NEW YORK CITY DEPARTMENT OF FINANCE

TAXRAPP 2015

NEW YORK CITY LITIGATION UPDATES

Moderator:
Glenn Newman
Shareholder
Greenberg Traurig, LLP
MetLife Building
200 Park Avenue
New York, NY 10166
212.801.3190
newmang@gtlaw.com

Panelists:
John J. Mulligan
Senior Tax Counsel
Legal Affairs Division
NYC Department of Finance
345 Adams Street, 3rd Floor
Brooklyn, NY 11201
718.488.2037
mulliganj@finance.nyc.gov

Amy F. Nogid
Counsel
Sutherland Asbill & Brennan LLP
1114 Avenue of the Americas
New York, NY
212.389.5086
amy.nogid@sutherland.com

Timothy P. Noonan
Partner
Hodgson Russ LLP
716.848.1265
tnoonan@hodgsonruss.com

I. Unincorporated Business Tax (UBT): Deductibility of Payments to Employee-Partners of General Partner

- ***Tocqueville Asset Management L.P.***, TAT 10-37 (E) (UB) (NYC Tax App.Trib., May 29, 2015)
    - The City Tax Appeals Tribunal (the "City Tribunal") affirmed an ALJ determination sustaining the Notice of Determination asserting a UBT deficiency. The taxpayer had deducted on its UBT return the salaries paid to and the pension plan payments made on behalf of certain employees of the taxpayer's general partner who were also the taxpayer's limited partners ("Employee-Partners"). The Department of Finance ("Department") disallowed the deduction on audit.

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- The Taxpayer did not have any employees of its own. Instead, it used the employees of its general partner to conduct operations. The taxpayer paid a management fee to the general partner for the general partner's services, including the use of the general partner's employees. The general partner did not include the management fee in its federal and UBT returns, and it did not deduct any of the related expenses, including the compensation to its employees. Rather, the taxpayer deducted on its federal and UBT returns each of the general partner's expense items, including the compensation expenses mentioned above. Before 2005, the tax year at issue, the Employee-Partners were shareholders of the general partner. At the beginning of 2005, the general partner was restructured, and the shares of the employee-shareholders were redeemed in exchange for limited partnership interests in the taxpayer.

- The City Tribunal concluded that the Department properly disallowed the deduction of the Employee-Partners' compensation expenses as payments to partners for services under Admin. Code § 11-507(3). The City Tribunal held that the management fee, which was equal to the compensations expenses plus certain administrative expenses, fell squarely within the express terms of § 11-507(3). It also rejected the taxpayer's contention that the deduction of the compensation expenses fell within the exception in 19 RCNY § 28-06(d)(i)(ii)(D) (the "D" Exception).

- The D Exception allows a deduction for amounts paid to a partner to the extent the payment is for services provided by employees of the partner. The City Tribunal concluded that the D exception did not apply to the payments to the Employee-Partners, because they were also partners of the taxpayer. The City Tribunal also noted the situation did not qualify for the D Exception because the general partner did not include the management fee in its gross income for federal tax purposes.

- The City Tribunal also rejected the taxpayer's contention that Admin. Code § 11-507(3) should not apply because the Employee-Partners were not employees of the taxpayer and the taxpayer did not pay the compensation expenses to the Employee-Partners. The taxpayer claimed the Employee-Partners as employee for federal tax purposes, and, hence, could not now assert they were not its employees for purposes of § 11-507(3).

- Further, even if the Employee-Partners were not the taxpayer's employees, the City Tribunal concluded that the deduction for the compensation expenses would still be disallowed under 19 RCNY § 28-06(d)(1)(i)(B) which treats the payments to a third party as compensation for a partner's services or capital as payments to the partner (the "Third-Party Payment Rule"). The City Tribunal rejected the taxpayer's argument that the Third-Party Payment Rule should not apply, because it became effective in 2007, after the 2005 tax year. The City Tribunal stated the Third-Party

Payment Rule had long-standing support in case law, and that the 2007 rule was a mere codification of exiting law.

II. UBT: Worker Status

- ***Timothy J. Young***, TAT(H) 12-19 (UB) (NYC Tax App. Trib., ALJ Div., Feb. 4, 2015)

  - The ALJ rejected the Department's Notice of Deficiency against the taxpayer for the 2005 tax year. The ALJ concluded the taxpayer was an employee of the William J. Buckley Associates, Inc. ("Associates"), a broker-dealer member of the American Stock Exchange (the "Exchange") , with whom the taxpayer was associated.

  - The taxpayer was a "floor clerk" on the exchange for Associates in 2005. The taxpayer's primary duties included receiving telephone orders from customers at Associates' desk on the exchange floor and then transmitting those orders to Associates principal, Mr. Buckley, who would then execute trades on the exchange floor. The taxpayer could also enter orders in the Exchange's trading system, but only on a limited basis.

  - Associates paid for workers compensation coverage on for the taxpayer. Associates provided health insurance to the taxpayer through a third party who had formed a purchasing pool for small business such as Associates. The third party issued a federal form K-1 to the taxpayer and other who received health insurance showing the amount of the insurance payment.

  - The taxpayer claimed Associates paid him both a regular salary of $10,000 per month and a commission or bonus. Associates paid the taxpayer commission income of $565,000. This sum was paid to TJY Brokerage LLC ("TJY"), an LLC taxpayer established in February 2005. The W-2 form Associates issued to the taxpayer only indicated wages of $20,000, and this amount was paid over a period of 2 months in early 2005.

  - During 2005, with Associates' consent, the taxpayer agreed to represent an unrelated entity, Raymond C. Forbes & Company ("RCF") on the Exchange floor. But, the taxpayer did not perform any trades for RCF and he did not receive any payments for services from RCF. Also during 2005, and with Associates' consent, the taxpayer entered into an employment arrangement with Lek Securities Corporation ("LSC"). The taxpayer did not receive any compensation from LSC in 2005. He apparently became a sales trader for LSC in 2006. The taxpayer also established a home office in 2005. However, the bulk of the work performed in this home office was for Associates.

- The ALJ concluded that under all of the facts and circumstances, the taxpayer was an employee of Associates during 2005 and was not subject to the UBT. The ALJ noted the taxpayer was clearly under the direction and control of Associates as to the hours and location of the work, as well as the particular duties that he had to perform. He also had no ability or authority to hire other people. Hence, Associates' control over the taxpayer extended beyond control over the result to be accomplished, but also the details and means regarding the accomplishment of the result. The taxpayer's activities concerning the other firms were subject to Associates' approval and related to his efforts interest to become a partner in Associates, which occurred in 2006. These efforts were preliminary and did not result in any income in 2005.

III. Real Property Transfer Tax (RPTT)

- ***GKK 2 Herald LLC***, TAT(H) 13-25 (RP) (NYC Tax App. Trib., ALJ Div., Apr. 1, 2015)

  - The ALJ sustained Department's Notice of Deficiency and upheld Department's use of the step transaction doctrine in a RPTT matter.

  - In 2007, the taxpayer and another entity, SLG 2 Herald LLC ("SLG"), purchased certain real property located at 2 Herald Square, New York, NY (the "Property"). Under the 2007 deeds, the taxpayer acquired a 45 percent tenants-in-common ("TIC") interest in the Property and SLG acquired a 55 percent interest in the Property. The taxpayer and SLG then, as lessors, entered into a ground lease with another entity, Sitt 2 Herald LLC, as lessee (the "Ground Lease")

  - In December 2010, 2 Herald Owner LLC ("Herald") was formed as a Delaware LLC. Later that month, on December 22, 2010, the taxpayer and SLG executed a TIC Contribution Agreement under which the taxpayer and SLG contributed their TIC interests in the Property to Herald. In return, SLG received a 55 percent interest in Herald, and the taxpayer received a 45 percent interest in Herald.

  - The same day, the taxpayer and SLG executed a purchase agreement in which SLG purchased the taxpayer's 45 percent interest in Herald. Under a separate Assignment and Assumption Agreement, the taxpayer withdrew from Herald.

  - Various provisions of the TIC Contribution agreement also contemplated the taxpayer's sale of its interest. For example, the taxpayer was to be released from its mortgage loan obligations and the return of a letter of credit issued to secure those obligations to the taxpayer. Also, the taxpayer was responsible for any transfer tax arising from the execution of the TIC agreement.

  - The taxpayer and SLG filed an RPTT return for the Contribution of the Property which stated the conveyance was exempt from RPTT as a "mere change in form" under Admin. Code § 11-2106(b)(8), The taxpayer also filed an RPTT return for

the sale of its interest in Herald which stated the transfer was not taxable as a transfer of a non-controlling economic interest in an entity owning real property. *See* Admin. Code §§ 11-2-11(7), 2101(8), 2102(b). On audit, the Department concluded that the transactions resulted in a 45 percent taxable change in beneficial ownership.

    - The ALJ concluded the application of the step transaction doctrine was appropriate. Under the circumstances, it was unlikely the conversion of the taxpayer's TIC interest to its membership interest in Herald or the sale of that membership interest would have occurred without the other. Hence, the step transaction doctrine applied because the "interdependence test" had been met.

    - The ALJ also concluded that each of the events in December 2010 were part of one transaction, the end result of which was taxpayer's sale of its 45 percent TIC interest to SLG while avoiding RPTT on that transaction. Hence, the step transaction doctrine applied because the "end result test" had been met. The ALJ also noted that it was unclear that the 45 percent TIC interest was truly the same beneficial interest as the 45 percent membership interest in Herald, because the taxpayer did not appear to have a clear right to income from the Property under Herald's LLC operating agreement.

- ***Jonis Realty / E. 29th Street, LLC***, TAT(H) 09-9 (RP) (NYC Tax App. Trib., ALJ Div., Sept. 9, 2015)

    - The ALJ rejected Department's denial of a refund claimed for RPTT paid and granted the refund claim. Prior to August 2005, Steven Halegua and his brother Nathan Halegua each owned a 46.5 percent interest in, Jonis Realty/E 29th Street, LLC ("Jonis"). Nathan's son, Joshua Halegua, owned the remaining 7 percent. Jonis held a 96 percent interest in 39 East 29th Street, LLC ("39 E 29 LLC"), which owned parcels of real property located at 39-43 East 29th Street (collectively with another adjacent parcel, the "Property"). An unrelated party owned the other 4 percent of 39 E 29 LLC.

    - As part of Nathan's effort to obtain capital to redevelop the property, Jonis transferred a 30 percent interest in 39 E 29 LLC to 39 East 29th Street LP (the "Transferee") in August 2005. 39 E 29 LLC used the proceeds from this transfer to purchase the adjacent parcel, 45 East 29th Street. A few months later, Jonis transferred an additional 18 percent interest in 39 E 29 LLC to the transferee. At that point, Jonis and the Transferee each had a 48 percent beneficial interest in the Property, with an unrelated party having the remaining 4 percent beneficial interest in the Property. At that time, the uncontroverted evidence showed that Nathan and Steven did not contemplate any further transfers of Jonis's interest in 39 E 29 LLC.

- Some months later, Steven became very uneasy about the situation because he could not get answers about the redevelopment of the Property, and he was not receiving any income from the Property. As a result, on March 14, 2006, Steven transferred his beneficial interest in the Property. This transfer was accomplished through Jonis' transfer of another 22.32 percent interest in 39 E 29 LLC to the Transferee. Following this transfer, the beneficial ownership of the Property was 70.32 percent for the Transferee, 25.68 percent for Jonis and 4 percent for the unrelated party. Nathan did not want Steven to make the transfer and the transfer led to some bitterness and acrimony between the brothers.

- The sales proceeds resulting from this third transfer were distributed directly to Steven. Jonis filed an RPTT return and paid tax, including interest and penalty on the third transfer, believing that RPTT was due because Jonis' three transfers to the Transferee should be aggregated. The RPTT amount was paid out of the sale proceeds from the third transfer, which had been withheld from Steven. Jonis submitted a refund claim signed by Steven.

- The ALJ concluded that the third transfer should not be aggregated with the first two, and, therefore, there was no transfer of a controlling interest triggering RPTT. The definition of controlling interest in 19 RCNY § 23-02 provides that related transfers are aggregated to determine if there has been a transfer of a controlling interest. The definition further provides that transfers within a 3-year period are presumed to be related and are aggregated unless the grantor or grantee is able to rebut the presumption.

- Steven, whom the ALJ determined was the real party in interest, was able to show the third transfer was unplanned, unexpected and occurred for independent reasons. Based on the uncontroverted evidence, the ALJ concluded the third transfer was unrelated because it was unplanned, unexpected and occurred for independent reasons. Indeed, the ALJ noted the third transfer led to bitterness and acrimony between Nathan and Steven. Therefore, Steven had rebutted the presumption set forth in the definition of controlling interest in 19 RCNY § 23-02.

IV. General Corporation Tax (GCT): Business Characterization of Health Maintenance Organizations (HMOs)

- ***Matter of Aetna, Inc.***, TAT(H) 12-3(GC) & TAT 12-4(GC) (NYC Tax App. Trib. ALJ Div. July 22, 2014)
  - Case involves the determination of whether the HMOs were insurance companies and are includible in a combined GCT return with their holding company parent, Aetna, Inc.

- Taxpayer asserted that the HMOs were "doing an insurance business" under the GCT's enabling legislation (L. 1966, ch. 772, Model Act § 41[4]).

- The Department argued that the HMOs were not doing an insurance business in New York under the GCT's enabling legislation, or when read in *pari materia* with the State Health Law, the State Tax Law and the City Administrative Code, and that the HMOs are only providing access to health care services, not insurance.

- The Department pointed to a 2009 amendment to Article 33, the State's premiums tax on insurance companies that explicitly subjected HMOs to the tax, for its position that prior to that time HMOs were not considered as doing an insurance business for tax purposes.

- Until 1974, the City imposed an Insurance Corporation Tax. Companies subject to the Insurance Corporation Tax were exempt from the GCT.

- The Insurance Corporation Tax was repealed in 1974, however, the enabling legislation was not revised to remove the GCT's exemption for companies doing an insurance business in New York State.

- The ALJ considered the three prong test for determining whether insurance is provided: (1) insurance risk; (2) risk shifting and risk distribution; and (3) commonly accepted notions of insurance, and determined, after evaluating federal, other state and State law in various contexts that insurance risk is present in the contracts between the HMOs and their members, that risk is distributed amongst the HMOs' members and that the State Insurance Law and the State Public Health Law regulate the HMOs.

- The ALJ rejected the City's argument that the exemption provided under the GCT for insurance companies should be narrowly construed, recognizing that "an exemption should not be interpreted so narrowly as to defeat its settled purpose."

V. GCT: Apportionment

- ***Matter of The McGraw-Hill Companies, Inc***., TAT(H) 10-19(GC) (NYC Tax App. Trib. ALJ Div. Feb. 24, 2014)

  - Case involves whether in computing the receipts factor, the taxpayer could include receipts for credit rating earned by one of its divisions that were allocated by the audience method and whether taxpayer was a manufacturer entitled to double-weight its receipts factor.

  - Taxpayer, The McGraw-Hill Companies, Inc. is a publisher and provider of information services. One of its divisions, Standard & Poor's (S&P), was a credit ratings business.

- On certain of its original returns, McGraw-Hill sourced S&P's receipts on an origin basis, but filed amended returns and later original returns on its position that S&P's receipts from its activities constituted "other business receipts" that were required to be sourced to the location of the customer.

- Taxpayer had entered into agreements with New York State Department of Taxation & Finance. The first agreement provided that the S&P debt-rating receipts factor would be computed on a destination basis with a 50% reduction in the numerator, and the second agreement sourced receipts based on the location of the customer with a 50% reduction in the numerator. The 50% reduction in the numerator was applied to reflect the user-audience for S&P's credit ratings.

- Taxpayer sought a ruling from the Department seeking revision of the S&P receipts factor, but the Department would not agree to issue a ruling.

- In an interesting turn for a tax case, the ALJ ruled that S&P's credit ratings were protected speech under the First Amendment to the Constitution, and that as part of a protected class of publishers, S&P could not be treated differently from other members of the press.

- The ALJ concluded that S&P's credit rating receipts were "other business receipts" and that S&P's receipts should be allocated in the same manner as publishers, which require a method based on circulation or audience. Since the method proposed by S&P, which takes into account subscription and audience matrices, the ALJ concluded that the method should be allowed as a discretionary adjustment.

- The ALJ found that less than 50% of McGraw-Hill's income was from manufacturing activities and that it could not, therefore, double weight its receipts factor.

VI. Bank Tax: Combined Reporting

- ***Matter of Astoria Financial Corp***., TAT(H) 10-35 (BT) (NYC Tax App. Trib. ALJ Div. Oct. 29, 2014)

    - Case involves the Department's attempt to require the inclusion of a wholly owned subsidiary that did no business in New York into a combined return with the taxpayer.

    - The taxpayer, Astoria Financial, a holding company that owned Astoria Federal Savings & Loan Association (Astoria), argued that Astoria's subsidiary, Fidata, should not be included in Astoria Financial's City bank tax combined return.

    - Fidata was a New York corporation that Astoria acquired from a third party in 1995, and was dormant until 2005 when it became a Connecticut passive investment company (PIC) formed to hold non-New York mortgages. However, for New York State purposes it was a "grandfathered" Article 9-A corporation.

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Under NY Tax Law § 1452(d), grandfathered Article 9-A corporations cannot be included in State bank tax combined returns. Since it did not do business in the City, it did not file GCT returns. As a nonfiler, it could not elect to remain subject to GCT rather than the bank tax.

- Connecticut PICs are not subject to Connecticut's corporation business tax, and dividends received from a Connecticut PIC are not considered "gross income." Connecticut PICs are required to maintain a Connecticut office and to employee at least five full-time employees.

- Fidata administered the loans, but did not solicit, investigate, negotiate or approve the loans. Astoria was paid by Fidata to service and administer the loans under a Master Loan Servicing Agreement and the companies entered into an Expense Sharing Agreement and a Custodial Agreement, all of which were asserted to be at arm's length rates.

- The Department argued that Fidata was a "sham," that it lacked economic substance, was not formed for a valid business purpose, and was formed to avoid the City's bank tax. The Department also argued that intercompany transactions were not at arm's length.

- The taxpayer countered that Fidata had economic substance and was formed for the business purpose of maintaining Astoria's Community Reinvestment Act (CRA) rating by segregating non-New York mortgages, and that the transactions were all at arm's length rates.

- The ALJ concluded that Fidata was not a sham corporation, was formed for legitimate non-tax business purposes as well as to secure tax benefits as a Connecticut PIC.

- The ALJ also concluded that the intercompany transactions identified by the Department (establishing Fidata as a PIC, Astoria's funding of Fidata by capital contribution, Fidata's distribution of dividends to Astoria, Fidata's purchase of loans from Astoria, Astoria's servicing of Fidata's mortgages, and Astoria's provision of administrative services to Fidata) were not distortive.

- Finally, the ALJ concluded that there was no "mismatch" of income caused by the relationship between Astoria and Fidata and that *Matter of Interaudi Bank F/K/A Bank Audi (USA),* DTA No. 821659 (NYS Tax App. Trib. Apr. 14, 2001) was neither "on all fours" since the facts were not analogous, or precedential, since *Interaudi* did not announce a new binding legal principle.

- The ALJ cancelled the assessment.

VII. State: Corporate Franchise Tax Combined Reporting

- ***Matter of Knowledge Learning Corp. and Kindercare Learning Centers, Inc.***, Dkt. No. 823962, 823963 (NYS Tax App. Trib., Sept. 18, 2014)

    - The Tax Appeals Tribunal reversed an ALJ determination and found that the taxpayers had engaged in substantial intercorporate transactions and that, therefore, combined reporting was required pursuant to Tax Law § 211(4).

    - For tax years commencing on or after January 1, 2007, Tax Law § 211(4)(a) was amended to require combined reporting where the substantial ownership requirement was met and where there were substantial intercorporate transactions among the related corporations, regardless of the transfer price for such intercorporate transactions.

    - The substantial intercorporate transactions in this case took the form of employee transfers between entities and reimbursement at cost for the transferred employees.

    - The Tribunal determined that these transfers were part of the taxpayers' reasonable business strategy of operating their subsidiaries as a single business. The transfers therefore had a valid business purpose and economic substance.

    - The Tribunal also found that it was erroneous for the ALJ to conclude that, following the 2007 amendments to Tax Law § 211(4), distortion was no longer a factor in the determination of combined filing.

- ***Matter of SunGard Capital Corp. and Subsidiaries***, Dkt. No. 824336 (NYS Tax App. Trib., May 19, 2015)

    - The Tax Appeals Tribunal reversed an ALJ determination and allowed a group of related corporations to file on a combined basis. The taxpayers in the case claimed refunds for the period August 13, 2005 through December 31, 2005 and for the calendar year 2006 by filing amended franchise tax returns on a combined basis for these periods. The refunds claimed in the amended filings were denied.

    - The combined group's primary line of business involved providing IT sales and services (data processing, information availability, software solutions and software licensing, etc.) to four main business segments. The taxpayers met the unity of ownership requirement for combined filing since the entities were commonly owned and controlled. The dispute lied in whether the taxpayers were engaged in a unitary business and whether separate filings resulted in distortion.

    - The ALJ upheld the denied refund claims, concluding that while there were similarities among the segments, the segments were too distinct to qualify as a unitary business.

- The Tribunal reversed the ALJ upon finding that the record established that the entities were engaged in a unitary business during the periods underlying the refund claims, specifically that "the Group's various entities were engaged in the same or related lines of business within the meaning of the Division's regulations and federal unitary doctrine." Unlike the ALJ, the Tribunal found that the various segments complemented each other and were sufficiently similar for the unitary business analysis.

- The Tribunal's reversal focused on particular indicia of the unitary business, specifically the group's centralized management, the absence of reimbursement for centralized corporate-level functions and services which resulted in "an obvious flow of value," the group's consolidated purchasing services which allowed the group to benefit from volume discounts, various financing arrangements where members guaranteed other members' debts, and cross-selling efforts that "resulted in a flow of value between the various business segments."

- While the case involved pre-reform law, the Tribunal's unitary business analysis remains applicable.

VIII. State: IRC § 338(h)(10) Retroactivity

- ***Burton v. New York State Dep't of Taxation & Fin.*****,** 25 NY3d 732 (2015), *aff'g* 43 Misc. 3d 312 (N.Y. Sup. Ct. Albany County 2014)

    - Case involves the sale of S corporation stock by nonresident shareholders pursuant to an IRC § 338(h)(10) election.

    - Taxpayers sold their stock in 2007. At the time, Tax Law § 632(a)(2) prohibited this income from being treated as New York source income to a nonresident, as the Tribunal held in *Matter of Baum*, Dkt. No. 820837 & 820838 (NYS Tax App. Trib., Feb. 12, 2009).

    - Section 632(a)(2) was retroactively amended in 2010 to "undo" the Tribunal's decision in *Baum,* and the amendment was made effective to years beginning on or after January 1, 2007. L. 2010, ch. 312, pt. B, § 1.

    - Taxpayers argued the amendment violated Article 16, section 3, of the N.Y. Constitution which prohibits New York from taxing the sale of a nonresident's intangible personal property, and that the Department's reliance on the amendment was unconstitutional.

    - Notably, the taxpayers withdrew the argument that the retroactive enforcement of the law was unconstitutional, at oral argument.

    - Court rejected the taxpayers' argument and held that since the transaction was treated as an "asset sale" per the federal election, taxing the gain "did not run afoul of the constitutional prohibition against taxing a nonresident's intangible personal property."

- ***Caprio v. New York State Dept. of Taxation & Fin.***, 25 NY3d 744 (2015), *rev'g* 117 A.D.3d 168 (1st Dep't 2014)

    - The case began in N.Y. County Supreme court where the Caprios challenged the retroactive application of the 2010 amendment to Tax Law § 632(a)(2), arguing that the amendment, as applied, violated the Due Process Clauses of the federal and New York State Constitutions.

    - Tax Law § 632(a)(2) was amended in 2010 with respect to nonresident S corporation shareholders who received installment obligations in exchange for their S corporation stock under IRC § 453(h)(1)(A). The 2010 amendment was made retroactive to the 2007 tax year. *See* L. 2010, Ch. 57, pt. C, § 1.

    - Under IRC § 453(h)(1)(A), an S corporation shareholder who exchanges S corporation stock for installment obligations (in a liquidation to which IRC § 331 applies) received by the S corporation in a sale or exchange, is treated as receiving payment for the sale of stock upon receipt of the installment payments. However, the 2010 amendment require nonresident shareholders receiving distributions of installment obligations to source the gain recognized on the payments according to the S corporation's business allocation percentage. It specifically targeted and intended to overturn a 2009 New York ALJ determination, *Matter of Mintz*, Dkt. No. 821807 & 821806 (NYS Div. of Tax App., June 4, 2009).

    - The Caprios were nonresidents of NYS who sold their S corporation stock in 2007. Both the Caprios and the buyers made elections under IRC § 338(h)(10), and the Caprios also received a liquidating distribution of installment obligations in exchange for their S corporation stock under IRC § 453(h)(1)(A).

    - In 2014, the Appellate Division, First Department, overturned the New York County Supreme Court and held that the retroactive application of the 2010 amendment denied the Caprios due process based on a three-factor ''balancing-of-the-equities'' test because (1) the Caprios reasonably relied on the existing law in 2007 to structure their transaction, and had no forewarning of the change made by the 2010 amendment, (2) the 3 ½ year retroactivity period was excessive and the amendment was not curative, and (3) the public purpose for the retroactive

application of the 2010 amendment asserted by the Tax Department was not convincing. The Court of Appeals disagreed.

- In reversing the First Department, the Court of Appeals (1) discounted the Caprios' reliance on the law in place during 2007, (2) noted that retroactivity periods in excess of 3 ½ years have been accepted, and (3) found that the amendment was curative in nature.

IX. State: Personal Income Tax: Review of Federal Taxability

- ***Matter of Steve and Linda Horn***, Dkt. No. 825333 (NYS Div. of Tax App., July 2, 2015)

  - This case involved the IRC § 183 "hobby loss" rules. The Tax Department argued that an S corporation was not a for-profit endeavor and therefore, the Horns were not entitled to claim losses that passed through to their returns during the years in question.

  - Mrs. Horn owned 100% of the Company's stock in an S corporation (the "Company") and the Horns' returns for 2004-2009 reported all of the income and losses that passed through to Mrs. Horn from the Company. The Horns were issued a Notice of Deficiency for 2004-2009 asserting personal income tax due by them. The tax was calculated by disallowing all of the Company's losses and its net operating loss (NOL) carryforwards and carrybacks. Basically, all adjustments related to issues of *federal tax law*.

  - The Company, formed in 1974, had three lines of business: a television commercial production business, an antiques business, and a real estate investment business. It employed between 14-20 employees in 2004-2009, though it reported losses each year. The Horns loaned $31 million to the Company during these years and the Company paid them interest on the loans.

  - The television commercial production business was initially quite successful but production business declined in early-2004 to 2005, and came to an end. The antiques business operated in a Manhattan storefront and also online during 2004-2009. From 2004-2006, it was a division of the Company operated as a "d/b/a" but was transferred to a wholly-owned LLC in 2006. The Company entered into several significant real estate deals during 2004-2009 in both New York and Florida, including IRC § 1031 like-kind exchanges.

  - The Tax Department audited the Company for 2004-2009 and determined that one of the like-kind exchanges didn't qualify for deferred gain treatment. It further determined that the company was not engaged in for profit for IRC § 183

purposes because: (1) the shareholder does not depend on the income from the business, (2) the business has not made a profit in at least the last eight years of operation, (3) losses were not due to circumstances beyond their control and they did not occur in the start-up phase of their business, and (4) the business has not changed their methods of operation to improve profitability.

- The Horns argued the three lines of business should be treated as one activity for IRC § 183 purposes. The Tax Department argued the commercial production businesses ended at the beginning of the audit period and the Horns were not engaged in real estate activities because the Company bought only four properties and sold only one during the years at issue (though they claimed significant NOL carryforwards and carrybacks each year).

- The ALJ decided the issue based on factors applied by the courts in deciding whether the characterization of several undertakings as one activity is unreasonable for IRC § 183 purposes: (1) the location of activities, (2) activities as efforts to derive revenue from land, (3), whether the undertakings were formed as separate activities, (4) each activity's benefit to the others, (5) cross-advertising, (6) shared management, (7) shared caretaker, (8) shared accountants, and (9) shared books and records. The factors seek to determine whether the undertakings are run in a businesslike manner.

- After examining these factors, the ALJ concluded that the Company's activities were run in a businesslike manner and therefore, the Horns had a profit objective and the Company's losses were properly passed through to their returns for 2004-2009.