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New York Tax Tribunals: It May Be Legal, But Is It Right?

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Taxation is frequently a matter of drawing lines and making close calls: Is the security issued by a company debt or equity? Is the item being sold exempt from sales tax as food or is it a taxable candy? Questions like these abound and range from the sublime to the ridiculous. One such example found in the sales tax used to define large marshmallows as taxable snacks but small marshmallows used in baking as exempt food[1]. Sometimes the answers are set in statutes or regulations; other times absurdities creep in to tax issues by other means. This article discusses two completely different situations in which the obvious fair and equitable answer (at least in the author's view) was undermined by technical restrictions and resulted in two Administrative Law Judge ("ALJ") determinations that may be technically correct but defy logic, reason and fundamental fairness for taxpayers.

Sales Tax on Leased Cars

The first case involved sales tax on a leased car.[2] In April 1997, while living in New York, the taxpayer leased a 1997 Toyota for a period of 36 months. Pursuant to Tax Law Search7RH1111(i)(A), sales tax in the amount of $685.02 was paid in advance on the basis of the lease payments for the entire lease period ($189/month x 36 months) and the initial down payment (of $1,255). The taxpayer made eleven lease payments before relocating to California in February 1998.

After she moved to California, the taxpayer was told that her lease payments would increase by $15.59 per month attributable to the California sales tax on the remaining 25 lease payments. She was also told that California would not give a credit for the sales tax 'pre-paid' to New York. The taxpayer filed a refund claim with the State of New York requesting a refund of the sales tax attributable to the lease payments that would be made after her New York residence ceased. (She took the total sales tax paid ($685.02) and divided it by 36 to arrive at New York sales tax per month of $19.03. She multiplied the monthly sales tax by the eleven months that she and the car were in New York and subtracted $209.31 from the tax paid and requested a refund of $475.71.)

In denying the claim, the ALJ cited the statute that requires the payment of sales tax at the inception of the lease on the total amount of lease payments on leases of motor vehicles, vessels and noncommercial aircraft for a period of one year or longer. The ALJ noted that a refund of sales tax can be made only if the tax was erroneously, illegally or unconstitutionally collected. Finding there was no error, illegality or unconstitutionality in requiring the payment of sales tax on leased vehicles at the inception of the lease, the ALJ denied the refund claim. The ALJ noted that the taxpayer's remedy in this situation was to claim a credit from the State of California for the sales tax paid to New York.

While perhaps well-intentioned, New York officials advising taxpayers that their claims should be made to California is a facile, but not helpful, suggestion. When asked to comment on the *Torquato* case, NYS Commissioner of Taxation and Finance Arthur J. Roth said, "in essence, this entire issue arises due to a quirky and outmoded statute in the State of California. While California does provide credits on a variety of use taxes, the law specifically imposes a use tax on vehicle leases and allows no credit. It should be noted that the statute in question dates to the mid-1960s and does not take into account the changes in the laws of other states dealing with sales tax on lease." California had already taken the position that the remaining lease payments are subject to California tax because the car would be used in California for the remaining term of the lease. The result is that this taxpayer pays tax on the same car payment twice. While not required by the law in either State, a taxpayer has the right to expect some coordination so that taxpayers do not get whipsawed between a tax jurisdiction looking to accelerate collection of its sales tax by imposing the tax in a lump sum at the inception of a lease and another jurisdiction collecting its tax on the monthly payments.

In this case, the taxpayer appeared *pro se.* It is difficult to believe that anyone would take a case involving a $475.71 refund claim to the courts to determine whether the New York 'prepayment' requirement is constitutional. (Has the tax been fairly apportioned as required by the Commerce Clause of the United States Constitution?) One could also quibble with the taxpayer's computation of the refund claim—maybe the down payment, made while the taxpayer was in New York, should be subject to New York tax rather than the *pro ration* methodology the taxpayer used. But, in any event, in this instance the taxpayer got a raw deal and has not received an accommodation that many would expect—that California and New York (and other state) tax officials would work on a means of fairly and equitably treating taxpayers who move between states.

The States often oppose action by the U.S. Congress that would restrict the States' rights of taxation in specific areas (the current moratorium on new taxes imposed on the Internet and recent legislation on state taxation of pensions (4 USC Search7RH114) are two examples). One argument used to oppose these initiatives is that States will coordinate efforts and cooperate to ensure fair and equitable taxation. This instance of double taxation cries out for the tax agencies to create a fair remedy.

Commercial Rent Tax Refund

The next case in which the taxpayer got a raw deal involves the much maligned, much deplored and soon (but not soon enough) to be repealed New York City commercial rent tax ("CRT"). Some years ago the courts upheld the imposition of CRT on rent escalation payments which are included in most commercial leases and require the tenant to pay increases in real property taxes attributable to its premises ("Property Tax Escalations").[3] Often, the landlord (or the tenant) protests the real property tax through a certiorari proceeding under RPTL Article 7. Under that procedure, the taxes must be paid when due and the case proceeds as a claim for refund of the taxes paid. Typically, cases take many years to go through the process of settlement or litigation and so several years of real property tax assessments are dealt with and, if the taxpayer succeeds in reducing the assessed value, substantial refunds are received.

The CRT is based upon rents paid or required to be paid and includes any real property taxes paid by a tenant as part of the rent escalation clause. So, when a tenant files a CRT return it will pay CRT on all amounts it pays to the landlord, including the Property Tax Escalations. Therefore, once a resolution of

any protests of the real property tax is reached and a refund is received, one would expect that an adjustment of the CRT paid on the overpaid real property tax would be available. At least that's what some people expected.

An ALJ in the New York City Tax Appeals Tribunal had to deal with this issue recently.[4] The tenant paid CRT for each of the years (1985-1992) including the Property Tax Escalations. The landlord protested the real property tax for each of the years and commenced an Article 7 proceeding. The tenant was not a party to or witness in the litigation. In 1992, after eight years of litigation, the real property taxes due on the parcel, located at One New York Plaza, were reduced and a refund was paid by the City to the landlord. The tenant's portion of the refund after legal expenses incurred in the litigation and an allocation to a subtenant was $2,671,592 plus interest of $849,255. In 1993, the tenant paid the full rent due under the lease to the landlord and received a rent rebate check for the amount of overpaid real property tax.[5]

On its next CRT return, the tenant claimed a credit for the amount received as a rent rebate and reduced its CRT accordingly. Due to the process of paying quarterly CRT payments, a refund was claimed on the annual CRT return. The City denied the refund claim and, after an audit, asserted additional CRT due based upon disallowance of the credit for rent rebates for periods prior to those periods that were still open for refund claims for the CRT year ended in 1993. The City's position was that the eighteen-month statute of limitations for refunds under the CRT bars any adjustment for the rent rebates relating to periods more than eighteen months old. The City argued that the taxpayer should have filed "protective refund claims" for all periods for which challenges to the real property tax were filed. The City also asserted a ten percent penalty for substantial understatement of tax, a five percent negligence penalty and another negligence penalty of fifty percent of the total interest due on the deficiency.[6]

The taxpayer argued that it had no entitlement to a refund when the original CRT returns were filed; it was not involved in the challenge to the real property tax assessment and that the overpayment of CRT occurred only when the rent rebate was received. The essence of the taxpayer's argument (putting aside the fact that the building ownership changed)[7] was that the landlord was only entitled to (and the CRT ought to be calculated based upon) the net rent due on the lease. The taxpayer argued that CRT base rent includes those amounts which, if not paid by the tenant, would result in eviction. The taxpayer also cited a series of cases and Department of Finance statements that CRT is due when rent is actually paid even if the payment relates to other periods, and CRT is not due if a tenant has not actually paid the rent. Therefore, the argument continued, since the tenant owed the landlord the stated rent and the landlord owed the tenant the rent rebate, CRT should be calculated on the difference.

The ALJ seemed to struggle with trying to balance the equities of the case with the strict legal requirements of the refund provisions of the CRT. The ALJ saw an insurmountable problem in applying the CRT to allow a credit for rent rebates in a later period to reduce the CRT in a current period. The ALJ cited the statute that provides that rent can be paid in money, property, services or *credits*. She then used as an analogy a purchaser returning an item to a store for credit and then purchasing another item by using that credit, concluding that the item was still "paid" with the credit.[8] Therefore, the ALJ reasoned that the rent was paid via the credit and that the taxpayer had not met its burden of proving that the rent paid was not part of base rent subject to the CRT. (It should be noted that, in the example cited by the ALJ, the purchaser would not pay sales tax twice.) In support of this conclusion, the ALJ noted that "[a]ny other conclusion would deprive of any remedy those taxpayers who, by the time they receive their rebates, were no longer leasing the same premises from the same landlord." (It is also worth noting that the hypothetical

taxpayer no longer leasing the premises was not before the ALJ and, therefore, that issue could have been left for another time.)

The ALJ also rejected the taxpayer's argument that it was denied due process of law since it did not have a valid CRT refund claim for the years 1985-92 until the real property tax challenge ended and the refund paid, well after the eighteen-month statute of limitations to file a CRT refund claim had expired for the years in issue. The ALJ determined that the taxpayer should have filed protective claims for refund with the Department within the statute of limitations and then waited while the real property tax case was litigated. The ALJ noted that this could create administrative complexities for both tenants and the Department in requiring protective refund claims to be filed in connection with almost all commercial leases.

Find Equitable Result

This gets us back to the theme of this article—while there may be a basis in law to preclude getting to the right answer that reasonable people expect in the State and City tax laws, tax administration ought to be more concerned with getting to the equitable result rather than erecting obstacles to achieving fairness. In the *Fried, Frank* case, it is clear that the taxpayer paid the CRT that was due including its Real Property Tax Escalations. It then got an adjustment of its real property tax through the protest by the landlord and sought (very reasonably) to reduce the CRT paid to the City on the tax it was required to (over)pay in advance to the City. It is bad enough to pay a City tax on a City tax but it adds insult to injury to have the City itself benefit from the fact that it took eight years for the real property tax protest to be resolved and then use an eighteen-month statute of limitations on CRT refund claims to defeat a clearly equitable result.

The ALJ's proposal to require protective refund claims would impose a tremendous burden on both the City and taxpayers. First, the purpose of refund claims, in general, is to put the tax authority on notice so that reserves are set up to pay the claims. Protective refunds in uncertain amounts do not serve this purpose. Second, some tenants may not even be aware of the real property tax challenges filed by their landlords.

Also, without the cooperation of the Department, the use of a protective refund claims would be useless. For example, if a tenant files its CRT return and within eighteen months files a protective claim, the Department could deny the claim as baseless until the property tax challenge was decided.[9] Once the Department denies the CRT refund claim, the taxpayer must protest that denial within ninety days. At that point the race is on. Can the real property tax challenge proceed faster than the administrative process for adjudicating the CRT refund claim ? It is entirely likely that, absent the Department's agreement to hold the refund claim in abeyance, the CRT matter would generally be heard (and denied) well before the challenge to the real property tax assessment is resolved (in Fried, Frank's case it took eight years to resolve the real property tax case; the CRT matter has been pending for three and a quarter years).

It is also troubling to note that the Department asserted penalties in this case. While the ALJ abated the penalties for substantial understatement of tax (ten percent of the tax understated, negligence (five percent of the tax) and the negligence penalty for interest (fifty percent of the total interest amount due), it is disturbing that penalties were even raised as an issue in this case.

In both of these cases the question is not how could the tax department win this litigation? Rather, the question is why would the tax department want to litigate these matters? Both the New York State and

New York City tax departments have come a long way in creating the perception of being fair and reasonable agencies that work with taxpayers in an effort to seek to and arrive at equitable resolutions. Sometimes it is necessary to examine the particular facts of a case and look at the 'big picture' and have someone at a senior level of tax administration ask the question: Does the agency's litigation position foster the perception (and reality) of the fair and equitable treatment of taxpayers?

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1 See, Publication 880 of July 1998, defining marshmallows (all sizes) as exempt.

2 *Matter of Sandra Ann Torquato* (ALJ Determination dated March 30, 2000).

3 NYC Rule Search7RH7-01 Definition of Rent.

4 *Matter of Fried, Frank, Harris, Shriver & Jacobson*, (ALJ Determination dated May 12, 2000).

5 Due to a change in building owners in the period, the rent for the 1993 year was paid to the landlord who owned the building in 1993 and the rent rebate was paid to the tenant by the previous owner.

6 NYC Administrative Code Search7RH11-715(j), (d)(1) and (d)(2).

7 The ALJ found that the new landlord assumed the obligations of the prior landlord and would have been required to accept the net rent and look to the prior owner for reimbursement, therefore the change in owners of the building had no effect on the outcome of the case.

8 One could debate the issue of what paid in money, property, services or *credit* means in this context but that is not the point of this article. It is assumed that the position may be legally supportable but the question remains—is it right?

9 The ALJ notes that the Department has established internal procedures "holding in abeyance" protective refund claims until the event that caused the need for the claim has been concluded. Those internal, unpublished procedures are subject to change without notice and, more importantly as noted, the tenant is not always aware of someone else's protest of real property taxes.