This Is Why We Fight: A Survey of New York Tax Issues

by Aaron M. Young, Jack Trachtenberg, and Jennifer S. Goldstein

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As a result of ambiguous and antiquated state tax codes, taxpayers and their advisers struggle to determine and comply with their state and local tax obligations. Too often, they also find themselves immersed in prolonged, expensive, and unnecessarily burdensome disputes with state taxing authorities.

From the states' perspective, unclear and outmoded tax laws create different challenges. As state tax bases rapidly erode, state revenue departments are faced with increasing demands to fill state coffers, along with pressure from various stakeholders to adopt policy positions regarding who or what should be taxed to address budget shortfalls. When legislative fixes are sought, politicians often balk, hesitating over comprehensive tax reform and modernization efforts that inevitably would create new sets of winners and losers. Absent legislative reforms, state tax authorities are then forced to apply existing taxes to new realities through audits, administrative guidance, and litigation.

While the current state of affairs is undoubtedly frustrating for taxpayers and tax authorities, the appropriateness of how each responds cannot be judged by the same standards. Our democratic system, understanding of taxpayer rights, and system of voluntary tax compliance dictate that both sides be governed by different duties and obligations.

Taxpayers should be expected (and most want) to understand their tax obligations and pay their fair share, but they are not obliged to pay any more taxes than required by law. State revenue departments, on the other hand, are tasked with collecting tax revenue, but are duty-bound to collect no more than authorized by legislatures. When state taxing authorities are pressured by lawmakers to counter the revenue eroding effects of unclear and outdated state tax codes with overly aggressive audit and litigation positions, the result is legislation by administrative fiat. This denies the citizenry their right to debate the wisdom of new taxes through their elected representatives. It can also lead to erroneous taxation, unsound policy, an increase in administrative and financial burdens on taxpayers, and too often a violation of taxpayer rights.

The Taxpayers' Advocate

Those and other concerns regarding state tax policy and administration have motivated us to write this column. Welcome to The Taxpayers' Advocate, a column dedicated to advocating for taxpayers by identifying current substantive, procedural, and policy issues where broad segments of the taxpayer community are being negatively affected by systemic state action or inaction. We will seek to identify issues throughout the country where state revenue departments are not only wrong as a matter of law, but also where a new course is warranted to avoid bad policy, a violation of taxpayer rights, unfair or inequitable treatment, or an imposition of unnecessary administrative, financial, or other burdens on taxpayers. We will also identify and advocate for beneficial reporting positions and refund claims that taxpayers are entitled to under the law.

With this focus, we hope to provide more than analysis of whether a department of revenue is interpreting the law correctly and broaden the discussion to the negative systemic impacts of state tax administration decisions. Our column will advocate for all taxpayers — discussing any issue that runs afoul of the principles that should govern proper tax administration — whether those issues implicate corporate taxes, sales and use taxes, personal income taxes, or any other tax, and regardless of whether the issue affects individuals, trusts, small businesses, or corporations.

A Survey of New York Issues

Among state and local taxpayers and practitioners, some states have a reputation for being aggressive in the administration of their tax laws and policies. New York is one of those states.[1] On a number of issues, the New York State Department of Taxation and Finance has adopted unique and questionable positions seemingly designed to protect revenue and apply old laws to new realities. As a result, taxpayers in New York are facing more audits, increasingly contentious tax disputes, and added difficulty in determining how to comply with their tax obligations. While we plan to discuss these issues in more detail in the future, it would be useful to introduce this column with a survey of hotly contested New York issues like the ones we will explore in other states.

1. Combination and Decombination Audits

For years, taxpayers have struggled to apply New York's ambiguous corporate tax combination law. To force or allow combination, a taxpayer has to meet not only the ownership and unitary business tests, but also the distortion test (in other words, that separate filing creates a distortion of income or capital).[2] Historically, a presumption of distortion was created when taxpayers had substantial inter-corporate transactions.[3] This presumption, however, could be rebutted by demonstrating arm's-length pricing.[4] This regime led to a perceived overabundance of costly litigation, often involving a "battle of the experts" over the appropriate pricing of a transaction.

In a supposed effort to simplify the analysis and reduce the need for litigation, legislation was adopted in 2007 to require combination if substantial intercorporate transactions exist, regardless of transfer pricing.[5] While simplification was the stated goal, the department's implementation of the new regime has so far had the opposite effect. Taxpayers are confronting sometimes incomplete, conflicting, and unclear case law, statutes, regulations, and guidance,[6] while the department's auditors have at their disposal a host of tools that — in the eyes of many taxpayers and practitioners — allow the state to reach the most beneficial, or revenue producing, outcome available.

In the authors' experience, when the department's auditors want to combine, they will attempt to assert that there are substantial inter-corporate transactions. When auditors want to decombine entities, they may challenge the presence of such transactions. And all the while, the department retains the discretion to adjust allocation percentages and make section 482-type adjustments in addition to or in lieu of requiring combination or decombination.[7]

The resulting confusion and uncertainty is making corporate income tax compliance exceedingly difficult and is resulting in costly, prolonged disputes with the department. As practitioners who focus on New York state and city tax matters, we frequently see the department's auditors (and their New York City counterparts) use the new regime to combine profitable companies, decombine loss companies, and make other discretionary stand-alone adjustments — often choosing, it appears, whichever method generates the most tax. If the department is going to apply the tax law in this manner, taxpayers should interpret the uncertainty of the new regime in the same manner, applying well-established legal principles to achieve the most favorable outcome for the company.

2. Constructive Possession of Software

It is hard to find an electronic service these days that the department's auditors do not think should be subject to sales tax. Although New York's laws regarding the taxation of services have not been amended in years, the department's recent policy has been to reverse prior guidance and broaden the scope of services subject to tax.

New York imposes sales tax on receipts from sales of tangible personal property, which includes "canned" or prewritten software.[8] A taxable sale may include transfers of tangible personal property accomplished through a rental, lease, or license to use.[9] According to the regulations, a taxable rental, lease, or license to use includes transactions in which there is a transfer of *possession* of tangible personal property, without a transfer of *title*, for consideration.[10]

The department has aggressively asserted that the purchases of electronic services provided through the cloud and similar Internet platforms

[1]New York is not alone in this regard. Other states that we will be discussing in future columns include California, Illinois, Massachusetts, New Jersey, and Pennsylvania, among others.

[2]*See* 20 NYCRR sections 6-2.1 through 6-2.5 (former).

[3]*Id.* at sections 6-2.3(a) and (b) (former).

[4]*See Matter of Sherwin-Williams Company v. Tax Appeal Tribunal, 784 N.Y.S.2d 178, 182* (N.Y. App. 2004).

[5]Tax Law section 211.4(4)(a); IRC section 482.

[6]For example, the updated regulations confirm that combined reports will be permitted or required when separate reports would distort a taxpayer's income or capital, even without a finding of substantial intercorporate transactions. 20 NYCRR section 6-2.1(b). However, a recent administrative law judge decision appears to suggest that discretionary combination is no longer permitted. *See Matter of Knowledge*

(Footnote continued in next column.)

Learning Corp. and Kindercare Learning Centers, Inc., No. 823962-823963 (N.Y. Div. of Tax Appeals 2013).

[7]Tax Law section 211.5.

[8]*Id.* at sections 1101(b)(5) and (6), 1105(a).

[9]20 NYCRR section 526.7(a)(2).

[10]*Id.* at section 526.7(c)(1).

are taxable licenses to use prewritten software because the customer, in essence, obtains constructive possession to the software.[11] This position ignores binding legal precedent and cannot stand.

New York courts have clearly stated that use, without control, is insufficient to establish a license to use.[12] Further, to establish constructive possession sufficient to constitute a license to use, the asserted possession must be more than temporary.[13] Certainly, it cannot be said with any degree of reasonableness that a cloud computing customer — who does nothing more than input or view data — has the requisite degree of use and control over the service provider's software to constitute a taxable possession of the software. The department's position is clearly erroneous and seemingly driven only to stem the tax base erosion that has accompanied a shift away from customers purchasing "canned," off-the-shelf software.

3. Receipts From Services vs. Other Business Receipts

As the economy and technology have evolved, an increasing number of services have migrated to electronic and online formats. This has created another tax base erosion problem for New York, which for corporate income tax purposes is allowed to apportion receipts from services to New York only to the extent the services are performed within the state. With remote service providers setting up shop in more hospitable environments, New York continues to lose revenue. Suddenly, what were once receipts from services are now deemed (according to the department) by New York to be "other business receipts" that are sourced to the state using a more revenue-friendly market or customer-based sourcing method.

Under New York's tax law, receipts derived from services may be apportioned to New York only if the services were "performed within the state."[14] If a lump sum is received for services performed both within and without New York, the receipts must be sourced to New York based on the "relative values of, or amounts of time spent in performance of, such services within and without New York State."[15] In comparison, other business receipts must be sourced to New York if they were earned in the state.[16] Since New York looks to where the customer is located to determine where an "other business receipt" is earned, classifying receipts from remote service providers as "other business receipts" is more beneficial to the state.

New York has chosen to implement new law through audit policy — embodied in a series of advisory opinions — that requires receipts from electronic and online services to be sourced to New York based on customer location, even if the services were previously subject to apportionment based on a cost-of-performance method.[17] The advisory opinions attempt to distinguish between situations in which an employee is directly involved with the customer and those in which a transaction is processed due to the activity of the customer accessing the Internet. In the latter situation, the department maintains that the transaction cannot be a service because there is no human interaction with the customer.

The advisory opinions are somewhat conclusory and lack any real legal support for the department's position. Through litigation of this issue, however, the department has been forced to go on record with its legal justification. As a result, it appears the department is relying on section 4-4.3(a) of its regulations, which provides:

> The receipts from services performed in New York State are allocable to New York State. All receipts from such services are allocated to New York State *whether the services were performed by employees, agents or subcontractors of the taxpayer, or by any other persons*.[18]

Apparently, the department interprets the highlighted section of the regulation to mean that a service is only a service if it is provided by a human being. Clearly, however, this regulation was simply designed to ensure (back when New York wanted to assert cost of performance for traditional, non-Internet-based services) that a taxpayer did not attempt to use a sourcing method other than cost of performance because the service was provided by an individual classified as an agent, subcontractor, or someone other than an employee. Moreover, it is counterintuitive to conclude that a service is no longer a service because the manner in which it is delivered has changed. In this regard, New York's position raises troubling questions regarding compliance with the Internet Tax Freedom Act, which prohibits discriminatory taxation of electronic commerce.[19]

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[11]TSB A-11(17)S (June 1, 2011); TSB-A-10(52)S (Oct. 18, 2010).

[12]*Shanty Hollow Corp. v. State Tax Comm'n*, 111 A.D.2d 968 (N.Y. App. Div. 1985); *see also American Locker Co. v. New York City*, 125 N.E.2d 421 (1955).

[13]*In re Darien Lake Fun Country, Inc. v. New York State Tax Comm'n*, 496 N.E.2d 217 (June 5, 1986); *see also Matter of Smart Carte, Inc.*, No. 812942-812945 (N.Y. Div. of Tax Appeals 1996).

[14]Tax Law section 210.3(a)(2)(B).

[15]20 NYCRR section 4-4.3(d)(1).

[16]Tax Law section 210.3(a)(2)(D).

[17]*See e.g.*, TSB-A-99(16)C; TSB-00(15)C; TSB-02(2)C; TSB-A-02(3)C; TSB-A-11(1)C; TSB-A-11(8)C.

[18]20 NYCRR section 4-4.3(a) (emphasis added).

[19]47 U.S.C.A. section 151, *et seq*.

Taxpayers who benefit from a cost-of-performance method for online services should strongly consider challenging the department's position. Taxpayers who benefit from a market approach may take comfort in following the department's administrative guidance, although an advisory opinion binding the department to a market-based method may be advisable since existing advisory opinions are binding only on the taxpayers that requested them.

4. Royalty Income Exclusion and Expense Addback

In 2003 New York adopted a related-party royalty income and expense addback regime that offers opportunities for taxpayers to reduce their income tax burdens. Generally, the related-party expense addback applies to otherwise deductible royalty expenses unless the royalty payments were made to a related party that paid the amounts to an unrelated party (the conduit exception); or a related foreign entity that was subject to a comprehensive tax treaty with the United States (the treaty exception).[20] Combined filers were further exempted from the addback requirement starting in 2007.

The 2003 law also contained an exclusion for royalty income (included in federal taxable income) that was received from related members:

> For the purpose of computing entire net income or other taxable basis, a taxpayer shall be allowed to deduct royalty payments directly or indirectly received from a related member during the taxable year to the extent included in the taxpayer's federal taxable income *unless such royalty payments* ***would not be required to be added back*** under [the expense addback provision].[21]

In other words, the royalty income exclusion applies when a related-party payer *would* be subject to the related-party expense addback requirement. While the 2003 law was amended effective January 1, 2013, to replace this regime with a narrower and more rigid expense addback provision, taxpayers with open years before 2013 may be able to claim refunds (or offsets on audit) based on the position that the royalty income exclusion is allowed even if the related-party payer was not actually a New York taxpayer subject to tax on the royalty expense addback.[22]

For example, assume an alien subsidiary (not a New York taxpayer) makes royalty payments to its New York parent. Assuming the conduit, treaty, or combined reporting exceptions do not apply, New York takes the position that the parent is not entitled to the royalty income exclusion because the foreign subsidiary is not actually required to add back and pay tax on the royalty expense. Yet the statute does not require that the payer *actually* be subject to the addback. Arguably, the statute should be read to permit the income exclusion if the foreign subsidiary *would have been* subject to the expense addback *had it been* a New York taxpayer.[23]

This position is not only supported by the plain language of the statute, but is also arguably required to avoid a violation of the commerce clause. Under well-established U.S. Supreme Court precedent, New York cannot enforce a tax statute in a manner that discriminates based on the level of an entity's in-state activity.[24] While the state may consider this a "loophole," its obligation is to enforce the statute as written and in a constitutional manner. Taxpayers operating under the appropriate factual circumstances should strongly consider claiming the royalty income exclusion to the fullest extent permitted by law.

Looking Forward

This column is going to be about advocating for taxpayers. We hope this initial column has given the reader a flavor for the types of issues we will be discussing. We look forward to further exploring these New York issues as well as other hot state and local taxation topics. ✰

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[20]Tax Law section 208.9(o)(2).

[21]*Id.* at section 208.9(o)(3) (emphasis added).

[22]The new law adopts a royalty expense addback provision based on the Multistate Tax Commission model statute.

[23]Similarly, there is a strong argument that the income exclusion applies when the related-party payer is a New York taxpayer, but with a small presence in the state (that is, a low business allocation percentage). While the related-party payer would be subject to tax on only a small fraction of the expense addback, the recipient of the royalty income should be entitled to the income exclusion to the full extent of its (perhaps larger) business allocation percentage.

[24]*See e.g.*, *Kraft General Foods Inc. v. Iowa Dep't of Revenue*, 505 U.S. 71 (1992).