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July 30, 1998

Six-Month Rule for Decisions: Corporate Tax on-Co-Ops

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The previous article discussed the *Bray Terminals* case (decided March 12, 1998 and reported in the New York Law Journal March 17, 1998) where the New York State Tax Appeals Tribunal failed to issue the decision within six months after the last brief or the oral argument, whichever is later. The Appellate Division, Third Department decision held that the six-month time period for issuance of a decision was directory rather than mandatory and therefore granted the taxpayer no relief. A motion for leave to appeal *Bray Terminals* to the Court of Appeals is pending (the author participated in a motion to appear as *amicus curiae* on the motion for leave to appeal). In the meantime, the New York State Tax Appeals Tribunal had occasion to cite the Appellate Division's *Bray Terminals* decision in *Matter of Jorge G. Chavez d/b/a/Loris Old Fashioned Ice Cream Fountain* (NYS Tax Tribunal decided June 11, 1998).

Chavez, insofar as it relates to this point, involved Tax Law Search7RH2010(3) which provides that an administrative law judge shall render a determination within six months after the completion of a hearing (or the submission of briefs) or extend such period for an additional three months. If the ALJ fails to issue a determination within the period, the taxpayer may institute an Article 78 proceeding to compel issuance. In *Chavez*, both the taxpayer and the attorney representing the Tax Department asked the ALJ to hold off issuing a determination while the parties discussed settlement after the hearing. When discussions broke down without reaching a settlement, the ALJ issued a determination beyond the six-month period (apparently, there was no extension of the initial six-month period).

The Tribunal was placed in a difficult spot in this case since the attorneys for both the taxpayer and the Department lead the ALJ to believe that a settlement was imminent. The Tribunal quoted the Appellate Division decision in *Bray Terminals* that the time requirement was directory but also said, "we continue to believe that the taxpayers of this State are best served by strict adherence to the time limitations set forth in the Tax Law and every effort must be made to so comply."

Aside from the unusual circumstance the Tribunal faced between the resignation of two of its members in August 1996 and the appointment of new Commissioners in December 1996, the Division of Tax Appeals and the Tribunal itself have complied with the six-month rule for issuing decisions. However, as noted in the previous articles, situations can, and inevitably will, arise due to recusals or other events in which decisions could be delayed beyond the statutory period. It remains to be seen whether there will be any real consequences if the time periods set forth in the statute become merely guidelines for which compliance is urged but without strong measures for enforcement.

Corporate Taxation of Housing Co-ops

The State Tax Appeals Tribunal issued a pair of decisions affecting cooperative housing corporations' New York State franchise taxes. Co-ops in New York typically operate so that their incoming cash flow approximates their cash expenses. The income is usually from rent payments from tenant-stockholders, interest from reserve funds or cash on deposit, and rental income from nonstockholder commercial leases (street-level stores, garages or others). Most co-ops file tax returns showing losses because total allowable depreciation and expenses generally exceed gross income from the cash flow noted above.

Under the Internal Revenue Code (the starting point for State franchise tax calculations) Subchapter T, certain types of co-ops are required to pay tax on "non-patronage income". While it is clear that maintenance charges from tenant-stockholders are not non-patronage income, the law is unclear whether interest income and rents from non-stockholders would constitute non-patronage income. Under IRC Search7RH277(a), certain member organizations are required to limit their deductions attributable to membership transactions to the gross income from those transactions. Thus, a net loss from membership transactions (maintenance from tenant-stockholders) could not be used to offset interest income or income from commercial non-stockholder tenants.

Most co-ops file returns under the assumption that neither Subchapter T nor Search7RH277(a) apply to them. Both the IRS and the State Tax Department have disputed that notion, arguing that Search7RH277(a) or, at least, Subchapter T apply to housing co-ops.

Subchapter T and Search7RH277(a)

The U.S. Tax Court ruled in *Buckeye Countrymark, Inc. v. Commissioner*,[1] that if Subchapter T applied to a co-op, then Search7RH277(a) did not apply. The IRS and the State have accepted that position, but continue to litigate whether Subchapter T or Search7RH277(a) apply to a typical New York co-op. More than 30 years ago the Tax Court decided that three criteria establish whether an entity is a cooperative subject to Subchapter T: 1) subordination of capital; 2) democratic control by the members; and 3) vesting in and allocation among the members of all the fruits and increases arising from the cooperative endeavors in proportion to their active participation.[2]

The court also seemed to suggest that the democratic control required one-member, one-vote rules and a prohibition against voting by proxy. Since typical housing co-ops permit voting based upon the number of shares owned and allow proxies, at least one State ALJ found that democratic control did not exist. However, a few weeks before the ALJ determinations were issued, the U.S. Tax Court held that a New York co-op was subject to Subchapter T notwithstanding proportional and proxy voting.[3]

The Tribunal held in *330 Third Avenue Owners' Corp.* and *Ocean Terrace Owners, Inc.* (NYS Tax Appeals Tribunal decided March 26, 1998), that Subchapter T applied to housing co-ops and Search7RH277(a) did not. The Tribunal also ruled (in *330 Third Avenue*) that it was too late for the Department to raise an argument about income from commercial lease and interest being non-patronage income since it was a factual issue that had not been raised before the ALJ.

We will have to wait and see whether or not the Department pursues the issue of what is non-patronage income subject to tax in other cases involving housing co-ops. The questions of the treatment of income from non-stockholder leases and interest on reserve funds are still open and will have to be addressed later.

Discretionary Adjustments to the Statutory Apportionment Formula

Both the State Tax Appeals Tribunal and the New York City Tax Appeals Tribunal rendered decisions addressing the always interesting issue of discretionary adjustments to the statutory apportionment formulas for corporate taxes. In the State Tax Tribunal case of *Christian Salvesen, Inc.* ("CSI") (decided April 2, 1998), the taxpayer was in the business of providing refrigeration, cold storage and related services for the food industry. When one of the CSI's New York-based customers experienced financial difficulties, CSI entered into a contract effectively providing for the financing of the customer's inventory in addition to CSI's normal provision of refrigeration storage services. To protect itself in the event of default, CSI structured the agreement as a sales contract requiring the customer to purchase inventory which was immediately sold to CSI which refrigerated and stored the inventory until it was sold back to the customer. CSI charged the customer cost (the same amount as the customer initially paid) plus an amount equal to the prime rate plus 2.5 points. Additional charges were received by CSI for refrigerated storage and handling.

This arrangement resulted in the gross receipts apportioned to New York under the statutory formula increasing from 5% to approximately 46% and the property factor for New York rose from 7% to 12%. The taxpayer argued that the "sales contract" was really a financing arrangement and that the statutory formula was distortive of its activities in, and the tax paid to, New York. The State Tribunal held that the apportionment of income to New York was not out of all proportion to the New York activities of CSI. The Tribunal continued stating that the activities in assisting its customer through the financing arrangement were part of the unitary business of providing refrigeration and storage services. Additionally, the Tribunal held that the choice by CSI of the form of the transaction as a sales contract yielded economic benefits "an advantage which cannot be overlooked. The fact that it also incurred more franchise tax was merely a byproduct of its choice to structure its arrangement" with its customer as it did.

The City Tax Tribunal came to a different conclusion in the case of *Just Born, Inc.* (decided March 30, 1998). In that case, the taxpayer's main business was the manufacture and sale of confectionery products. Its only activities in New York were the solicitation of sales and delivery into New York by common carrier. Had this activity been the only activity of the taxpayer, the City would have been precluded from imposing its corporate tax by virtue of P.L.86-272, an act of Congress prohibiting state and local governments from imposing income taxes on business whose activities are limited to soliciting sales and shipping tangible personal property into the jurisdiction.

Real Estate

However, the taxpayer also had approximately a 20% limited partnership interest in a partnership that owned real property in the City. That partnership generated losses in the years at issue but generated taxable income in later years. There was no allegation that the taxpayer was actively engaged in the conduct of that partnership's business.

On its New York City general corporation tax return, the taxpayer showed net income from confectionery operations of more than $8 million (including almost $1 million in gross receipts to NYC customers of the candy business) and a loss of $25,647 from the New York real estate partnership. In apportioning income to NYC, the taxpayer treated the partnership's receipts, property and payroll factors as a "flow through" and showed them on its corporate tax return. On its return, the taxpayer sought a discretionary adjustment to its apportionment factors by excluding the factors and income of its confectionery business claiming it was not unitary in nature with the investment in the partnership and that the City's taxing the confection business amounted to taxation of extraterritorial values. The City argued that there was a "flow of value" between the partnership investment and the confection business as represented by the federal tax benefit of deducting the partnership losses from the income of the confection business.

In the determination below, the ALJ had adopted the "California approach" using formula apportionment to separately compute the income base for each line of business. The result was that 100% of the partnership loss offset the portion of income from the confection business allocated to the City. The City objected claiming that the statutory formula did not yield an outrageous result, that both businesses were conducted in New York and also argued that the ALJ had no authority to exercise the discretion of the Commissioner to adjust the apportionment formula.

The Tribunal modified the ALJ determination giving the taxpayer a greater benefit than the ALJ had given. First, it agreed that the businesses were not operated in a unitary manner there being no transactions between entities, no centralized management nor functional integration. Second, the Tribunal held that the use of partnership losses to offset confection income on the federal tax return was not a "flow of value" that is critical to finding a unitary business. Finally, the Tribunal held that the taxpayer should be permitted to use separate accounting to allocate income to the City. Under separate accounting only the partnership loss was allocable to the City; thus, no tax was due.

The Tribunal based its conclusion on the fact that, but for the limited partnership interest, the confection business would have been protected from the City's corporate tax due to P.L. 86-272. In addition the Tribunal pointed to a Statement of Audit Procedure (SAP AP/AU-15 issued August 27, 1990) that instructs auditors to permit separate accounting for corporate limited partners subject to GCT solely due to their ownership of a limited partnership interest in a partnership doing business in the City. Although by their terms, neither P.L. 86-272 nor SAP AU/AP-15 applied to this taxpayer, the City Tribunal exercised the discretion of the Commissioner, citing N.Y.C. Charter Search7RH168.a, to give the taxpayer the benefit of both.

Subjective Discretion

Examining the two cases shows just how subjective the exercise of discretion in this area can be. The State Tribunal's decision that the taxpayer was stuck with the form of the transaction chosen could easily have been the basis for the City Tribunal's ruling. After all, the taxpayer in *Just Born* chose to hold its limited partnership interest in the corporate entity and could have been held to the disadvantages arising from that choice. At least as compelling however, is the City Tribunal's view that if two activities that are, for policy reasons (either federal policy or internal Finance Department policy), given beneficial treatment, then the benefit ought not to be taken away when the two activities are put together in one entity. In that view, carrying on two exempt activities does not make a taxable activity. This concept is embodied in the New York City unincorporated business tax that provides that certain activities are exempt and "any combination of the activities described"[4] may be conducted and not jeopardize the exemption.

Voluntary Disclosures and Industry Settlements

A very recent determination of the State's division of Tax Appeals had an ALJ writing about the confluence of two areas that are rarely discussed in litigated cases. Voluntary disclosure procedures and industry-wide settlements are areas in which tax administrators and tax practitioners work together to reach reasonable agreements that are intended to avoid litigation and maximize tax compliance.

In *Goetz Energy Corporation* (Division of Tax Appeals decided June 18, 1998), the taxpayer arranged a voluntary disclosure under which Goetz, a gas marketer that had not filed tax returns under Tax Law Search7RH186-a, agreed to pay tax and interest for the years 1991, 1992 and 1993. The agreement also provided that the State would not assert penalties for those years and would not audit or assess the tax-payer for years prior to 1991. Such agreements are not uncommon.[5] They benefit the State by getting tax-payers on the tax rolls and paying tax going forward; they benefit the taxpayer by eliminating penalties and possible exposure for many old years for which no tax returns were filed.

Subsequent to the consummation of the voluntary disclosure agreement, the attorney (the same person who represented Goetz in the voluntary disclosure), engaged in discussions on behalf of other gas market-ers and obtained an agreement with the Audit Division of the State Tax Department under which gas mar-keters who voluntarily came forward and filed tax returns and paid the tax under Tax Law Search7RH186-a for the year 1994 would not be audited or assessed the tax for prior years.

After the agreement between the Tax Department and the industry was made, Goetz filed a claim for re-fund of the taxes it paid under its voluntary disclosure agreement. The taxpayer's position was that while both the voluntary disclosure agreement and the industry agreement were within the Department's author-ity, the tax Goetz paid should be refunded since it was being treated unfairly, inequitably and more harshly than similarly situated taxpayers. Goetz also claimed that the State had violated the equal protec-tion clauses of the State and federal constitutions as a result of the decision not to audit or assess other gas marketers for the years that Goetz had paid the tax.

The refund was denied by the Department on the grounds that the tax was validly owed, that Goetz was not similarly situated to the other gas marketers and that there was no unconstitutional violation of equal protection.

The ALJ upheld the denial of the refund on the grounds that the different treatment of Goetz "was ration-ally related to the legitimate State interest of enforcing the Tax Law." The ALJ also found that the claim of violation of equal protection failed because there was no invidious discrimination, a necessary element in a selective enforcement claim. In order to prevail on a claim of selective enforcement of the law one must "show a palpable and deliberate scheme to oppress him while excluding all others who come within the terms"[6] of the statute.

While the taxpayer's argument in this matter was very sympathetic, there are compelling reasons for tax administrators to enter into voluntary disclosure agreements and industry-wide settlements without the risk of incurring refund liabilities for everyone who went before. It might be best for the availability or preclusion of a refund claim to be spelled out in the agreements between taxpayers and the Department.

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1 103 T.C. 547 (1994).
2 *Puget Sound Plywood v. Commissioner*, 44 T.C. 305 (1965).
3 *Thwaites Terrace House Owners v. Commissioner*, 72 TCM 578.
4 N.Y.C. Administrative Code Search7RH11-502(b)(2).

[5] See, Carlton Smith and Glenn Newman, *Consequences of Failure to File*, New York Law Journal, February 28, 1995, p.1.
[6] *People v. Dahlman*, 371 NYS2d 60, 63, aff'd. 383 NYS2d 946.