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TRIAL COURT HOLDS THAT FEES RELATED TO THE NEW YORK HIGHWAY USE TAX ARE UNCONSTITUTIONAL

By Michael J. Hilkin

In a class action lawsuit, an Albany County trial court held that flat highway use registration and decal fees charged to heavy motor vehicles operating on New York public highways discriminate against non-New York based businesses in violation of the Commerce Clause of the U.S. Constitution. *Owner Operator Indep. Drivers Ass'n et al. v. N.Y.S. Dep't of Taxation and Fin.*, No. 5551-13 (N.Y. Sup. Ct., Albany Cnty. Jan. 22, 2016). The trial court declared the registration and decal fees unconstitutional even though they amount to only $15.00 and $4.00, respectively, and are charged once every three years.

New York Highway Use Tax and Fee Scheme. New York imposes a highway use tax "for the privilege of operating" certain heavy vehicles (such as semi-trailers) on New York highways. Tax Law § 503(1). The highway use tax is based on the gross weight of a vehicle and the number of miles such vehicle is operated on New York highways. The highway use tax was not at issue in the *Owner Operator* case.

Carriers with vehicles subject to the highway use tax must apply for a certificate of registration and pay a $15.00 fee (Tax Law § 502(1)(a)). The New York State Department of Taxation and Finance (the "Department") is also authorized to "require the use of decals as evidence that a carrier has a valid certificate of registration," and charge $4.00 for each decal (Tax Law § 502(6)(a)). While the Department is authorized to issue replacement certificates of registration or decals once every year (Tax Law § 509(8)), it instead issues certificates of registration and decals in series, each of which has always been valid for at least a three-year period. According to the Department, the purpose of the registration and decal fees is to enforce and ensure compliance with the highway use tax.

Case Background and Decision. The plaintiffs filed a complaint in New York Supreme Court (a trial court) seeking injunctive and declaratory relief and a refund of registration and decal fees. The complaint alleged, among other things, that the registration and decal fees constituted an undue burden on interstate commerce in violation of the Commerce Clause because they imposed a higher per mile tax rate on out-of-state trucks.

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In an earlier decision, the trial court certified the case as a class action lawsuit, including in the class interstate motor carriers residing outside of New York State that paid the registration and decal fee and are now, or may in the future be, liable for such fees. Now, the trial court has held that the registration and decal fees violate the Commerce Clause and has enjoined the Department from implementing or enforcing such fees against the plaintiffs.

The trial court's analysis primarily relied on the U.S. Supreme Court's decision in *American Trucking Associations, Inc. v. Scheiner*, 483 U.S. 266 (1987). In *American Trucking*, the Court ruled that two flat taxes imposed by Pennsylvania on commercial users of its highways violated the Commerce Clause. Pennsylvania imposed an annual $25.00 fee for an identification loan marker exclusively on out-of-state vehicles, and also imposed an annual $36.00 per vehicle axle fee on in-state and out-of-state vehicles. The Court in *American Trucking* stated that the marker fee had the practical effect of imposing flat taxes at a cost five times as high per mile for out-of-state vehicles than for local vehicles, and the axle fee similarly exerted "inexorable hydraulic pressure on interstate businesses" to do business within the state enacting such a fee rather than among several states. While the Court in *American Trucking* agreed that the Commerce Clause does not require states to avoid flat taxes "when they are the only practicable means of collecting revenues from users and the use of a more finely gradated user-fee schedule would pose genuine administrative burdens," the Court concluded that such justification was not applicable to the Pennsylvania taxes under consideration.

The trial court in *Owner Operator* treated the registration and decal fees as state taxes subject to Commerce Clause scrutiny. The trial court found, based on interrogatory responses, deposition testimony, and an expert affidavit that, in fiscal years 2013 and 2014, the cost per mile for New York's registration and decal fees was about 4 to 5 times greater for non-New York based businesses than it was for New York based businesses. This evidence demonstrated that the registration and decal fees have a discriminatory impact on interstate commerce.

The Department did not submit any evidence disputing the discriminatory effect of the registration and decal fees and instead argued that the fees were below the level that any court had ever considered worthy of Commerce Clause scrutiny. The trial court, however, stated that a fee's constitutionality cannot turn on the "*amount* of the flat fees charged" and pointed out that "the U.S. Supreme Court has rejected the notion of a 'de minimus' defense to an allegation that a tax is discriminatory under the Commerce Clause."

The Department also argued that the registration and decal fees could not practically be apportioned, because the miles traveled on New York highways by any covered vehicle is not known until the relevant highway use tax return is filed. The court, however, stated that it could "envision several ways that registration and decal fees can be apportioned," including by providing credits on highway use tax returns based on annual mileage traveled in New York by a vehicle subject to the fees.

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The court in *Owner Operator* highlighted that its decision is consistent with other state court decisions issued after *American Trucking* by Alabama, Maine, and Maryland courts, each of which struck down unapportioned flat fees similar to those at issue in *Owner Operator*. Those other state cases involved challenges to fees ranging from $12.00 to $25.00 a year. Collectively, such decisions show that even seemingly nominal fees are subject to scrutiny under Commerce Clause principles. It is not yet known whether the Department will appeal the decision in *Owner Operator*.

Separately, the procedural posture of the *Owner Operator* case is notable. While the vast majority of New York State tax cases originate in the New York State Division of Tax Appeals (New York's administrative tax appeals system), the plaintiffs in *Owner Operator* brought their case directly to the New York Supreme Court. While not discussed in the summary judgment decision, the plaintiffs' action was likely allowed to proceed because it involves a constitutional challenge to the basic applicability of a New York tax statute and seeks declaratory and injunctive relief, circumstances in which taxpayers may not be required to exhaust administrative appeals before going to court. Further, *Owner Operator* is a rare example of a class action lawsuit successfully brought against the Department. As a result of the unique procedural posture, if the decision is not reversed on appeal, further proceedings may be necessary to address damages, class administration, and attorneys' fees.

REFUND CLAIMS TIME-BARRED DESPITE UNCONSTITUTIONAL STATUTE

By Hollis L. Hyans

A New York State Administrative Law Judge has held in eight separate decisions that several owners of limited partnership interests could not claim refunds for credits under the State's Qualified Empire Zone Enterprise ("QEZE") program for real property taxes, even though

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the Department's retroactive application of amendments to the statute denying the credits had been found unconstitutional due to the claims were not being timely asserted. *Matter of Dorothy Krause F/B/O Angela Krause et al.*, DTA Nos. 826752-826759 (N.Y.S. Div. of Tax App., Feb. 4, 2016).

Facts. Each of the petitioners in the eight related matters (referred to as the "Owners") owned an interest in 450 South Salina Street Partnership ("450 South Salina") as a beneficiary of the Alfred F. Krause Family Benefit Trust (the "Trust"). 450 South Salina owns and operates real property in Syracuse, New York, and invested more than $4.2 million to acquire and renovate the property. 450 South Salina filed a New York State Partnership Return for 2008, claiming a QEZE credit for real property taxes of approximately $142,000. The return included a New York Partner's Schedule K-1 for the Trust, allocating to the Trust a portion of the QEZE credit for real property taxes.

The ALJ upheld the Department's denial of the refunds, finding that the amended tax returns were all filed after the expiration of the three-year statute for claiming refunds.

In April 2009, the New York Legislature enacted modifications to the law governing QEZE-certified businesses, requiring all such businesses to verify that they qualified for continued certification under new criteria, in order to receive benefits for years beginning on or after January 1, 2008. The Department issued technical advice requiring individuals claiming credits through a pass-through entity, such as a partnership, to file an EZ Retention Certificate with their tax returns claiming a QEZE Credit for tax years beginning after January 1, 2008. *Legislative Changes to the Empire Zone Program*, TSB-M-09(4)I, TSB-M-09(5)C (Dep't of Taxation & Fin., Apr. 15, 2009). In April 2009, the Department also modified its Form IT-606, Claim for QEZE Credit for Real Property Taxes, for the 2008 year, to include a new instruction requiring the attachment of a retention certificate.

In June 2009, the Department of Economic Development revoked the certification of 450 South Salina, claiming it did not provide economic returns greater in value than the tax benefits it received. 450 South Salina appealed the Notice of Decertification, and a copy of that appeal was provided to the Assistant Deputy Commissioner of the Department of Taxation and Finance. In its appeal, 450 South Salina argued that the amendment to the Tax Law was unconstitutional and that continued certification was warranted. The appeal was denied by the Empire Zone Designation Board in the fall of 2009.

Each Owner filed New York State personal income tax returns for 2008, at a time after TSB-M-09(4)I was issued, and after 450 South Salina received notice of revocation. Each Owner believed he or she was legally barred from claiming the QEZE credit.

In 2013, as discussed in the July 2013 issue of New York Tax Insights, the Court of Appeals held in *James Square Associates L.P. v. Mullen,* 21 N.Y.3d 233 (2013), that the Department's retroactive application of the 2009 amendments was unconstitutional, and that revocations of certifications made retroactive to January 1, 2008, were void.

In 2013, the Owners all filed amended New York State personal income tax returns for 2008, claiming the QEZE credits for real property taxes. All the claims were disallowed, on the grounds that the amended returns were untimely.

ALJ Decision. The ALJ upheld the Department's denial of the refunds, finding that the amended tax returns were all filed after the expiration of the three-year statute for claiming refunds. While recognizing that informal claims for refunds might be sufficient, here the ALJ rejected the arguments of the Owners that they had provided informal refund claims, either by filing a partnership return with a Schedule K-1 showing distributions to them, or by providing a copy of the appeal of 450 South Salina's Notice of Decertification to an official of the Department. The ALJ held that neither submission amounted to an informal refund claim, relying on a federal case, *Rothman v. United States*, 75-2 U.S.T. C. (CCH) ¶ 9720 (D. N.J. 1975), which found that a protest by a partnership is not considered an informal claim for a refund by a partner.

The Owners argued that they had been prevented from filing returns claiming the QEZE credit by TSB-M-09(4)I and the enactment of the new statute, and that any such claims for credits would have involved filing a false or fraudulent return. The ALJ found that argument "without merit," since a taxpayer may file a protective claim to protect an interest as long as the claim fully discloses the facts, nature and basis for the protective claim. The ALJ also rejected the argument that the denial of the refunds violated the constitutional requirement for "meaningful, backward-looking relief" for constitutional violations, as set forth by the U.S. Supreme Court in *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18 (1990), finding that New York's system of allowing timely claims for refund satisfies the Due Process Clause.

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These cases highlight the importance of filing timely claims for refund on a protective basis whenever a taxpayer believes a statute is being improperly applied. Litigation challenging the Department's position can take many years to resolve, particularly when a constitutional issue is involved, and, even when a statute is ultimately declared unconstitutional, New York law includes no provision for a blanket extension of the ordinary statute of limitations while issues are being litigated or when a statute is found to be unconstitutional. Taxpayers who decide to wait while litigation in a "lead case" proceeds should be sure to protect their interests with timely refund claims.

POWER PLANT'S VOLTAGE STEP-UP TRANSFORMERS HELD TO QUALIFY FOR SALES TAX EXEMPTION

By Irwin M. Slomka

The scope of the sales tax exemption for machinery or equipment used in production has been a vexing issue, including the question of when the production process ends and the distribution process begins. A recent New York State Administrative Law Judge decision helps provide some clarity in the case of electricity producers and raises questions about the Department's policy as expressed in at least one Advisory Opinion. The decision holds that the owners and operators of nuclear power plants that produce electricity were entitled to the production exemption from sales tax on their purchases of step-up transformers and related costs because the transformers were used directly and predominantly to produce electricity for sale. *Matter of Entergy Nuclear Operations, Inc. et al.*, DTA No. 826017 et al. (N.Y.S. Div. of Tax App., Jan. 28, 2016).

Facts. The case involves several subsidiaries of Entergy Corporation that own and operate three nuclear power plants in New York, two of which are at Indian Point. The plants produce electricity for sale solely to electricity wholesalers and utilities. At issue was whether the operators' purchase and installation of "step-up transformers," as well as costs for maintenance and/or repair services for the transformers, were subject to sales tax. The underlying question was whether the production of electricity for sale ended when the electricity exited the generators (in which case the transformer is solely for distribution and therefore taxable) or whether production includes the process of stepping-up the electricity so that it can be sold to the purchasers through the electricity transmission system. The ALJ reached the latter conclusion and held that the transformers were exempt from sales tax.

[S]ince the electricity could only be sold to customers at specific voltage levels, the voltage level was an integral part of the product sold, which the step-up transformers were directly and predominantly used to create.

The decision discusses the restructuring of the electricity industry in New York State beginning in the 1990s. In 1998, the New York Independent Service Operator ("NYISO"), a not-for-profit corporation, was formed to manage New York's wholesale electricity market and to oversee the State's electricity transmission system. The transmission system is a series of high-voltage lines and interconnections owned by various transmission companies, including the New York Power Authority and Con Edison.

The decision goes into considerable detail concerning how electricity is produced at a nuclear power plant. Electricity produced for sale at the power plants issue must be input into the transmission system. The transmission system operates at a voltage of 345 kV, as determined by the NYISO and the owners of the transmission system. This means that the electricity produced at the power plants must achieve that voltage in order to be input into the transmission system. The step-up transformers are used to step up electricity solely for that purpose.

No "energy creation" takes place after the electricity leaves the electric generator at the power plant. The step-up transformer does not create electricity, but instead induces voltage that allows the electricity to travel. Electricity enters a step-up transformer at relatively low voltage and high amperage and exits the transformer at relatively high voltage and low amperage. The power plant operators did not own any portion of the transmission system, nor did they own any of the electricity being transmitted on that system.

Parties' Positions. The operators took the position that their purchases and installation of the step-up transformers, as well as repair and maintenance services for the transformers, were exempt from sales tax because the transformers qualified as "[m]achinery or equipment for use or consumption

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directly or predominantly in the production of . . . electricity . . . for sale . . . by manufacturing, processing, generating, assembling, refining, mining or extracting . . . ." Tax Law § 1115(a)(12). The term "production" generally includes "continuing through the last step of production where the product is finished and packaged for sale." 20 NYCRR 528.13(b)(1)(ii). The sales tax regulations provide that product "distribution" does not qualify for the exemption. 20 NYCRR 528.13(b)(2).

The Department took the position that the production process ended at the power plant generators, and that the transformers were used only for distribution of the electricity, which would mean that they did not qualify for the exemption. The taxpayers maintained that since the product being sold was not merely electricity, but rather electricity delivered at a prescribed voltage level, the exemption should apply.

The Decision. The ALJ agreed with the taxpayers, concluding that since the electricity could only be sold to customers at specific voltage levels, the voltage level was an integral part of the product sold, which the step-up transformers were directly and predominantly used to create. Quoting 20 NYCRR 528.13(b)(1)(ii), the ALJ concluded that "Petitioners' product is not 'finished and packaged for sale'... until such time as it reaches the required voltage levels."

Addressing the Department's claim that the courts have already held, in *Matter of Niagara Mohawk Power v. Wanamaker*, 286 A.D. 446, *aff'd*, 2 N.Y.2d 764 (1956), that "production stops at the generator," the ALJ found that *Niagara Mohawk* was distinguishable since the vast majority of Niagara Mohawk's customers purchased the electricity at the voltages put out by the transformers. In contrast, the ALJ found that the voltage level was an essential component of the final product being sold.

Once it was concluded that the step-up transformers were exempt, the installation, maintenance, and repair services relating to that equipment was also found to be exempt under Tax Law § 1105-B(b).

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The ALJ's decision seems entirely reasonable given that the electricity was not saleable without having the transformer step up the voltage to the necessary level. The Department's position in this case was consistent with its position in an Advisory Opinion, *ABB Power Transmission, Inc.*, TSB-A-90(34)S (N.Y.S. Dep't of Taxation & Fin., July 17, 1990), and with its position in *Matter of Zapco Energy Tactics Corp.*, DTA No. 815824 (N.Y.S. Div. of Tax App., Dec. 10, 1998), a case in which an ALJ concluded that step-up transformers were integral parts of the production process but that was not appealed to the Tax Appeals Tribunal, leaving that decision as non-precedential. Whether or not the Department appeals the *Entergy* decision, the ALJ's reasoning calls into question the continued viability of the Department's policy regarding the production exemption for electricity producers and perhaps for others.

TAX DEPARTMENT ISSUES NEW CORPORATE TAX REFORM FAQS

By Irwin M. Slomka

This past month, the Department of Taxation and Finance made several important additions to its FAQs on Article 9-A Corporate Tax Reform, which appear on the Department's website. They include the following:

1. *Combined returns where the capital stock requirement is met for only part of the year.* Unitary corporations are included in a combined return only during the portion of the year for which the more than 50% capital stock requirement for combination is met. The FAQs now include an example where a parent corporation sells its entire 60% interest in a unitary subsidiary in mid-2015, and the example provides that the parent must include that subsidiary in its combined return only for the period through mid-2015, not for the entire year.

2. *Capital base for captive REITs, captive RICs or combinable captive insurers.* The capital of a captive real estate investment trust, captive regulated investment company or combinable captive insurance company is included in the computation of a combined group's capital base. The FAQ does not discuss the computation of the combined capital base.

3. *Deriving New York receipts.* A non-New York bank that has interest income solely from federal funds sourced to the State under the mandatory 8% sourcing rules for certain types of receipts and net gains, and that otherwise does not "derive receipts" in the State, will not have economic nexus with the State on that basis. This is consistent with informal guidance previously provided by the Department that the mandatory 8% sourcing provisions are not alone a basis for a finding of economic nexus.

4. *Unavailability of certain tax forms.* For New York State partnerships with corporate partners, in the absence of new Forms IT-204.1 (NY Corporate Partners' Schedule K) and IT-204-CP (NY Corporate

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Partner's Schedule K-1) – the release of which has been delayed – where a partnership with a short 2015 tax year has a 5-month extension that is about to expire, if the tax forms are not yet available before the extended due date, the partnership will automatically be given an extension of 90 days after the forms become available, and no penalties will be imposed in those instances. The FAQ does not discuss how the affected corporate partner obtains an extension.

INSIGHTS IN BRIEF

N.Y.C. Issues Press Release Encouraging Corporate Tax Filers to File 6-Month Extensions

On March 1, 2016, the New York City Department of Finance issued a press release in which it is "encouraging all corporate tax filers to file extensions" for 2015 corporate returns that are due on March 15, 2016. The corporate income tax forms for the new corporate income tax that went into effect for most corporations for tax years beginning on or after January 1, 2015 – Forms NYC-2 and NYC-2A – are not yet available. Therefore, the Department is suggesting that all corporate taxpayers with a March 15, 2016 due date obtain 6-month extensions to file their returns, the application form for which is available on the Department's website.

N.Y.C. Taxpayer Advocate Issues Operating Procedures Manual

The New York City Taxpayer Advocate has published on the Department of Finance website detailed operating procedures of the Office of the Taxpayer Advocate. The operating procedures include the organization structure, the mission statement of the Taxpayer Advocate, confidentiality rules, case criteria and procedures, and the Taxpayer Advocate's liaison functions with other parts of the Department. The operating procedures are the first step in the preparation of a comprehensive Internal Finance Manual that will cover all aspects of the Department of Finance and that will be modeled after the IRS Internal Revenue Manual.

Tribunal Upholds Denial of Earned Income Credit in Absence of Documentation of Earned Income and Child Care Expenses

The New York State Tax Appeals Tribunal has upheld the disallowance of refundable earned income credits claimed by an individual because she failed to establish her actual earned income and child care expenses as required for entitlement to the credit. *Matter of Albania Espada*, DTA No. 826098 (N.Y.S. Tax App. Trib., Jan. 28, 2016). The New York State earned income credit is based on a percentage of the earned income credit allowed for federal purposes. The individual's inability to produce any records from employers to document her earned income proved fatal to her case. The fact that she was paid in cash, and that she paid for child care in cash, did not absolve her of the obligation to substantiate her eligibility.

Two Adult Clubs are Found Liable for Sales Taxes on Scrip Used to Purchase Dances

In two separate cases, the Tax Appeals Tribunal and an ALJ have held two different adult entertainment businesses responsible for sales taxes on scrip used to pay for dances and tips. In *Matter of HDV Manhattan, LLC et al.*, DTA Nos. 824229, 824231, 824232, 824233 & 824234. (N.Y.S. Tax App. Trib., Feb. 12, 2016), the Tribunal held that the scrip was properly treated as a taxable admission charge, even though it could not be used for admission to the club or to the club's private areas, because it could be used to pay for a dance in the private area. The Tribunal also found that the charges were not excluded from tax as payments for choreographic performances because, it concluded, private dance rooms did not qualify as a "concert hall or other hall or place of assembly" where such performances need to be held to be entitled to the exclusion. Finally, the Tribunal rejected all of the club's constitutional arguments, finding that taxability was based not on content but rather on the "setting" of the performances.

In *Matter of The Executive Club, LLC*, DTA No. 825850 (N.Y.S. Div. of Tax App., Jan. 28, 2016), an ALJ similarly upheld the imposition of sales tax on charges for "executive dollars" that could be used to purchase dances and for tipping. While rejecting the Department's factual argument that the executive dollars could be used to purchase admission to private rooms, the ALJ nonetheless found that the executive dollars were subject to tax, relying on the decision in *Matter of Marchello, DTA*. No. 821443 (N.Y.S. Tax App. Trib., Apr. 14, 2011). The ALJ found that, although the scrip in *Marchello* could have been used to purchase admission to a private room – not the case at the Executive Club – it was also useable to purchase a dance in a public area, and therefore the Tribunal had sustained the tax as an "admission charge" even when it was being used to purchase a dance and not to be admitted to the club or any area in the club.

Petitioner Found Not to Be a Professional Gambler

A New York State ALJ has found that an individual taxpayer was not engaged in the trade or business of being a professional gambler, and therefore he could only claim gambling losses as a miscellaneous itemized deduction on Schedule A of his personal income tax return, subject to a 50% reduction under Tax Law § 615(f). *Matter of Kayata*, DTA No. 825935 (Div. of Tax App., Feb. 11, 2016). First, the ALJ noted that

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the itemized deduction reduction provision in Tax Law § 615(f) for gambling losses is valid, and has been specifically upheld by the Tax Appeals Tribunal against similar challenges. With regard to Mr. Kayata's status, the ALJ found that although he gambled regularly, winning and losing large sums of money, he had failed to establish that he was a professional gambler (which would have allowed him to claim business losses without the 50% limitation), citing such factors as the absence of detailed records tracking gambling activities and related expenses, the fact that his losses consistently exceeded his winnings and Mr. Kayata's primary business activities and income as a chiropractor, which the ALJ concluded financed his gambling activities.

