that they had

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introduced evidence not considered in those earlier Tribunal decisions, and that the Tribunal should revisit those earlier decisions. They also argued that proposed 2015 legislation to expressly provide a tax credit for geothermal systems would have provided a separate credit, but not a new credit, and claimed that the legislation, which was vetoed by the Governor, was introduced because of the Department's alleged misinterpretation of the existing tax credit statute.

[T]he Tribunal concluded that it was unreasonable to have relied on the verbal assurances of Departmental personnel, and noted that the lack of any written confirmation from the Department meant that there was no way to verify what information was provided to the Department's representatives who made the statements.

Tribunal decision. Before addressing the Petitioners' legal argument, the Tribunal addressed their claim that they had relied on statements from Department personnel that the geothermal systems qualified for the solar energy equipment credit, an issue not addressed by the ALJ. Viewing this claim as an argument for estoppel—which, the Tribunal pointed out, was inapplicable to government acts unless necessary to avoid "manifest injustice"—the Tribunal concluded that it was unreasonable to have relied on the verbal assurances of Departmental personnel, and noted that the lack of any written confirmation from the Department meant that there was no way to verify what information was provided to the Department's representatives who made the statements. The Tribunal pointed out that Petitioners could have sought an Advisory Opinion from the Department, although the Tribunal did not mention the sometimes excessive delays in obtaining those opinions from the Department.

As for the legal issue of entitlement to the solar energy equipment credit, the Tribunal first noted that the Petitioners bore the burden of showing "unambiguous entitlement" to the credit, and of showing that their interpretation "is the only reasonable construction," a considerable burden. It concluded that the Petitioners did not meet that burden. Thus, the Tribunal saw no reason to deviate from its decisions in *Matter of Kathleen Grimm* and *Matter of Carlos Li*, which held that geothermal systems did not qualify for the credit, finding that there was no evidence that the Legislature intended to include geothermal systems and that the Department's different treatment of the two types of heating systems was rational.

The Tribunal also found that the failed 2015 legislation, which would have expressly permitted the credit for geothermal systems, actually supported the Tribunal's earlier construction of the scope of the tax credit statute that was in effect in 2012 when Petitioners purchased and installed the geothermal system in their home. The Tribunal applied the principle of statutory construction that presumes that legislative amendments are made to effectuate some actual change in existing law. Moreover, statements in documents that the Petitioners introduced into evidence from the Assembly and Senate sponsors of the 2015 legislation, consisting of letters written after the legislation was voted on, were of little significance in overcoming the presumption that the failed legislation was intended to expand the tax credit to cover geothermal systems, and not to merely continue the applicability of the credit to those types of systems.

ADDITIONAL INSIGHTS

Although the Petitioners' argument that the source of the heat from a geothermal system qualified it as solar energy system equipment was not unreasonable, the strict and narrow statutory construction principle applied by the Tribunal ultimately made it too difficult to overcome the Department's interpretation. Likely, the failed 2015 legislation was considered dispositive of the Department's interpretation that the existing statutory language did not extend the credit to geothermal systems. The Tribunal's decision also reveals the significant impediments in seeking to estop the Department based on oral statements of Department personnel—particularly third-hand statements—in the absence of written confirmation and of evidence of "manifest injustice" to the taxpayer.

INSIGHTS IN BRIEF

CONGESTION SURCHARGE ON FOR-HIRE TRANSPORTATION GOES INTO EFFECT IN MANHATTAN

Beginning at 12:01 a.m. on February 2, 2019, the New York congestion surcharge enacted in 2018 went into effect. It is now added to the charge for each transportation-for-hire ride (such as taxis, limousines, and Lyft-type ride services) at the rate of $2.50 per trip (for medallion taxis), $2.75 (for nonmedallion for-hire vehicles besides pool vehicles), and $0.75 (per pool-trip rider) that begins in, ends in, or passes through Manhattan south of 96th Street. It is collected from the passenger and must be remitted monthly to the New York State Tax Department. The congestion surcharge had originally been scheduled to go

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into effect on January 1, 2019, but had been the subject of a temporary restraining order, which was lifted by a New York State Supreme Court judge on January 31, 2019. *Important Notice*, "New York State Supreme Court Lifts Temporary Restraining Order on Congestion Surcharge," N-19-2 (N.Y.S. Dep't of Taxation & Fin., Feb. 1, 2019).

HOURLY KARAOKE ROOM CHARGES ARE NOT DEDUCTIBLE IN COMPUTING KARAOKE BUSINESSES' BASE RENT SUBJECT TO COMMERCIAL RENT TAX

In a recently released letter ruling involving the New York City commercial rent tax, the Department of Finance ruled that, in computing its base rent subject to the tax, a commercial tenant that operates a karaoke business in Manhattan may not deduct amounts it receives from customers for the hourly rental of private karaoke rooms. *Finance Letter Ruling*, FLR-18-4988 (N.Y.C. Dep't of Fin., May 17, 2018), released Feb. 7, 2019. The ruling first concludes that the amounts are nondeductible because the individual karaoke rooms do not constitute commercial premises, even if used by customers to entertain clients or employees. Acknowledging that a deduction can also be allowed for rents received or due for premises that are not taxable under a common law landlord-tenant relationship, the ruling concludes that the hourly room rental is not a common law landlord-tenant relationship and therefore does not qualify for the deduction on that basis.

ALJ FINDS ESTIMATED SALES TAX AUDIT METHODOLOGY IMPROPER

A New York State ALJ has granted the petition of a convenience store operator canceling a sales tax assessment of approximately $58,000 in tax, plus interest and penalty, finding that the use of an indirect audit method was improper because the Department of Taxation and Finance did not establish that it had thoroughly examined the taxpayer's documentation before resorting to an estimate. *Matter of Hilario Taveras*, DTA No. 828051 (N.Y.S. Div. of Tax App., Feb. 7, 2019). Although the Department did make an explicit request for books and records, the audit log showed only that an assessment was issued, with no indication that the taxpayer's records were examined, and stating that no time was spent on the case. Therefore, the Department was found not to have established that it thoroughly examined the documentation submitted, a necessary step before resorting to an estimated audit method, and the assessment was canceled because it lacked a rational basis.

MOTION FOR SUMMARY JUDGMENT DENIED IN DRIVER'S LICENSE SUSPENSION CASE

A petitioner's challenge to a driver's license suspension survived a motion to dismiss because the Department failed to prove that it had properly issued the underlying notices. *Matter of Peter Keehn*, DTA No. 828667 (N.Y.S. Div. of Tax App., Jan. 17, 2019). As has been previously discussed in *New York Tax Insights*, there are only six very narrow grounds on which a driver's license suspension for unpaid final assessments may be challenged, such as the liabilities having been satisfied or the wrong taxpayer assessed, but not including financial hardship or challenge to the underlying assessment. Here, the Department failed to establish that the notices were properly mailed to the taxpayer's last known address, so the required existence of "past-due tax liabilities" was not met. The Department's motion to dismiss for lack of a timely protest was denied, and the matter was set for a hearing to develop a full factual record.

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