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NEW YORK ENACTS SIGNIFICANT CHANGES TO RELATED MEMBER ROYALTY ADD-BACK LAW

By Irwin M. Slomka

Governor Cuomo has signed into law changes to the related member royalty income exclusion and expense add-back law, applicable for both New York State and New York City corporate tax purposes for tax years beginning on or after January 1, 2013. S. 2609D, A. 3009D, Ch. 59, N.Y. Laws of 2013. Most significant is the elimination of the royalty income exclusion where the related payor is subject to the royalty expense add-back.

Background. Since 2003, in computing its taxable net income under the State and City corporate and bank tax laws, a corporation must add back royalty expenses paid to related members, to the extent deductible for federal purposes. The add-back law contained two exceptions: (i) where the related member royalty recipient, in turn, paid the amount over to an unrelated party ("conduit exception"), and (ii) where royalties were paid to a related member organized under the laws of a foreign country subject to a comprehensive tax treaty ("foreign member exception"). Also, no add-back is required for royalty payments made between related members that are included in a New York combined tax return.

Unless the royalty payments were not required to be added back, the related member receiving the royalties could exclude that income from its own New York taxable income. The interplay between the royalty exclusion and royalty add-back made sense — if the payor could not deduct the royalty expense, the recipient should not have to include the royalty income in its taxable income (thereby rendering the related party royalty arrangement, in effect, a nullity).

The newly enacted law, modeled after a 2006 Multistate Tax Commission model add-back statute, significantly changes the New York State and City royalty add-back. First, it removes altogether the royalty income exclusion (referred to in the Executive Branch memorandum in support of the new legislation as a "royalty income loophole.") Second, the add-back exceptions have been reworked. The "conduit" exception has been changed to make clear that, in order to qualify, the related member receiving the royalty income must be taxable on that income in New York, another state or U.S. possession, or a foreign country. The "foreign member" exception has also been changed to now require that the royalty income actually be taxed in the foreign country at an "effective rate of tax" at least equal to the New York statutory tax rate, and that the transaction resulting in the royalty payments has a valid business purpose "using terms that reflect an arm's length relationship."

The new law adds an additional add-back exception for royalties paid to a related member that is subject to tax on net income in New York or another state, provided the royalty income received by the related member is being taxed at a threshold "aggregate effective tax" of at least 80% of the New York statutory tax rate. Also new is a discretionary relief provision under which taxpayers and the State or City can agree to an alternative adjustment to the add-back, where the Commissioner determines that application of the add-back would not properly reflect the taxpayer's New York income.

No changes were made to the related member interest add-back provisions.

Additional Insights

The memorandum in support of the amendments refers to the now-repealed royalty income exclusion as a "loophole" that was "subject to exploitation by taxpayers," and gave as an example a situation of a taxpayer having a low New York apportionment percentage adding back the royalty deduction, while the recipient with the higher apportionment gets to exclude the income, resulting in tax savings. The memorandum also alludes to the former royalty income exclusion as being "interpreted by some taxpayers in ways that are inconsistent with the intent of the statute." Although the memorandum does not give further details, reportedly some taxpayers have taken the position for earlier years that the income exclusion applies even if the royalty payments are made by a related member that is not subject to New York tax at all, and therefore not subject to the add-back.

NUCLEAR POWER PLANT THAT PRODUCES STEAM AND WATER TO GENERATE ELECTRICITY NOT ELIGIBLE FOR INVESTMENT TAX CREDIT

By Kara M. Kraman

A New York State Administrative Law Judge has held that various assets operated by a pair of nuclear power plants to produce steam used to generate electricity did not qualify for the investment tax credit ("ITC") allowed under Article 9-A. *Matter of Constellation Nuclear Power Plants LLC*, DTA No. 823553, (N.Y.S. Div. of Tax App., Apr. 11, 2013).

The taxpayer owned and operated two nuclear power plants in New York State. Both nuclear power plants created steam from water, which was then used to generate electricity. Although different methods were used to create the steam in each plant, both plants used the steam to turn turbines attached to a generator, generating electricity that was sold by the plants. Both of the plants sold only electricity, and did not sell steam or water.

An investment tax credit ("ITC") is allowed against the tax imposed under Article 9-A for tangible personal property, and other tangible property, including buildings and structural components of buildings, that meets various criteria, and that is "principally used" by the taxpayer in the production of "goods" by manufacturing. Tax Law § 210(12)(b)(i)(A). The statute specifically provides that the term "goods" does not included electricity. "Principally used" is defined by regulation as meaning more than 50 percent. 20 NYCRR 5-2.4(c).

Consistent with the ITC law, the taxpayer did not claim the ITC for equipment, such as the turbines and electrical generator, that was clearly used to produce electricity. The taxpayer did claim the ITC for equipment used to turn steam into water and water into steam. The taxpayer contended that this equipment was eligible for the ITC because it was principally engaged in the production of steam from water and water from steam, not in the production of electricity, and both water and steam qualify as "goods." The taxpayer filed refund claims attributable to the ITC totaling more than $22 million.

The ALJ disagreed with the taxpayer, finding that the equipment was part of "an integrated and continuous system that must operate in a synchronized and harmonious manner" to produce electricity. In reaching his determination, the ALJ relied on *Matter of Brooklyn Union Gas Company*, DTA No. 822692 & 892693 (N.Y.S. Tax App. Trib., Mar. 8, 2012) in which the Tax Appeals Tribunal held that "the relationship

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The equipment was part of "an integrated and continuous system that must operate in a synchronized and harmonious manner" to produce electricity.

of the individual components of equipment to the primary function with which the equipment is involved" should be examined when determining whether the ITC applies to production equipment.

Applying that test, the ALJ was unwilling to classify different types of equipment here as being involved in theoretically distinct steps of production — production of steam versus production of electricity — and instead found that the primary function of the steam-producing equipment was the generation of electricity, a non-qualifying activity. The ALJ also noted that the fact that the plants did not sell steam, or even have the necessary infrastructure or equipment to sell steam, further reinforced his conclusion that the primary purpose of the steam generation was the production of electricity.

Additional Insights

The decision, which is not binding precedent and is subject to appeal, makes clear that when examining whether certain equipment qualifies for the ITC, the primary function with which the equipment is involved is a key factor. In this case, the ALJ found that the equipment's primary function was to produce electricity and that, in fact, electricity was the product sold by the plants, not steam. However, it is worth noting that nothing in the ITC law requires that the product being manufactured be *sold* by the taxpayer for the ITC to apply. For example, as noted by the ALJ, in *Matter of Plattekill Mountain Ski Center, Inc.*, (State Tax. Comm. Aug. 1, 1985), the former State Tax Commission held that the ITC was available to a ski resort operator for its snow-making equipment.

APPELLATE DIVISION UPHOLDS DENIAL OF INSURANCE COMPANY'S CLAIM FOR REFUND OF RETALIATORY TAX

By Open Weaver Banks

In *Prudential Insurance Co. of America v. Wrynn*, 2013 NY Slip Op. 02343 (1st Dep't, Apr. 9, 2013), the Appellate Division, First Department, upheld a lower court's determination that Prudential was not entitled to a refund or credit against retaliatory tax paid in prior years as the result of an additional payment of the Article 33 franchise tax on insurance companies.

As discussed in the June 2012 issue of *New York Tax Insights*, the taxpayer, Prudential, a non-New York insurer, sought a refund or credit of retaliatory tax as the result of an Internal Revenue Service adjustment to a net operating loss ("NOL"), which Prudential had carried back to 1995. The federal NOL adjustment increased Prudential's Article 33 franchise tax liability for 1995. In 2006, Prudential paid the additional franchise tax liability for the 1995 year. Thereafter, Prudential applied for a refund or credit of retaliatory tax paid in 2003, and cancellation of an assessment of retaliatory tax for 2007.

In a relatively short opinion, the Appellate Division set out four reasons for its denial of Prudential's claims. First, the Appellate Division reasoned that Prudential had an underpayment, rather than an overpayment, of franchise tax in 1995 and, therefore, cannot recover any refund of its additional franchise tax payment under Insurance Law § 9109.

Second, Prudential's underpayment did not result from any erroneous interpretation of a New York statute or statute of another state, as required for a refund under Insurance Law § 9109. Rather, Prudential's underpayment resulted from a misinterpretation of the NOL provisions of the Internal Revenue Code.

Third, Tax Law § 1511(b) does not permit franchise taxes to be offset against retaliatory taxes in *any year*. As explained by the lower court, while Tax Law § 1511(b) allows a credit against retaliatory tax for "any taxes paid under this article," the word "any" refers to the *type* of taxes paid under the article, not the period of time for which a credit is permitted.

Finally, Prudential was not permitted to rely upon a 2007 opinion of the Insurance Department's Office of General Counsel, which the Insurance Department declined to follow, because the court found Prudential had failed to preserve its argument that the Insurance Department's change of opinion should be applied only prospectively. In any case, according to the Appellate Division, even if it were to consider Prudential's new argument, it would not find the Insurance Department's change of opinion so palpably unjust as to warrant prospective-only application.

Additional Insights

There is an the apparent conflict between the denial of Prudential's claims and the decision in *Matter of Phoenix Home Life Mutual Ins. Co. v. Curiale,* 162 Misc.2d 142 (N.Y. Sup. Ct. 1994), in which a New York County Supreme Court judge rejected the argument that Tax Law § 1511(b) requires a year-to-year matching of the credit at issue. Under the reasoning of *Phoenix Home*, Prudential's payment of franchise tax in 2006 created an overpayment of retaliatory tax in 2003, for which Prudential was entitled to a credit or refund. The Appellate Division decision does not discuss *Phoenix Home*.

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An interesting development on appeal is the Appellate Division's conclusion that Prudential failed to preserve its argument with respect to the retroactive application of the Insurance Department's change in position. While the opinion does not provide very much in the way of an explanation, the Appellate Division relied on *Recovery Consultants v. Shih-Hsieh*, 141 A.D.2d 272, 276 (1st Dep't, 1988), in which it had held that an issue that was never raised in the motion court could not be considered by an appellate court.

Prudential clearly raised and relied on the Insurance Department's 2007 opinion itself before the lower court, where Prudential argued that the Insurance Department had failed to give deference to its own counsel's legal opinion, yet the Appellate Division concluded that Prudential had not raised the argument about improper retroactive application until the appeal. It is important to remember that not only must a taxpayer develop a complete factual record for appeal, but must raise all legal arguments in the court of original jurisdiction, or run the risk that it is precluded from arguing a theory on appeal not presented to the court of original jurisdiction.

S CORPORATION SHAREHOLDERS PERMITTED TO ALLOCATE HIGHER QEZE CREDIT TO NY

By Hollis L. Hyans

In *Matter of Batty* and *Matter of Pennefeather,* DTA Nos. 824061 & 824063 (N.Y.S. Div. of Tax App., Apr. 4, 2013), a New York State Administrative Law Judge held that the petitioners, shareholders of a New York S corporation, properly calculated their credits under the State's Qualified Empire Zone Enterprise ("QEZE") program using a "tax factor" based on their personal income tax filings. The ALJ rejected the argument made by the Department of Taxation and Finance that the individual petitioners were required to use the business allocation percentage of the S corporation's subsidiary, finding no basis for that position in the statute or regulations.

Facts Regarding the Subchapter S entities. Mssrs. Batty and Pennefeather were shareholders of Buckingham Group, Inc., a New York corporation that had properly elected to be taxed as a Subchapter S corporation pursuant to federal and state law. Buckingham Group, in turn, was the sole shareholder in three separate Subchapter S corporation subsidiaries. Buckingham Group and one of the three subsidiaries, Buckingham Manufacturing, Inc., were certified by the State as "QEZE enterprises" in 2001. During 2006 through 2008, the years in issue, Buckingham Manufacturing manufactured arborist and lineman safety equipment in its factory in Binghamton, NY, and approximately 90% of its product was exported outside New York. Buckingham Manufacturing was a successful enterprise, growing from 38 employees in 1984 to 135 in 2001, at the time of its QEZE certification, and to 208 in 2013.

The QEZE credit claimed. Mr. Batty and Mr. Pennefeather filed New York State resident personal income tax returns, and reported and paid tax to New York on all income that flowed through to them from Buckingham Manufacturing. They paid no tax to any other state on that income. They claimed the QEZE tax reduction credit, set forth in Tax Law § 16, for each of the years at issue.

The QEZE credit was enacted as part of the Empire Zones Program Act, added in 2000 to provide new tax credits and other incentives to businesses that agreed to create employment and make investments in areas that were economically depressed. The credit is a product of four factors: the benefit period factor, the employment increase factor, the zone allocation factor, and the tax factor. Only the last one, the tax factor, was in dispute in this case.

There is no mention in Tax Law § 16 or in any regulation of application of the entity's business allocation factor when the credit is being claimed by individual resident shareholders of an S corporation.

Where the taxpayer is an S corporation shareholder, the statute provides that the tax factor is the product of the ratio of the shareholder's income from the QEZE allocated within New York, divided by the shareholder's New York State adjusted gross income, multiplied by the shareholder's New York State income tax. According to the ALJ, the tax factor is designed to represent "the portion of the shareholder's New York State income tax resulting from income from the QEZE allocated to New York." Based on this formula, Mr. Batty calculated QEZE tax reduction credits of approximately $108,000, $159,000, and $228,000, respectively, for each of the three years in issue. Mr. Pennefeather calculated tax reduction credits of approximately $23,000, $35,000 and $51,000, respectively.

On audit, the Department recalculated the tax reduction credits, taking the position that the calculation should have used only Buckingham Manufacturing's income allocated within New York State, which it defined as the company's income reported on the shareholders' forms K-1, multiplied by Buckingham Manufacturing's business allocation percentages. The Department's calculations reduced Mr. Batty's credits for each of the years by 61%, 88%, and 89%,

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respectively, to approximately $42,000, $18,700, and $25,000; and Mr. Pennefeather's credits by similar percentages, to approximately $9,000, $4,000 and $5,500.

The Department claimed these adjustments were required "to fairly allow the tax reduction credits to residents and nonresidents alike." Mr. Batty and Mr. Pennefeather, however, claimed that nothing in the statute or regulations required or permitted use of the entity's business allocation factor, and that, as residents, they had allocated all of their income from Buckingham Manufacturing to New York, so that amount should be used in computing the tax factor. They argued that there was no discernible intent by the legislature, which had enacted the QEZE program to create employment in economically depressed areas – a goal fully met by Buckingham Manufacturing – to reduce the available credit whenever a QEZE's products happened to be shipped largely out of state, resulting in a small New York sales factor.

The ALJ's decision. The ALJ held for the petitioners. He found that the statute, Tax Law § 16(f)(1), required the computation of the tax factor to be made pursuant to Articles 9-A or 22, "depending on the filing nature of the taxpayer claiming the credit." Since Buckingham Group was the sole shareholder in Buckingham Manufacturing, and both were Subchapter S corporations, their income and tax attributes flowed through to the individual taxpayers. As residents, they had allocated all of their income to New York, and their tax was determined under Article 22, the personal income tax law. Therefore, their tax factor was based on their personal income tax filings and had been properly calculated.

The ALJ found that the Department "went a step further than the statute provides," since there is no mention in Tax Law § 16 or in any regulation of application of the entity's business allocation factor when the credit is being claimed by individual resident shareholders of an S corporation. The ALJ noted that while a Technical Services Bureau Memorandum issued by the Department did discuss the use of a business allocation percentage, that discussion was in the context of instructions for calculating the tax factor for *corporate* partners. *See* TSB-M-06[1]C and TSB-M-06[2] I (Dep't of Tax. and Fin., Feb. 2, 2006). No such language was included in any pronouncements or return instructions for personal income taxpayers. The ALJ also rejected the Department's attempt, "as a matter of fairness to nonresident taxpayers," to rely on the Privileges and Immunities Clause of the U.S. Constitution as a basis for its adjustment. The Privileges and Immunities Clause, contained in Article IV of the Constitution, provides that "Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States," and the ALJ noted that the object of the Clause is to place "citizens of each State upon the same footing" as citizens of other States." *Lunding v. New York Tax Appeals Tribunal*, 522 U.S. 287. 296 (1988) (citations omitted). The ALJ, however, found that the Division's position would actually treat nonresident taxpayers more favorably than residents.

Finally, the ALJ rejected the Department's argument that its interpretation of the statute was entitled to great weight, finding that, when the issue is one of pure legal interpretation, no deference to the Department is required. Since the language of the statute clearly and unambiguously required the method used by the petitioners, that method was deemed correct.

Additional Insights

The ALJ's decision appears to recognize that the calculation of the credit should properly parallel the income that the New York taxpayer – whether a corporation or an individual – earned and reported because of the QEZE's activity. The personal income taxpayers in this case reported and paid tax on 100% of the income generated by the QEZE, and the entity's business allocation percentage was totally irrelevant to that determination, so there seems to be no reason to refer to such a percentage in calculating the credit.

The ALJ also made it clear that, where the issue is one of pure legal interpretation, the Department's position is not entitled to the usual deference that is paid to its interpretation of the tax laws, since no special expertise on the agency's part is required when the statute itself is unambiguous. When that is the case, the ALJ noted that any administrative practice inconsistent with the statute should be disregarded by the courts.

In addition, while deserving recognition for ingenuity, the Department's argument based on the Privileges and Immunities Clause seems unsupported. That constitutional provision is generally invoked by taxpayers challenging state action, not by states as an affirmative grant of power, and the decision does not reveal whether any precedent was cited by the Department as support for such affirmative use.

INSIGHTS IN BRIEF

Bulk Sale Purchaser Held Liable for Seller's Sales Tax Liability

A New York State Administrative Law Judge has held that a bulk sale purchaser of a liquor store is liable for the seller's existing sales tax liability, up to the greater of the purchase price or fair market value of the assets purchased. Although the purchaser filed a Notice of Bulk Sale with the Department, that notice was untimely filed. Consequently, it did not provide the protections normally available to a bulk sale purchaser that gives timely notice. *Matter of Sky Liquor, Inc.*, DTA No. 823935 (N.Y.S. Div. of Tax App., Mar. 14, 2013).

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N.Y. "Mansion" Tax Held to Be Due on Purchase of Residential Real Property from U.S. Government

In a petition brought to challenge the denial of a refund claim, a New York State Administrative Law Judge held that the New York State "mansion tax" was properly owed by the purchaser of residential real property from the United States Government, which had acquired the property in an asset foreclosure sale relating to a federal tax lien. *Matter of 182-188 Columbus Avenue LLC*, DTA No. 823746 (N.Y.S. Div. of Tax App., Mar. 14, 2013). The purchaser claimed that its purchase from the government was exempt from the tax as a "conveyance given in connection with a tax sale." The ALJ, interpreting the phrase "tax sale" based on its ordinary meaning, found that all tax liens had already been discharged when the purchaser acquired the property, and held that the $8.3 million purchase from the U.S. Government did not qualify for exemption.

New Criminal Charges Allege Scheme to File Fraudulent Tax Returns

On April 12, 2013, the Queens District Attorney and the Commissioner of Taxation and Finance announced that criminal charges had been filed against a Queens CPA and two other individuals, alleging they participated in a wide-ranging plan to file fraudulent returns. According to a press release, more than 350 New York State 2009 tax returns were submitted, seeking more than $6 million in special additional mortgage recording tax credits, which the taxpayers allegedly were not eligible to claim. *Press Release*, District Attorney, Queens County, Apr. 12, 2013. Refunds in the amount of over $317,000 had been paid before the Department discovered the alleged scheme. The District Attorney's office advises that, if convicted, the defendants could face up to 15 years in prison.

Federal Court Dismisses Claims Challenging NYC Property Tax Lien Process

A suit filed in federal court challenging New York City's process for dealing with tax lien sales was dismissed as barred both by the Tax Injunction Act, which prevents actions in federal court to challenge a tax under State laws as long as there is a "plain, speedy and efficient remedy" in State court, and by the doctrine of comity. *Order, Four K. Group, Inc. v. NYCTL 2008-A Trust, et al.*, Nos. 12-2135 & 12-3172, (E.D.N.Y., Apr. 15, 2013), ECF No. 31. The plaintiffs claimed that the City had a "custom and practice" of failing to provide timely and adequate notice of tax lien sales, in order to provide favored parties, also named as defendants, an opportunity to purchase the tax liens that was not available to the plaintiff property owners. However, the court found that the plaintiffs had adequate remedies in state court, and that their claims, which had been adjudicated in state court foreclosure proceedings, could not be raised and reviewed in a federal court.

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