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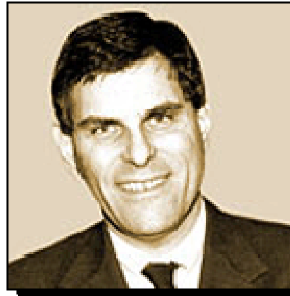
Safeguarding New York City's Tax Interests



Recent articles have focused on activities of the Law Department that raise revenue for the city, a vital function especially in these troubled economic times. Some of the Law Department's most important contributions in this regard result from the work of its Tax and Bankruptcy Litigation Division.

The 36 attorneys of the Tax and Bankruptcy Litigation Division represent the city in a range of proceedings and other matters, including bankruptcy proceedings, in which the city as creditor seeks to protect its interests, consisting primarily of the payment of delinquent taxes, with respect to a bankrupt debtor; condemnation proceedings; and proceedings to review real property tax assessments.

Division attorneys also represent the city in proceedings before the city's Tax Appeals Tribunal, an independent tribunal established within the Department of Finance to adjudicate taxpayer appeals from certain determinations of the Commissioner of Finance, and in judicial proceedings brought by taxpayers to review tribunal determinations with respect to income and excise taxes.

In this article, I will focus on recent examples of income and excise tax cases handled by the Tax and Bankruptcy Litigation Division, describing the issues confronted by Law Department lawyers in their efforts to secure payment to the public of taxes due and owing. I will conclude with a discussion of a tax-related case that resulted in a unanimous ruling for the city by the U.S. Supreme Court.

Unincorporated Business Tax

The city's Unincorporated Business Tax (UBT), imposed pursuant to chapter 5 of Title 11 of the Administrative Code, is levied on the business income of unincorporated entities, primarily partnerships and limited liability companies, operating in the city. Attorneys of the Tax and Bankruptcy Litigation Division successfully defended the city in two recent cases arising from application of the UBT. In *Citrin Cooperman v. Tax Appeals Tribunal*, 52 A.D.3d 228; 859 N.Y.S.2d 158 (1st Dept. 2008), the court dismissed an Article 78 petition challenging the Tax Appeals Tribunal's determination that certain payments made to retiring partners were not deductible for UBT purposes. The case involved the relationship between the federal income tax code and the UBT, and the classification of the payments to the retiring partners. This case illustrates some of the complexities involved in litigating New York City tax cases.

The starting point for calculating the UBT is a taxpayer's gross income for federal income tax purposes, but this amount is modified in accordance with Administrative Code §11-506. The resulting amount is a taxpayer's unincorporated business gross income. Unincorporated business taxable income is determined by reducing unincorporated business gross income by unincorporated business deductions.

Pursuant to Administrative Code §11-507, a taxpayer's unincorporated business deductions are equal to allowable federal deductions, but, again, subject to certain modifications. These modifications are set forth in section 11-507, which disallows certain deductions that may be taken for federal income tax purposes. Among those disallowed federal deductions are payments to partners (or to members in the case of a limited liability company) for services. Without this modification, partnerships would simply distribute all of their profits to their partners, effectively nullifying the UBT.

Under federal law, payments for services to retiring partners are taxed as ordinary income to the retiring partner. The partnership, however, is entitled to deduct such amounts from its federal taxes. On the other hand, federal law does not permit a partnership to deduct payments to retiring partners for good will, "to the extent that the partnership agreement provides for a payment with respect to good will." Internal Revenue Code §736(b)(2)(B). Thus, payments to a retiring partner for good will, specified as such, are not deductible by the partnership for federal income tax purposes.

The UBT issue litigated in *Citrin Cooperman* arose when a partnership deducted for federal tax purposes payments to retiring partners specified as payments for services. The partnership claimed a deduction for the same payments for UBT purposes, arguing that they were actually payments for good will, which did not come within the list of disallowed federal deductions set forth in Administrative Code §11-507, and could therefore be deducted from its business gross income in calculating the amount owed under the UBT. When the city refused to allow this claimed deduction, the partnership brought the matter before the Tax Appeals Tribunal, where the city, represented by attorneys of the Tax and Bankruptcy Litigation Division, prevailed.

The partnership appealed the tribunal's ruling to the Appellate Division, First Department, which also ruled in favor of the city, noting that "numerous partnership documents" described the payments in question as "past service compensation." Thus, the court concluded, the partnership could not characterize the payments as payments

for goodwill for UBT purposes. *Citrin Cooperman*, 52 A.D.3d at 229.

In another UBT case, the Tax Appeals Tribunal held, and the Appellate Division confirmed, that payments made by partnerships to deferred compensation plans were also payments to partners for services and were not deductible for UBT purposes. *Proskauer Rose LLP v. Tax Appeals Tribunal*, 57 A.D.3d 287; 868 N.Y.S.2d 206 (1st Dept. 2008). As the Appellate Division noted, "[p]etitioner's federal tax deductible contributions to deferred compensation plans on behalf of active partners, while made not to the partners but directly to the plans, clearly are for the direct benefit of the partners and thus are also not deductible under Administrative Code §11-507(3)." 57 A.D.3d at 288.

Real Property Transfer Tax

The city's Real Property Transfer Tax (RPTT), imposed pursuant to chapter 21 of Title 11 of the Administrative Code, applies to the transfer of real property or an interest therein where the consideration exceeds $25,000. For purposes of the RPTT, a transfer of real property includes the transfer of a leasehold interest. However, in the case of a leasehold interest, consideration does not include rent paid for the use and occupancy of real property. Administrative Code §2102(a)(10(iii).

In *Matter of Hubrecht*, NYC Tax Appeals Tribunal, TAT (H) 05-10(RP) (Feb. 21, 2008), the Tax Appeals Tribunal was required to determine what constitutes rent for purposes of the RPTL. The taxpayer net leased his property for 49 years less one day in exchange for a single, lump-sum up-front payment of $7.25 million. The taxpayer contended that the grant of the leasehold was not subject to the RPTT because the amount prepaid was rent for use and occupancy of the property. The city, represented by attorneys of the Tax and Bankruptcy Litigation Division, did not prevail in arguing that the amount of consideration subject to the RPTT was the amount paid that was not rent subject to the city's commercial rent tax, and that the entire prepayment was consideration to obtain the leasehold rather than a payment for use and occupancy.

The tribunal held that, although the entire amount of the payment for use and occupancy of the property was paid at the start of the lease term, it was nevertheless rent within the meaning of Administrative Code §11-2102(a)(10)(iii). As a result, the taxpayer did not owe any real property transfer tax.

Hotel Room Occupancy Tax

The city's Hotel Room Occupancy Tax, which is computed pursuant to chapter 25 of Title 11 of the Administrative Code for the occupancy of each room in a hotel located in the city, exempts rooms occupied by permanent residents. Any person occupying a room or rooms in a hotel for at least 180 consecutive days is considered a permanent resident "with regard to the period of such occupancy." Administrative Code §11-2501.8. In *Matter of American Airlines Inc*., NYC Tax Appeals Tribunal, TAT (H) 05-29(HO) (June 29, 2009), the taxpayer provided hotel rooms for its flight crews in three hotels in the city with which it had agreements. The taxpayer used at least one room in each of the hotels for more than 180 days.

The taxpayer argued that since it was a permanent resident with regard to at least one room, it was, pursuant to the definition of "permanent resident" set forth in Administrative Code §11-2501.8, entitled to an exemption for any additional rooms it used, whether or not those additional rooms were also occupied for 180 consecutive days. The city refused to allow the full exemption claimed by the taxpayer, arguing that the definition of "permanent resident" applied only with regard to particular rooms occupied for the specified time period.

The taxpayer appealed the city's determination to the Tax Appeals Tribunal, which resolved the statutory ambiguity in the city's favor, ruling that the occupancy of a single hotel room for more than 180 days did not exempt the taxpayer from payment of the tax for occupancy of other rooms in the same hotel for less than 180 days.

Supreme Court Case

Section 1127 of the New York City Charter requires every applicant for city employment to agree that, if the applicant is employed by the city and is or becomes a non-resident of the city, he or she will pay to the city an amount equal to the city's personal income tax on residents, if such amount exceeds any city earnings tax and city personal income tax owed by the applicant for the same taxable period. In *United States ex rel. Eisenstein v. City of New York*, 556 U.S.—, 129 S.Ct. 2230, 173 L. Ed. 2d 1255 (2009), a former city employee, acting pro se, sued the city in the U.S. District Court for the Southern District of New York, challenging the requirement of section 1127. In addition to several constitutional claims, plaintiff argued that the fee deprived the United States of tax revenue that it otherwise would have received had the amount not been deducted as an expense from a worker's taxable income, and therefore violated the federal False Claims Act, 31 U.S.C. §3729 et seq. Plaintiff's success would have deprived the city of substantial tax revenues from non-resident employees.

The False Claims Act imposes civil liability for "any person who knowingly presents, or causes to be presented, to an officer or employee of the United States Government…a false or fraudulent claim for payment or approval." 31 U.S.C. §3729(a)(1). Under the False Claims Act, the United States has 60 days to decide whether it wants to intervene and take over the case. If the government declines to intervene, the relator, the person who brought the action, may proceed independently, and the government may intervene later only

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"for good cause shown." In either case, the relator receives a portion of the recovery if the action is successful. The United States declined to intervene in this case.

The city, represented by attorneys of the Tax and Bankruptcy Litigation Division, prevailed in the District Court, which dismissed the complaint for failure to state a claim upon which relief could be granted. 2006 U.S. Dist. LEXIS 14944 (S.D.N.Y. March 30, 2006) (Batts, J.). 54 days after entry of the final judgment in the District Court, plaintiff filed a notice of appeal.

Generally, pursuant to the Federal Rules of Appellate Procedure (F.R.A.P.), a litigant has 30 days to file a notice of appeal after entry of judgment. F.R.A.P. 4(a)(1)(A). However, as an exception to this rule, when the U.S. government is a party, all parties have 60 days to file a notice of appeal. F.R.A.P. 4(a)(1)(B). An untimely filed notice of appeal deprives the appellate court of subject matter jurisdiction.

At the time of plaintiff's appeal, there was a split among the federal circuit courts of appeal as to whether the United States is a party to a False Claims Act suit where, as here, it declines to intervene. The U.S. Court of Appeals for the Tenth Circuit had held that the United States was not a party, and therefore a litigant had 30 days to file a notice of appeal. *United States ex rel. Petrofsky v. Van Cott, Bagley, Cornwall, McCarthy*, 588 F.2d 1327 (10th Cir. 1978), cert. denied, 444 U.S. 839 (1979). However, the U.S. Court of Appeals for the Fifth, Seventh and Ninth circuits had held that the United States was a party even when it declined to intervene, and that therefore a litigant had 60 days to file a notice of appeal. *United States ex rel. Russell v. Epic Healthcare Mgmt. Group*, 193 F.3d 304 (5th Cir. 1999); *United States ex rel. Lu v. Ou*, 368 F.3d 773 (7th Cir. 2004); *United States ex rel. Haycock v. Hughes Aircraft Co*., 98 F.3d 1100 (9th Cir. 1996), cert. denied, 520 U.S. 1211 (1997).

The U.S. Court of Appeals for the Second Circuit, which had not yet ruled on the subject, directed the parties and the U.S. government to brief the question of which time limit applied. The city argued that the shorter, 30-day limitations period applied and that plaintiff's appeal was therefore time-barred. The city further argued that a non-attorney pro se litigant may not prosecute an action under the False Claims Act.[1] The Second Circuit accepted the city's position and dismissed the appeal for lack of jurisdiction, noting that "the inability to participate without moving to intervene is simply not consistent with the principal characteristics of being a party to litigation." *Eisenstein*, 540 F.3d 94, 98 (2d Cir. N.Y. 2008), aff'd, 556 U.S.— (2009).

Plaintiff, represented by a pro bono attorney appointed by order of the Second Circuit, petitioned the U.S. Supreme Court for certiorari, which the Court granted. 555 U.S.—,129 S. Ct. 988, 173 L. Ed.2d 172, 2009 U.S. LEXIS 588 (2009). Paul T. Rephen, Executive Assistant Corporation Counsel, presented the city's case before the Court. In a unanimous decision written by Justice Clarence Thomas, the Supreme Court affirmed the Second Circuit's dismissal of the appeal. The Court noted that, when a private person brings an enforcement action under the False Claims Act, the statute authorizes the United States to "elect to intervene and proceed with the action[.]" Therefore, the Court concluded, the United States becomes a "party" to such an action only if it exercises its option to intervene in accordance with the statute.

The Court further noted that, although the False Claims Act designates the United States a "real party in interest" in all actions, that term merely denotes "an actor with a substantial right whose interests may be represented in litigation by another [party]." To conclude otherwise would, in the Court's view, "render the intervention provisions of the [False Claims Act] superfluous, as there would be no reason for the United States to intervene in an action in which it is already a party." Therefore, the Court held, the United States was not a party to the present action, and plaintiff's time to appeal the district court's judgment was limited to 30 days. *Eisenstein*, 556 U.S.— (June 8, 2009), Slip Opinion at pages 4-6.

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1. The Court did not reach this issue. However, in a case argued on the same day as *Eisenstein*, the Second Circuit held that a non-attorney litigant may not prosecute a False Claims Act action pro se. *United States ex rel. Mergent Services v. Flaherty*, 540 F.3d 89 (2d Cir. 2008).

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