EIGHTEENTH ANNUAL
NEW YORK STATE AND CITY TAX INSTITUTE

INCOME TAX CASES AND OTHER DEVELOPMENTS

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I. Statutory Residency

A. ***Matter of Gaied v. New York State Tax Appeals Trib.*** (___ NY3d ___, 2014 NY Slip Op 1101 [2014])

- New York State's high court holds that in order to treat a person as a statutory resident, there must be some basis to conclude that the taxpayer had a dwelling in New York that "was utilized as the taxpayer's residence."

- The Court observed that the legislative history of the PPA statute (which was previously examined by the Court in *Tamagni*) as well as the Department's own regulations support the view that maintaining a PPA in New York requires that "the taxpayer must, himself, have a residential interest in the property."

- In particular, the Court noted that the statutory residence provision in the law "fulfils the significant function of taxing individuals who are 'really and [for] all intents and purposes . . . residents of the state.'" This legislative history, according to the Court, illustrates that the law was designed to "prevent tax evasion by New York *residents*" (emphasis in original).

- Thus, the Court held that there was no rational basis for the Tax Appeals Tribunal's interpretation that "a taxpayer need not reside in the dwelling but only maintain it."

B. ***Matter of Zanetti*** (Tax Appeals Tribunal, February 13, 2014)

- Statutory residence case focused on what constitutes a "day" for purposes of the 183-day requirement of the statutory residence test.

- Outcome hinged on whether 26 days in 2005 counted towards the 183-day requirement. The taxpayer, a Florida resident, owned a residence in Long Island and either arrived in or departed from New York on each of these 26 days via private jet. The ALJ, citing *Matter of Leach v. Chu*,[1] concluded that these were New York days, thereby rendering him a statutory resident.

- Tribunal affirmed, relying on *Leach*. It rejected the taxpayer's argument that the 26 travel days weren't New York days pursuant to General Construction Law § 19's definition of "day" as a 24-hour period or the definition of a "day" in the revised Black's Law Dictionary.

C. ***Noto v. New York State Dept. of Taxation & Fin.*** (2014 NY Slip Op 30578[U] [Sup. Ct. Suffolk County 2014])

- The taxpayers, domiciled in Connecticut, conceded being statutory residents of New York by virtue of their vacation home and time spent in New York and claimed credits on their 2005 and 2006 returns for taxes paid to Connecticut on income from the exercise of stock options (presumably because of the *Barker* case). The Department disallowed the credits because the income was not derived from Connecticut sources, thereby resulting in tax being assessed in excess of $3.5 million, plus interest, and $1.8 million, plus penalties and interest, for 2005 and 2006, respectively. The taxpayers paid the tax and claimed refunds, which the Department denied.

- The taxpayers commenced declaratory judgment actions for each year in the Suffolk County Supreme Court seeking an order that the statutory residence rules of Tax Law § 605 were unconstitutional, as applied to them. They argued that their income was not derived from New York sources, including income from the exercise of stock options and deferred compensation, and contended that taxing this income would violate the Commerce Clause and fail the "internal consistency test" articulated by the Supreme Court in *Container Corp. of Am. v. Franchise Tax Bd.*,[2] whereby a state's apportionment formula "must be such that, if applied by every jurisdiction, it would result in no more than all of the [taxpayer's] income being taxed." They further argued that the tax imposed violated the Due Process Clause.

- Both parties moved for summary judgment which the court ultimately granted in the Department's favor, finding the taxpayers were not entitled to the credit claimed which is allowable only for income tax paid to another state on

[1] 150 AD2d 842 (3d Dept 1989), *lv dismissed* 74 NY2d 839 (1989) (upholding regulation interpreting a day as "presence within New York State for any part of a calendar day").

[2] 463 US 159 (1983).

income derived from such other state. Since the income at issue was investment income which has no situs, the court held that the taxpayers were not entitled to the credit. Their due process argument was also rejected.

II. Domicile

A. ***Matter of Ingle v. Tax Appeals Trib. of the Dept. of Taxation & Fin. of the State of N.Y.*** (110 AD3d 1392 [3d Dept 2013])

- Domicile case focused on the timing of a taxpayer's domicile change, *i.e*., whether she abandoned her New York domicile and established her Tennessee domicile before or after realizing $2 million in capital gains from a stock sale.

- In 2004, the taxpayer entered into a Tennessee apartment lease term beginning on April 1, realized the capital gain on April 30, but had extended her New York City apartment lease through July. She argued that the extension was necessary due to extensive business travel which prevented her from moving out of the New York apartment before she began living in Tennessee. Taxpayer never offered proof of where she was spending her time in April-June.

- Appellate Division, Third Department, confirmed the Tribunal's decision that she failed to prove by clear and convincing evidence that she had established her Tennessee domicile until July 2004 – after the stock sale.

III. Nonresident Income Allocation

A. ***Matter of Gleason*** (Tax Appeals Tribunal, March 18, 2014)

- Income allocation case focusing on stock options. At issue was gain from the exercise of stock options received by the taxpayer in 2006.

- For years prior to 2006, the taxation of nonresidents' income from exercising stock options was incredibly unsettled as a result of cases such as *Stuckless* and *Rawl*.[3] Much of this confusion was theoretically settled in 2006 when, in response to the *Stuckless* litigation, the Department promulgated a new regulation setting forth a "grant-to-vest" multi-year allocation formula for the taxation of stock option income to a nonresident.[4]

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[3] *Matter of Stuckless*, Tax Appeals Tribunal, August 17, 2006; *Matter of Rawl*, Division of Tax Appeals, December 10, 1998.

[4] 20 NYCRR 132.24.

- On exception, the Petitioner argued that the new “grant-to-vest” regulation is an improper exercise of the Department’s authority in that it retroactively overturned prior Tribunal decisions.

- Tribunal affirmed the ALJ’s determination which upheld the method set forth in the new regulation and rejected the argument that the retroactive enforcement of the regulation was improper.

B. ***Matter of Guffin*** (Division of Tax Appeals, January 23, 2014)

- Petitioner was a California resident during 2007. After timely filing her original 2007 nonresident return, she filed an amended 2007 return on July 20, 2012 claiming a refund of about $23,000 based on a corrected W-2. The refund was denied as untimely.

- She filed a petition protesting the refund denial in which she conceded that it was late-filed but argued that although she didn’t live in New York in 2007, her employer erroneously reported New York wages on her W-2. She further claimed that she relied on tax professionals who told her when she filed the original return that without a corrected W-2, she had to file based on the original W-2, and she was only able to obtain the corrected W-2 from her employer immediately prior to filing the amended return in 2012 – well after the deadline for requesting the refund.

- The Department moved for summary judgment arguing that no question of fact existed as to whether the refund claim was properly denied since it was late-filed. The ALJ sustained the refund denial finding no authority to extend the statute of limitations under Tax Law § 687(a) (*i.e.*, the latter of 3 years from the date the return was filed or 2 years from the date tax was paid) which in her case would’ve required the amended return to have been filed no later than April 15, 2011.

- The Division had affirmatively raised (and rejected) the application of the “special refund authority” in Tax Law § 697(d) in its motion papers, but the Judge declined to address it since the argument was not raised by the taxpayer.

IV. 338(h)(10) Retroactivity

A. ***Burton v. New York State Dept. of Taxation & Fin.*** (978 NYS2d 653, 2014 NY Slip Op 24004 [Sup Ct, Albany County 2014])

- Case involving the sale of S corporation stock by nonresident shareholders pursuant to an IRC § 338(h)(10) election.

- Taxpayers sold their stock in 2007. At the time, Tax Law § 632(a)(2) prohibited this income from being treated as New York source income to a nonresident, as the Tribunal held in *Baum.*[5]

- Section 632(a)(2) was retroactively amended in 2010 to "undo" the Tribunal's decision in *Baum,* and the amendment was made effective to years beginning on or after January 1, 2007.[6]

- Taxpayers argued the amendment violated Article 16, section 3, of the N.Y. Constitution which prohibits New York from taxing the sale of a nonresident's intangible personal property, and that the Department's reliance on the amendment was unconstitutional.

- Notably, the taxpayers withdrew the argument that the retroactive enforcement of the law was unconstitutional, at oral argument.

- Court rejected the taxpayers' argument and held that since the transaction was treated as an "asset sale" per the federal election, taxing the gain "did not run afoul of the constitutional prohibition against taxing a nonresident's intangible personal property."

B. ***Caprio v. New York State Dept. of Taxation & Fin.*** (37 Misc 3d 964 [Sup. Ct. N.Y. County 2012], *rev'd* 2014 N.Y. Slip Op 02399 [1st Dep't April 8, 2014])

- This case was initially heard in N.Y. County Supreme court. The plaintiffs, the Caprios, challenged the retroactive application of the 2010 amendment to Tax Law § 632(a)(2) that dealt with nonresident S corporation shareholders who received installment obligations in exchange for their S corporation stock under I.R.C. § 453(h)(1)(A). The Caprios argued that the retroactive application of the amendment violated their New York and federal due process rights.

- The 2010 amendment to Tax Law § 632(a)(2) that dealt with I.R.C. § 453(h)(1)(A) specifically targeted and intended to overturn a 2009 New York ALJ determination, *Matter of Mintz*. Under I.R.C. § 453(h)(1)(A), an S corporation shareholder who exchanges S corporation stock for installment obligations (in a liquidation to which I.R.C. § 331 applies) received by the S corporation in a sale or exchange, is treated as receiving payment for the sale of stock upon receipt of the installment payments. The 2010 amendment, however, requires nonresident shareholders who receive such distributions of

[5] *Matter of Baum*, Tax Appeals Tribunal, February 12, 2009.

[6] L. 2010, ch. 312, pt. B, § 1.

installment obligations to source the gain recognized on the payments according to the S corporation's business allocation percentage.

- The Caprios, who were nonresidents of New York, sold their S corporation stock in 2007. The Caprios and the buyers both made I.R.C. § 338(h)(10) elections, and the Caprios also received a liquidating distribution of installment obligations in exchange for their S corporation stock under I.R.C. § 453(h)(1)(A).

- In 2012 the Supreme Court determined that the retroactive application of the 2010 amendment to Tax Law § 632(a)(2) did not violate the Caprios' due process rights. The Caprios appealed the Supreme Court's decision, however, and it was recently overturned by the Appellate Division, First Department.

- The First Department applied a 3-factor test (which was reaffirmed in *James Square*) to determine that the retroactive application of the 2010 amendment to Tax Law § 632(a)(2) violated the Caprios' due process rights. The First Department found that (1) the Caprios reasonably relied on the existing law in 2007 to structure their transaction, and had no forewarning of the change made by the 2010 amendment, and (2) that the length of the period of retroactivity (3.5 years) was excessive, and that the 2010 amendment was not curative, and finally (3) that the public purpose for the retroactive application of the 2010 amendment asserted by the Tax Department was not convincing.

V. Tax Shelters

A. ***Matter of Sznajderman*** (Division of Tax Appeals, March 6, 2014)

- Case centered upon whether the 6-year statute of limitations for a deficiency attributed to an "abusive tax avoidance transaction."[7] A secondary issue was whether penalties should be abated.

- An "abusive tax avoidance transaction" is defined as "a plan or arrangement devised for the principal purpose of avoiding tax."[8] Notably, as the ALJ observed, the taxpayer – not the Department – bears the burden of proving the transaction in question was not an "abusive tax avoidance transaction."

- The transaction related to an investment in an oil and gas well drilling partnership which hired drilling contractors using "turnkey contracts" where

[7] Tax Law § 683(c)(11)(B) (extending the statute of limitations to 60years from the time the return is filed).

[8] Tax Law § 683(c)(11)(C).

the driller was paid a fixed fee for their work, regardless of the contractor's actual expended costs. To account for the risk up unanticipated costs, a markup is built into each contract – in this case, the markup was 500%. The Petitioner and other partners assumed a loan to finance the turnkey contract.

- Following an audit of the partnership, the Department disallowed certain intangible drilling cost ("IDC") deductions and issued the Petitioner an assessment for the resulting tax for his distributive share. The assessment was issued on March 14, 2008 which was more than 3-years but less than 6-years from the filing date of his 2001 return.

- The petitioner protested the assessment, arguing that the transaction did not implicate the 6-year statute of limitations and therefore the assessment was time barred. At the hearing, the Department's expert witness established that the industry standard for turnkey contracts was a markup of 10-25%. This, the Department argued, rendered the 500% markup in the turnkey contract in question unreasonable which, in turn, rendered the investment an abusive tax avoidance transaction.

- Despite finding that the structure of the investment created genuine debt to the partners, the ALJ held that the transaction was subject to the 6-year statute of limitations, finding that no credible evidence was introduced to counter the Department's evidence in order to show that the 500% markup was reasonable. Consequently, the ALJ determined that the Petitioner failed to meet his burden of proving that the related IDC expenses generated from the contract and claimed as deductions were reasonable and not abusive. Thus, the assessment was upheld.

VI. Empire Zones

A. ***Matter of Batty and Pennefeather*** (Division of Tax Appeals, April 4, 2013)

- ALJ determined that resident owners of flow-through entities are entitled to a tax reduction credit (the "TRC") based on the tax paid to New York on all income that flowed-through to them to them from the entity.

- Department had unsuccessfully argued that the TRC was available only for the portion of their income that would have been deemed to have been "New York source income" had they been taxed as nonresidents.

- Department did not appeal the ALJ's determination – but is not acquiescing to it either.

B. ***Matter of Henson and Hamel*** (Division of Tax Appeals, April 10, 2014)

- Issue was the same as *Batty*, i.e., whether a resident shareholders of a New York S corporation are entitled to the TRC based on the tax paid to New York on all income that flowed-through to the shareholder from the corporation. The ALJ cancelled the assessment based on the same rationale as was outlined in *Batty.*

C. ***James Sq. Assoc. LP v. Mullen*** (21 NY3d 233 [2013])

- The Court of Appeals struck down the retroactive imposition of 2009 amendments to the General Municipal Law that introduced new criteria that businesses needed to meet in order to retain their Empire Zone Program Certificates of Eligibility.

- The amendments that added the decertification criteria were proposed in April, 2009, and made retroactive to January 1, 2008. The retroactivity provision was not initially added to the enacted amendments, but the legislature officially made the amendments retroactive to January 1, 2008 in August, 2010. Thus, the plaintiffs argued that the period of retroactivity was 32 months, while the defendants argued that the amendments were only made retroactive 16 months.

- Applying a three-part factor test, the Court determined the retroactive application of the 2009 amendment violated the plaintiffs' due process rights. The Court's holding was based on the fact that (1) the plaintiffs had no forewarning of the amendments (and couldn't have structured their affairs accordingly) and reasonably relied on the receipt of tax benefits under the prior program requirements, (2) the period of retroactivity was excessive (regardless of whether it was 16 or 32 months), and (3) there was no valid public purpose to warrant the retroactive amendments.

VII. Other Developments

A. **Enforcement of Delinquent Tax Liabilities Through the Suspension of Drivers' Licenses** (Tax Law § 171-v)

- 17,700 New Yorkers were notified that their licenses were at risk of being suspended due to their tax liabilities in August 2013.

- On March 17, 2014, Governor Cuomo announced that 8,900 New York drivers' licenses have been suspended under for outstanding tax liabilities.[9]

[9] "*Governor Cuomo Announces Initial Results of Tax Scofflaw Driver License Suspension Initiative*," http://www.governor.ny.gov/press/03172014-drivers-license-suspension-initiative.

- The Department attributes tax collections of $56.4 million to the program.

B. **Tax Return Preparer Penalties** (Tax Law §685[aa])

- Imposes penalty of up to $1,000 for each return prepared by a preparer which either understates the tax liability or seeks a refund if the return is:

    1. "due to a position for which there was not a reasonable belief that the tax treatment in that position was more likely than not the proper treatment,"[10]

    2. if the preparer "knew (or reasonably should have known) of such position," and the position was either undisclosed or "there was no reasonable basis for the tax treatment of that position,"[11]

    3. *UNLESS* "it is shown that there is reasonable cause for the understatement and such person acted in good faith."[12]

- Imposes penalty of up to $5,000 for each return prepared by a preparer which either understates the tax liability or seeks a refund if the return is due to either:

    1. "a willful attempt in any manner to understate the liability for tax by a person who is a tax return preparer with respect to such return or claim,"[13] or

    2. "any reckless or intentional disregard of rules or regulations by any such person."[14]

- The penalty is deemed expired and repealed on July 1, 2015.

- Regulations promulgated in December 2013 for regulating unlicensed tax return preparers.[15]

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[10] Tax Law § 685(aa)(1)(A).

[11] Tax Law § 685(aa)(1)(B).

[12] Tax Law § 685(aa)(1)(C).

[13] Tax Law § 685(aa)(2)(A).

[14] Tax Law § 685(aa)(2)(B).

[15] 20 NYCRR Part 2600.

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