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Aggressive Tax Planning Backfires in NYC Installment Sale Case

By: Joseph Lipari

It is common for business entities (corporations, limited liability companies, or otherwise) to be organized solely for the purpose of owning a single piece of real property. Unsurprisingly, it is also common for such entities to cease active operations after the sale of such property. What may not occur to many taxpayers is that the cessation of business operations may result in an unforeseen acceleration of taxes. In *1018 Morris Park Avenue Realty Inc.*, TAT(E)14-4(GC) (N.Y.C. Tax App. Trib., Aug. 7, 2017), the New York City Tax Appeals Tribunal ruled that a corporation must recognize all gain derived from an installment sale in the year in which the corporation ceased doing business in the City. Although this result may be harsh since the corporation may not have the resources necessary to pay the accelerated tax liability, the problem likely results from overly aggressive tax planning.

In *Morris Park*, petitioner was a corporation subject to New York City General Corporation Tax ("GCT"). Contemporaneous with its formation in 1993, petitioner acquired certain real property located in the Bronx. Petitioner sold such property in 2009 for a purchase money note. After the sale of the property, petitioner's only activities were collecting periodic payments on the installment sale.

The sale qualified as an installment sale under Internal Revenue Code ("I.R.C.") § 453 since some of the payments with respect to the sale were to be made after the year of sale). Under the "installment method" of accounting (provided for in I.R.C. § 453), a taxpayer reports and pays tax on the gain generally as and when payments are made on the installment note.

With respect to both its GCT and Federal income tax returns, petitioner reported income only with respect to the amount of gain recognized in 2009 under the installment method), rather than the entire amount of the gain realized from the sale of the property. Additionally, for GCT purposes, petitioner reported that 2009 was its final year. No GCT returns were filed with respect to 2010, 2011, or 2012 and petitioner did not pay any GCT in those years with respect to future installment payments received). Thus, it appears that the transaction was structured as an installment sale at least in part in an attempt to avoid payment of GCT with respect to future payments. In 2013, possibly as a result of the GCT audit, petitioner amended its GCT return to indicate that 2009 was *not* petitioner's final year.

Under N.Y.C. Admin. Code §§ 11-602.1(1) and -603(1), for tax years prior to January 1, 2015, all corporations were subject to GCT "[f]or the privilege of doing business . . . or of owning or leasing property[, or performing certain other activities] in the city." (For tax years beginning on or after January 1, 2015, GCT applies only to I.R.C. subchapter S corporations, N.Y.C. Admin. Code § 11-602.1(1); all other corporations are subject to New York City Corporate Tax, N.Y.C. Admin. Code § 11-651 et seq.)

N.Y.C. Admin. Code § 11-603(1) provides that (for purposes of the instant matter) the applicable GCT base was "entire net income." N.Y.C. Admin. Code § 11-602(8)(i) provides that entire net income "is presumably the same as the entire taxable income . . . which the taxpayer is required to report to the United States treasury department," subject to certain adjustments, provided for in N.Y.C. Admin. Code § 11-602(8)(a)–(p). Among such adjustments, N.Y.C. Admin. Code § 11-602(8)(d) provides that the City Department of Finance (the "Department") "may, whenever necessary in order properly to reflect the entire net income of any taxpayer, determine the year or period in which any item of income or deduction shall be included, *without regard to the method of accounting employed by the taxpayer*" (emphasis added).

In finding for the Department, the Tribunal looked generally to analogous state authority on the issue of accelerating gain under an installment sale where taxpayer is no longer subject to New York tax. (Although there was previous City administrative guidance on the issue, the Tribunal correctly characterized

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them as "Department policy," rather than authority.)

Principally, the Tribunal looked to an example in an analogous State regulation, which held that a corporation ceasing to do business in New York must recognize all gain from an installment sale in the year the corporation ceases to do business in New York. Additionally, the Tribunal looked to an Appellate Division case, *Delmhorst v. State Tax Comm'n*, 92 A.D.2d 981 (3d Dep't 1983), aff'd 60 N.Y.2d 628 (1983), under the State *personal* income tax. In *Delmhorst*, an individual State resident sold his seat on the New York Stock Exchange in an installment sale, and subsequently moved to Connecticut (and relinquished his New York State residency). After his move, he filed no further New York State tax returns (and, assumingly, did not pay any further New York State tax). The Appellate Division determined (under a rule analogous to N.Y.C. Admin. Code § 11-602(8)(d)) that the individual's gain from the installment sale should all have been recognized in the year that he changed his residency from New York to Connecticut.

The Tribunal could have found for the Department on the plain language of N.Y.C. Admin. Code § 11-602(8)(d). However, the Tribunal, momentarily, looked as if it might give petitioner leeway if petitioner could have shown that it continued to do business in the City (and, assumingly, continued to pay GCT as it received installment payments). This hope was fleeting; the Tribunal made quick work of explaining why petitioner was not doing business in the City.

First, the Tribunal noted that 19 R.C.N.Y. § 11-04(c)(1)(i) provides that "[a] corporation will not be deemed to be doing business [in the City] . . . because of . . . the maintenance of cash balances with banks or trust companies or brokers in" the City. (Taxpayers often rely on this rule when arguing that they are not doing business in the City, so as to not become subject to City taxes.)

Second, the Tribunal cited to two City Finance Letter Rulings noting that the facts of the instant matter were "squarely within" those rulings. In each situation, the taxpayer's only continuing business operations in the City, after selling assets, were the receipt of installment payments. Each ruling concluded that receipt of such payments did not constitute doing business in the City, and, therefore, all of the taxpayer's gain from the sale of such assets was taxable in the year of sale. Finally, the Tribunal looked to the *Delmhorst* case: The Appellate Division determined therein that (as paraphrased by the Tribunal) "merely holding and collecting on an installment obligation received from the sale of property in the City does not constitute engaging in a trade or business in the City." Finally, about halfway through the decision, the Tribunal stated what seems to be its principal concern with petitioner's actions: "With the exception of the gain reflected in the first installment payment, the entire gain on the sale of the [p]roperty would permanently escape GCT."

It is easy to understand the Tribunal's approval of the exercise of the Commissioner's discretion in an egregious case such as this. Other cases, however, are likely to be less clear. Installment sales are often used to achieve tax benefits, not only by enabling a taxpayer to defer the obligation to pay tax until cash payments are received and available but also in many cases to enable the taxpayer to shift gain to years in which its aggregate tax liability may be reduced by offsetting losses or otherwise. What limits, if any, apply to the Commissioner's discretion to shift income from one period to another? Is it sufficient for the Commissioner to point out that the aggregate amount of GCT would be lower if the installment method were utilized?

Morris Park also raises interesting questions for taxpayers who engage in like-kind exchanges under I.R.C. § 1031. Suppose instead of selling its property located in the City in an installment sale, petitioner exchanged such property for like-kind "replacement property" located outside of the City in a fully tax-deferred transaction. In that case the gain would not have disappeared (it would be merely deferred and reflected in the lower tax basis in the replacement property), but it would "permanently escape GCT."

Although it is an understandable policy goal to avoid such "escape," the statutory provision in this case may be inapplicable on the ground that I.R.C. § 1031 is not a "method of accounting." Additionally, a like-kind exchange of property out of the City is more akin to a business moving out of the City than the cessation of business operations. As the business continues as a going concern, it is now subject to the state and local taxes of the jurisdiction to which it moves. This is not the same as escaping state and local tax entirely, which is what petitioner attempted to achieve. Upon a subsequent disposition of the replacement property, petitioner would be subject to appropriate state and local taxes in its new jurisdiction. Other states, most notably California, have by statute provided that tax will be due on the sale of I.R.C. § 1031 replacement property located outside California.

Some may view *Morris Park* as a cause for concern but it is probably better viewed as a reminder to be prudent in tax planning, and to not try to achieve too much. As the saying goes, "pigs get fat, hogs get slaughtered". Petitioner's attempt to achieve near-complete exemption from GCT backfired and it ended up with full taxation on a current basis. Had it settled for the more appropriate goal of deferral, we might not have this case on the books.