NY Tax Minutes: City Finances, Transparency, Tribunal Rulings

By **Timothy Noonan and Craig Reilly** (September 17, 2019, 1:37 PM EDT)

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August is often a slow month in the state and local tax world, with attorneys, accountants and auditors looking to squeeze the last bit out of summer. But not everyone at the New York State Tax Department took a break this month. And our most seasonally appropriate update comes from the Tax Department's August appearance at The Great New York State Fair in Syracuse, New York.[1]

This year, the Department arrived with a "myth-buster wheel" that allowed fair-goers to respond to tax pointers as either "myth" or "fact," with the chance to win a folder to help organize their tax documents. And while the Tax Department's new commissioner, Michael Schmidt, admitted that the department likely couldn't "compete with all the thrills, entertainment and delicacies at this great venue," good on the Tax Department for getting out in the public and trying to add a little excitement and accessibility to New York state taxes.

As for those of you who couldn't make it to this year's fair, not to worry, we're here with our regular flow of tax updates from the past month. This month, we highlight the New York state comptroller's review of New York City's financial plan for the fiscal years covering 2020 through 2023. We also outline the state's new legislation, requiring industrial development agencies to livestream and post video recordings of all open meetings and public hearings. Finally, we check in on the past month's noteworthy state tax decisions and opinions, including three noteworthy decisions from the Tax Appeals Tribunal.

The Headlines

New York State Comptroller Reviews New York City Financial Plan

As the state's chief financial officer, State Comptroller Thomas DiNapoli has the constitutional and statutory responsibility of monitoring the finances of New York City. With that responsibility, the comptroller recently released his latest report,[2] reviewing the city's financial plan for the fiscal years 2020 through 2023.

According to the report, "New York City is currently experiencing the largest and longest job expansion in the post-World War II period," which has "made balancing the budget easier in recent years." But although the city ended fiscal year 2019 with a surplus of $4.2 billion, the report still warns that the city's current planned spending for fiscal years 2020 through 2023 "may not be sustainable during a prolonged economic downturn." And on that front, the report notes that many "economists believe the risk of a national recession has grown as a result of increased trade tensions and slower global economic growth."

In the absence of a major economic setback, however, the report predicts that tax collections will likely exceed the city's forecasts, helping the city to address any future budget shortfalls. The city predicts tax collections growing from $63.4 billion in fiscal year 2020 to $69.1 billion in fiscal year 2023, including anywhere from $999 million to $721 million in tax audit revenue. Interestingly, the city predicts a more than 25% decrease in tax audit revenue collection during these years. The comptroller, however, believes that it is "likely that audit revenue will exceed the City's estimates for these years."

Within the report's tax projections, the comptroller notes that "[a]lthough personal income tax collections are projected to resume growing in FY 2020 [after a slight decrease in FY 2019], the [city's plan] projects an increase of only 1%, much less than the average of 7.1% during fiscal years 2010 through 2017." The reasons for this slow down, according to the report, include "changes in federal tax policies that affected taxpayer behavior [i.e., the state and local tax deduction cap], and swings in Wall Street bonuses and capital gains."

On the business tax front, the report focuses on the city's business corporation tax, which the report notes was "created in April 2015 through state legislation that combined the City's banking and general corporation taxes." Although the report indicates that the change was "intended to be revenue-neutral," collections "declined and fell short of expectations" in the years immediately after the change. In fiscal year 2019, however, the report indicates that collections "rebounded, increasing by 15.4% to reach nearly $4 billion, the highest level in four years."

IDAs Required to Livestream All Open Meetings and Public Hearings

On Aug. 27, Gov. Andrew Cuomo signed new legislation requiring industrial development agencies, or IDAs, to livestream and post video recordings of all open meetings and public hearings. When first proposed, the legislation applied only to meetings at which payment-in-lieu-of-tax agreements, which give developers property tax breaks, were discussed. But the final version of the bill passed by the state senate and assembly applies to all open meetings and public hearings held by the agencies.

Under New York's General Municipal Law, an IDA is a public benefit corporation engaged in the promotion of economic development in its local community. As such, IDAs are authorized to undertake projects and to appoint agents or project operators to develop projects that will benefit economic development. IDAs can then provide financial assistance to their agents, including sales and property tax exemptions.

According to the governor's press release,[3] while IDAs "are tasked with revitalizing communities and fostering economic growth at the local level ... most New Yorkers don't have time to attend meetings and participate in the process." The new law is therefore intended to "help foster civic engagement and get more residents involved in the meetings and hearings that will ultimately have a huge impact on the future of their communities."

Under the state's new rule, video recordings must be posted online within five business days of the meeting or hearing and remain available for at least five years. The new law takes effect on Jan. 1, 2020.

The Cases

Each month, we highlight new and noteworthy cases from New York State's Division of Tax Appeals and Tax Appeals Tribunal, along with any other cases involving New York taxes.

This month, we cover the Tax Appeals Tribunal's review of sales of scrip currency at a New York City adult entertainment club; the tribunal's denial of an animal welfare trust's claim of exemption from real property transfer taxes; and the tribunal's review of the proper sourcing of digital service receipts under the state's pre-2015 cost-of-performance souring rules. We also highlight a recent administrative law judge determination, which addressed whether in-state vacation homes qualify as permanent places of abode under the state's statutory residency test.

Tax Appeals Tribunal Finds Adult Entertainment Scrip Taxable at Time of Purchase

In Matter of The Executive Club LLC,[4] the Tax Appeals Tribunal reviewed whether the receipts from a New York City adult entertainment club's sales of executive dollars — a kind of scrip utilized by the business — were subject to sales and use tax at the time of purchase, or, alternatively, at the time the scrip was redeemed.

The scrip currency at issue in the tribunal's decision was purchased by patrons inside the club in order to pay entertainers for private dances and other services. The club levied separate admission charges on patrons entering the club, on which the club already charged and collected tax. But the club believed that its scrip sales did not qualify as taxable admission charges.[5]

The club instead argued that its "executive dollars are essentially the equivalent of gift cards and thus, the taxation of the receipts from the sales of executive dollars are not taxable when sold, but upon the redemption of the executive dollars for taxable items."

In New York, gift cards, whether given away for no charge or sold to a customer, are generally not subject to sales tax at the time of sale. But when the gift certificate is used, sales tax is charged if a taxable purchase is made. This distinction was important to the petitioner in Executive Club, as the club argued that patrons could redeem their executive dollars for both taxable and nontaxable services, such as tips and gratuities paid to the entertainers.

In issuing its decision, the tribunal noted that it had previously ruled that similar types of scrip can be taxed as receipts for entrance to a place of amusement. The tribunal acknowledged, however, that its prior decisions did not address the issue of whether the dollars were subject to tax at the time of purchase by the customer, or, alternatively, at the time of redemption.

The tribunal therefore analyzed the issue here and rejected the petitioner's claim that the executive dollars were intangible property, similar to gift cards. The tribunal therefore held that the sales of scrip were taxable admission charges, with the tax due at the time of purchase.

It's not surprising that the tribunal maintained its historic position that scrip can be taxed as receipts for entrance to a place of amusement. But on the issue of when the tax is due, we found the tribunal's analysis a little light.

Specifically, we can't help but wonder whether a loyalty program that existed outside of the adult entertainment industry would have receive the same treatment. Take, for example, the following hypothetical from the Tax Department's bulletin on sales by restaurants, taverns and similar establishments.[6]

Mr. W. comes into your restaurant and purchases a $25 gift certificate for his parents' anniversary. When Mr. W. purchases the gift certificate, the sale of the certificate is not subject to sales tax. Mr. W's parents come in to the restaurant to eat, and after the meal, the wait person gives them their check for a total of $22.13 for food, beverages and sales tax. The purchase of the gift certificate was not subject to sales tax, but the purchase of food and beverages is subject to the tax. Mr. W's parents can use the gift certificate to pay the entire bill including the sales tax.

Is this example, in which the customer purchases an intangible to be used at a later date in order to acquire taxable goods and services, not the same as a customer in the petitioner's club purchasing executive dollars that they may later redeem for services related to their admission to a place of amusement?

Tax Appeals Tribunal Denies Animal Welfare Trust's Real Estate Transfer Tax Refund Claim

In Matter of the Estate of Phyllis Millstein,[7] the Tax Appeals Tribunal denied a charitable trust's claim for a refund of real estate transfer tax on the sale of a $15.6 million Upper East Side townhouse.

The trust, known as the Irving and Phyllis Millstein Charitable Trust for Animals, was both exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code and exempt from New York State sales and use taxes. But, as explained by the tribunal, the only entities exempt from the state's real estate transfer tax are (1) "The state of New York, or any of its agencies, instrumentalities, political subdivisions, or public corporations…" and (2) "The United Nations, the United States of America and any of its agencies and instrumentalities."[8] Other tax exempt entities remain on the hook for real estate transfer taxes.

The trust attempted to argue that it was properly exempt from the payment of real estate transfer tax because it was an agency or instrumentality of both New York and the federal government. According to the trust, it was "closely related to the government since the goal and purpose of the trust [i.e., animal welfare] is in alignment with the public policy of the state of New York and the United States." And the trust claimed that "the financial burdens of the government are reduced by the work of the trust." Based on this reasoning, the trust argued that it was acting on behalf of the government and should therefore be entitled to the same tax benefits.

The tribunal rejected the trust's claims, however, noting that, under agency law, "[t]he authorization of the principal is necessary to establish an agency relationship." And, according to the tribunal, "[w]hile the public policy of the federal and state governments may be to support the protection and welfare of animals; while the trust funding may reduce the financial burdens placed upon the government; and while the public-at-large may benefit from the work of the trust, there is no evidence indicating that any governmental body specifically authorized the trust to act 'on its behalf' as an agency or instrumentality." In other words, no good deed goes unpunished.

Tax Appeals Tribunal Sources Digital Service Receipts Out of State Based on Cost of Performance

In Matter of Catalyst Repository Systems Inc.,[9] the Tax Appeals Tribunal ruled that receipts from digital services, including what the tribunal labeled as "other business receipts," should be sourced to where the work is performed and not to where customers are located. Although the importance of the tribunal's decision is limited by the state's 2014 **shift to market-based sourcing**, for precorporate tax reform years (and for purposes of New York City's general corporation tax), a decision requiring corporations to source “other business receipts” to where the work gets done qualifies as a seismic event.

The petitioner in the Catalyst decision was a Colorado-based litigation support business that provided electronic document storage and management. It took the position that its receipts were not from New York sources, as the receipts qualified as service receipts, which, under the state’s pre-2015 franchise tax statutes, were sourced using a “where performed” analysis. On audit, the Audit Division took the position that the petitioner engaged in an unclassified nonservice activity that generated “other business receipts,” and that those receipts should be sourced in and out of New York based on the location of the business’s clients.

Initially, an administrative law judge disagreed with the division’s view that only personal services could give rise to service receipts. The ALJ found that the litigation support services performed by the petitioner were, well, services, the receipts from which were to be sourced using the “where performed” approach.

On appeal, the Tax Appeals Tribunal affirmed the ALJ’s determination, but the tribunal’s analysis is something new. Contrary to the ALJ’s determination, the tribunal found that the petitioner did not sell services. Instead, the tribunal found that the petitioner provided a license to use intangible property (i.e., its litigation support software platform) and that the receipts therefore qualified as “other business receipts.” The tribunal found support for its conclusion in the form of the agreement that the petitioner used, which did not mention services but, instead, required clients to pay for the right (i.e., a license) to access and use the litigation support system.

The tribunal’s finding that the receipts qualified as “other business receipts” should have been a cause for concern for the petitioner, as several prior advisory opinions issued by the Tax Department indicate that receipts from digital service transactions are to be sourced to the customer’s location. But instead of finding the receipts subject to customer-based sourcing, the tribunal ruled that the location where an “other business receipt” is earned is “the location of the work that resulted in the income.”

This, in essence, is the same as the “where performed” standard applied to service receipts. So, to the tribunal, it wasn’t particularly relevant whether the receipt was from a service or from an “other business receipt,” since, in either case, the receipts were sourced to Colorado.

The tribunal’s decision disregards a long line of nonbinding advisory opinions, which previously found that other business receipts must be sourced to the location of the taxpayer’s customers. And the tribunal specifically noted that “the cited advisory opinions are not persuasive because they offer no statutory or regulatory justification for the conclusion that receipts for digital transactions as described in the opinions are properly sourced to the customer’s location; they simply assert it.” Moreover, the tribunal rejected the division’s claim that the state’s 2015 shift to customer-based sourcing was consistent with the long-standing purpose of the receipts factor.

According to the tribunal, it should instead be “presumed that the corporate tax reform amendments affected a material change in the law.” And citing to the memorandum in support of the corporate tax reform legislation, the tribunal noted that the legislative history “describes customer sourcing in contrast to the then-current sourcing rules.” Accordingly, the tribunal found that the corporate tax reform provisions, effective for taxable years commencing on or after Jan. 1, 2015, supported its interpretation of the former tax law.

But for the fact that New York's tax law was changed effective 2015 to make the distinction between unclassified service receipts and other business receipts largely academic (both are now subject to market-based sourcing), the tribunal's decision would have qualified as a major development. As it stands, the case still may have huge implications for tax years prior to 2015 and for federal S corporations paying New York City's general corporation tax, which still follows the pre-2015 sourcing rules.

Administrative Law Judge Treats Vacation Home as Permanent Place of Abode

In Matter of Coulson,[10] an administrative law judge from the Division of Tax Appeals found that the taxpayers' upstate vacation property qualified as permanent place of abode, such that the taxpayers qualified as statutory residents of the state.

The taxpayers in Coulson were domiciled in New Jersey, but one of the taxpayers, Nelson Obus, worked full-time in New York City and, accordingly, was in New York State more than 183 days per year. At the end of 2011, the taxpayers purchased a vacation home in Northville, New York, which was roughly a three-and-a-half-hour drive from New York City. The Northville home was used exclusively for vacations by the taxpayers, and everyone agreed that those vacations totaled no more than two or three weeks per year.

The Audit Division audited the taxpayers, taking the position that because the Northville home constituted a permanent place of abode, and because Obus spent more than 183 days in New York, he qualified as a "statutory resident" of New York State, required to pay New York state personal income tax on all of his income and not just on his New York-source wage income.

The taxpayers argued that, for purposes of the state's statutory residency test, they did not "maintain a permanent place of abode," which is a requirement under Section 605 of New York's tax law. In particular, the taxpayers argued that the presence of a full-time tenant in a separate building on their Northville property indicated that the property was maintained for the benefit of the tenant and not for their exclusive benefit. The ALJ, however, found that the tenant's use of the separate building did not affect the taxpayers' use of their Northville home. We tend to see where the judge was coming from on this issue.

But where we disagree with the ALJ is in her review of the New York State Court of Appeals decision in Matter of Gaied. The ALJ held that "Gaied simply does not apply to the facts of this case." And the ALJ appeared to base her finding on the factual distinctions between the two cases (Gaied involved an abode that was owned for the benefit of the taxpayer's parents).

Nevertheless, the ALJ also quoted the following language from the Court of Appeals' decision: "The legislative history of the [statutory residency] statute, to prevent tax evasion by New York residents, as well as the regulations, support the view that in order for a taxpayer to have maintained a permanent place of abode in New York, that taxpayer must, himself, have a residential interest in the property."[12]

Our interpretation of the importance of this language from Gaied is different from the judge's. In particular, we see Gaied as very applicable in that the "residential interest" requirement mentioned by the Court of Appeals must be viewed in light of the court's statement that New York's statutory residency rules were "created to prevent tax evasion by New York residents." Obviously, the Court of Appeals was not referring to tax evasion by statutory residents, because asserting that the Legislature created statutory residency to prevent tax evasion by statutory residents doesn't make sense.

Instead, the Court of Appeals was saying that the statutory residency rules were created to combat tax evasion by domiciliary residents who maintained a permanent home in New York but claimed faux-tax residence elsewhere. When viewed in this light, it seems natural to view the court's "residential interest" language as requiring the use of the abode in question like one would use his or her own home. And, in our opinion, two to three weeks per year of vacation use does not make an abode a home.

We also note that the Tax Appeals Tribunal has previously laid out a post-Gaied framework for the residential interest test. In Matter of Mays,[13] the tribunal noted that even when taxpayers have the legal right to occupy dwellings that exhibit the physical characteristics ordinarily found to be suitable for year-round habitation, Gaied now requires a further showing that the taxpayer actually "exercised that right by enjoying his or her residential interest in that dwelling." The ALJ in Coulson did not cite the tribunal's Mays decision, and we again question whether spending a few weeks per year at a vacation home qualifies as enjoying a "residential interest in that dwelling."

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Disclosure: Timothy Noonan represented the appellant, John Gaied, in his appeal to the New York State Court of Appeals in Matter of Gaied.

[1] https://www.tax.ny.gov/press/rel/2019/nysfair082319.htm.

[2] https://s3.amazonaws.com/pdfs.taxnotes.com/2019/2019-30329_STTDocs_NYcomp_080119FinPlanNYCpdfonly.pdf.

[3] https://s3.amazonaws.com/pdfs.taxnotes.com/2019/2019-32982_STTDocs_NYgovPR_082719LegislationIDAs.pdf.

[4] Matter of The Executive Club LLC, DTA Nos. 827313, 823315, 827317, https://www.dta.ny.gov/pdf/decisions/827313.dec.pdf.

[5] New York state imposes sales and use tax on "[a]ny admission charge where such admission charge is in excess of ten cents to or for the use of any place of amusement in the state, except charges for admission to race tracks or combative sports which charges are taxed under any other law of this state, or dramatic or musical arts performances, or live circus performances, or motion picture theaters, and except charges to a patron for admission to, or use of, facilities for sporting activities in which such patron is to be a participant, such as bowling alleys and swimming pools." N.Y. Tax Law § 1105(f)(1).

[6] https://www.tax.ny.gov/pdf/tg_bulletins/sales/b19-806s.pdf.

[7] Matter of the Estate of Phyllis Millstein, DTA No. 827359, https://www.dta.ny.gov/pdf/decisions/827359.dec.pdf.

[8] N.Y. Tax Law § 1405(a).

[9] Matter of Catalyst Repository Systems, Inc., DTA No. 826545, https://www.dta.ny.gov/pdf/decisions/826545.dec.pdf.

[10] Matter of Coulson, DTA No. 827736, https://www.dta.ny.gov/pdf/determinations/827736.det.pdf.

[11] Gaied v. New York State Tax Appeals Tribunal, 22 N.Y.3d 592, 596 (2014).

[12] Matter of Mays, DTA No. 826546, https://www.dta.ny.gov/pdf/decisions/826546.dec.pdf.