Is New York Overreaching on Audit and Litigation of Federal Issues?

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Under New York law, an individual's personal income tax is calculated by making certain adjustments to the taxpayer's federal adjusted gross income. In this, New York is similar to many other states. Thus, in addition to issues under the New York tax law, issues under the IRC may also be relevant to the determination of the proper amount of tax due. Historically, the New York State Department of Taxation and Finance (the "Department") has concentrated its audit resources on New York-specific issues, such as whether an individual is a resident or nonresident and what portion of a nonresident's income is derived from New York sources. The Department has largely left the auditing of federal tax issues to the IRS for review.

In recent years, however, the Department's position has changed, and it has significantly increased the audits of federal tax issues. Department personnel have acknowledged the change and argued that additional enforcement is necessary in light of the decrease in the IRS's own audits. We understand that the audits of federal issues have increased in other states as well. Clients are frequently surprised (and frequently outraged) that a New York state audit can involve a review of their federal adjusted gross income.

Although New York State is well within its rights to conduct audits of federal issues, the determination of these issues requires a knowledge and understanding of federal tax. In our experience—and from discussions with other tax practitioners—there is widespread concern that the Department's auditors and attorneys do not have sufficient training, experience, or overall familiarity with the IRC, federal regulations, rulings, and case law to analyze and address complicated federal issues in a competent manner. A recent case, *Matter of Steve and Linda Horn*, in which we represented the taxpayers, demonstrates that such concerns are merited. On Apr. 20, 2017, the Tax Appeals Tribunal sustained the determination made by an administrative law judge ("ALJ") in favor of the taxpayers.

The taxpayers in *Horn* owned an S corporation, Steve and Linda Horn, Inc. (the "Company"). The Company incurred extremely large losses totaling approximately $30 million in the years at issue, attributable to the purchase and renovation of real estate in Florida, an antique store in Manhattan, and the winding-down of the Company's previously successful television commercial production business. Much of the losses were incurred following the financial crises in 2007 and 2008, which hurt all of their businesses.

The Department asserted that under IRC section 183—the so-called "hobby loss" rule—all of the activities of the Company were "not engaged in for profit," and therefore all of the losses should be disallowed. Most significantly, the Department's determination was made on the basis of a desk audit: one which is done solely on the basis of a review by the auditor of tax returns and documents received from the Company. At no time did an auditor seek to visit any of the businesses conducted by the Company or speak with any of the Company's employees before claiming that none of the businesses were engaged in for profit. The Department also failed to conduct any investigation of the Company's businesses in connection with the conciliation conference held in the matter and in preparation for trial.

At trial, the evidence submitted by the Department consisted of schedules prepared by the auditor from the Company's and taxpayers' tax returns, which showed (i) that the losses were substantial, and (ii) the taxpayers had substantial other income, which was offset by the losses. In contrast, the taxpayers introduced into evidence thousands of pages of financial records; sales materials; and photographs of the store, the warehouses, and the Florida properties. They and several employees of the business testified to the manner in which the business was conducted, the efforts to increase sales at the store by selling online, and the efforts to cut expenses.

The regulations under IRC section 183 enumerates nine factors for determining whether an activity is engaged in for profit:

1. the manner in which the taxpayer carries on the activity
2. the expertise of the taxpayer or his/her advisors
3. the time and effort expended by the taxpayer in carrying on the activity
4. the expectation that assets used in the activity may appreciate in value
5. the success of the taxpayer in carrying on other similar or dissimilar activities
6. the taxpayer's history of income or losses with respect to the activity
7. the amount of occasional profits, if any, that are earned
8. the financial status of the taxpayer
9. any elements of personal pleasure or recreation derived by the taxpayer from the activity

While the factors are not intended to be exclusive, and no one factor by itself is determinative, the courts look at the combination of these factors to determine if the requisite profit motive exists. The Department, however, while arguing that the Horns failed to satisfy the listed factors, primarily sought to apply a different test—did the Company conduct its business properly, as determined with the benefit of hindsight by the Department?

The Department acknowledged that the television commercial business was previously engaged in for profit, but argued that the winding down of that business, as well as the Horns' real estate activities and antique store, were not engaged in for profit. Thus, the Company's losses from such activities should be disallowed. The Department made a number of arguments and assertions, including that:

- the absence of a written business plan and formal budget shows that taxpayers did not act in a businesslike manner.
- the company's advertising for the antique business was inconsistent and intermittent and, as such, should weigh against a finding of a profit objective.

- the company's cost-cutting measures were insufficient.
- the taxpayers should have anticipated that an economic recession would adversely affect the business.
- the taxpayers were not engaged in real estate activity because the company bought only four properties and sold only one during the years at issue.
- the taxpayers did not follow their accountant's advice by not appraising the antique business's inventory during the recession and then offering the items for a lower price.
- the taxpayers did not seek their tax accountants' advice on how to make their businesses more profitable.
- the taxpayers' expectation that the inventory and the building will appreciate in value is purely speculative.
- in order to be engaged in for profit, the taxpayers must demonstrate that future profits would exceed all of the losses incurred in earlier years.

Since the Department failed to conduct any examination of the business, many of its arguments were simply baseless assertions. Although the Department argued that the antique store had too many employees with too large salaries and did not spend enough on advertising, the Department did not make any effort to determine what other stores did. Other arguments reflected a complete lack of knowledge and understanding of federal tax principals. For example, the Department claimed that the company was not engaged in the real estate business because it only owned a few properties, demonstrating a complete lack of knowledge of IRC section 212, which permits the deduction of expenses incurred in the maintenance of property held for the production of income, regardless of whether it constitutes a trade or business. The Department also argued, without any legal basis for support, that over $10 million of gains should be disregarded in analyzing the IRC section183 issue because the gains were deferred by means of a IRC section 1031exchange.

The ALJ diligently analyzed the tests in the regulations and case law, rejecting virtually all of the Department's contentions. For example, she acknowledged that a business plan, especially in a small company, need not be written down—and that formal budgets are not the answer to turning a losing business around. She rejected the Department's criticism of the Horns' advertising plan. She noted that the antique store had many fixed costs, such as rent, that could not be further reduced. The taxpayers focused on trying to sell more inventory and cutting whatever small costs they could—a formal budget would not have had any impact on these efforts and magically turn around the business, as New York State implied.

The Department also placed significant emphasis on the fact that the taxpayer derived enjoyment from the antiques she sold in her business, ignoring the fact that the antiques store was a legitimate business operating in a professional manner. The ALJ also rejected this, noting that "suffering has never been made a prerequisite to deductibility" (citing *Jackson v. Comm'r*). The ALJ determined that elements of enjoyment could not trump the professional manner in which the antiques business was run and turn the activity into one not engaged in for profit.

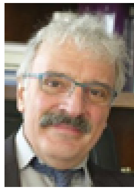
The ALJ ultimately found that five of the factors were in the Horns' favor, three were neutral, and only one—the fact that there were no occasional profits from the company's antiques business—weighed against the taxpayers. She issued a determination in favor of the Horns.

Despite the very fact-specific nature of the determination, however, the Department was not willing to concede and chose to appeal.

The Tax Appeals Tribunal agreed that based on the factors in the regulations, all of the activities of the corporation were engaged in for profit. On exception from the ALJ determination, the Department raised another federal issue and argued for the first time that the passive loss rules of IRC section 469 applied to limit the losses. The Tribunal held this "to be essentially a factual determination with legal consequences that would have been addressed by the Administrative Law Judge had it been presented in the Division's argument at the hearing," which was thus "not preserved for [the Tribunal's] consideration on exception." The Tribunal sustained the determination of the ALJ in favor of the taxpayers.

Horn shows the Department was out of its depth in litigating a federal issue: It sought to substitute its own business judgment (undertaken with no investigation of the facts) for an analysis of the factors in the regulations. It argued a position well at odds with case law interpreting IRC section183—there are no cases under either New York or federal law that provided any support for the state's position, and the ALJ easily distinguished all of the cases the Department cited. It appealed a determination that was based on extensive factual findings and, unsurprisingly, the Tribunal deferred to the ALJ as fact-finder. And it failed to raise another potential issue—the applicability of IRC section 469—until it was too late.

The case also demonstrates that when litigating these cases, it is important that the taxpayers' representatives have a thorough understanding of both the federal and state issues to effectively challenge the Department's positions.



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