NEW YORK CITY TAX APPEALS TRIBUNAL
ADMINISTRATIVE LAW JUDGE DIVISION

In the Matter of the Petition	:	
	:	**DETERMINATION**
of	:	**TAT(H)06-20(GC)**
	:	
IMPERIAL RENTAL INVESTMENTS, INC.	:	

Murphy, A.L.J.:

Petitioner, Imperial Rental Investments, Inc., filed a Petition with the New York City ("City") Tax Appeals Tribunal ("Tribunal") on June 20, 2006, protesting a Notice of Determination of City General Corporation Tax ("GCT") for the period January 1, 2001 through December 31, 2002 ("Tax Years").

Petitioner was represented by John M. Aerni and John Weber, Esqs. of Dewey & LeBoeuf. Respondent Commissioner of Finance (the "Commissioner") was represented by Martin Nussbaum, Esq., Assistant Corporation Counsel, and Frances J. Henn, Esq., Senior Counsel, participated in the briefing. A series of pre-trial conferences and hearing sessions were held. Petitioner filed two post-hearing briefs and the Commissioner filed one.

CONCLUSION

The Commissioner may not constitutionally require Petitioner's share of income from the sale of California real property owned by a limited partnership in which it had an 30% interest to be included in Petitioner's allocated City income subject to the GCT, as that would result in a tax which is out of all appropriate proportion to Petitioner’s activities in the City.

FINDINGS OF FACT

Werner Otto, a citizen and resident of Germany, invested in commercial real estate in the United States principally to provide income for his children. Mr. Otto established a number of corporations and partnerships which owned and invested in real property. At different times, Mr. Otto transferred the control over these entities to his relatives, including his adult children.

Petitioner, a Delaware corporation, is engaged in investing in limited partnerships in the United States. Mr. Otto established Petitioner for the benefit of his daughter, Ingvild Goetz, and transferred control of it to her between 1991 and 2000. Ms. Goetz lived in Munich, Germany, where she owned and managed an art museum. During the Tax Years, Petitioner’s sole shareholder was Ms. Goetz.

Petitioner invested only in commercial real estate limited partnerships and a limited liability company which had an interest in a real estate limited partnership. Petitioner did not independently conduct a trade or business in the City or elsewhere and had no employees and no payroll.

During the Tax Years, Petitioner invested directly or indirectly in four real estate limited partnerships (the “Partnerships”):

a. One Wilshire Arcade Imperial, Ltd. (the “California Partnership”), a limited partnership which began business on

October 12, 1978 and owned an office building located in Los Angeles, California (the "California Property"). Petitioner had a 30% limited partnership interest in the California Partnership.

b. Old Slip Associates, L.P. (the "Old Slip Partnership"), a limited partnership which began business on March 2, 1995 and owned an office building located in lower Manhattan in an area known as Financial Square (the "Downtown NY Property"). Petitioner had a 4.95% limited partnership interest in the Old Slip Partnership.

c. 712 Fifth Avenue, L.P. (the "712 Fifth Avenue Partnership"), a limited partnership which began business on June 24, 1998 and owned an office building located 712 Fifth Avenue in the City (the "Midtown NY Property"). Petitioner owned a 4.9% limited partnership interest in the 712 Fifth Avenue Partnership.

d. 712 Fifth Avenue G.P., L.L.C. ("Fifth Avenue LLC"), a Delaware limited liability company which began business on April 19, 1998 and was a general partner holding a 0.5% interest in 712 Fifth Avenue Partnership. Petitioner owned a 10% interest in Fifth Avenue L.L.C.

Collectively, the Downtown NY Property and the Midtown NY Property are referred to as the "New York Properties" and the Old Slip Partnership, the 712 Fifth Avenue Partnership and Fifth Avenue LLC are referred to as the "New York Partnerships." Petitioner received passed through income from these four partnerships according to its proportionate direct and indirect holdings in each partnership.

Petitioner did not provide management or other services to the California and New York Partnerships or the California and New York Properties.

During the Tax Years, Thomas Finne and Thomas Armbrust were the only directors of Petitioner. Mssrs. Finne and Armbrust were employees of Cura Vermoegensverwaltung, a German wealth management firm. They were responsible for making real property investment decisions for Petitioner. Thomas Armbrust was also Petitioner's President.[1]

Paramount Group, Inc. ("Paramount") is a Delaware corporation with offices in the City. Its activities include financial and technical consulting and managing office buildings (including leasing space in the buildings, contracting for maintenance and other services, public relations, hiring of personnel and accounting oversight). Paramount was formed by Werner Otto in the late 1970s. Mr. Otto's children, other than Ingvild, own shares in Paramount. Alexander Otto and Albert Behler were directors of Paramount during the Tax Years. Paramount's clients are primarily real property investment entities and, during the Tax Years, included Petitioner and other Werner Otto family investment partnerships. Paramount's revenue was solely from management fees charged its clients.

Paramount managed Petitioner's books and records (including preparing and filing tax returns) and consulted on investments pursuant to an Administrative and Consulting Management Agreement.

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[1] During the Tax Years, the following individuals were also officers of Petitioner: Bernie Marasco, Assistant Vice President; Mike Zubrycky, Treasurer; Vito Messina, Treasurer (who replaced Mr. Zubrycky); and Martha Gladstein, Secretary. See, *e.g.*, Pet. Ex. 63, 64; Resp. Ex. A. These individuals were also employed by Paramount Group Inc. at one time or another.

Mssrs. Finne and Armbrust consulted with Paramount under the Management Agreement. Neither Petitioner nor its shareholder owned any stock in Paramount and Paramount owned no stock in Petitioner. Paramount charged Petitioner an annual fee of $15,000 during the Tax Years.[2]

Paramount entered into individual contracts with each of the California and New York Partnerships, both as manager of the Partnerships and as managing agent of the Properties.

Under Petitioner's by-laws, Mr. Armbrust had "complete executive authority" over Petitioner. Petitioner's other officers performed ministerial functions under the direction of Mssrs. Finne and Armbrust.

Petitioner did not control the general or limited partners of the California and New York Partnerships, which were controlled by members of the extended Otto family or members of an unrelated German family, the von Finks. Petitioner made no decisions concerning the management of any of the Partnerships.

No moneys flowed between the California and New York Partnerships or between the California and New York Properties. There were no loans, cross-financing, guarantees or other transactions between or among them.[3]

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[2] Paramount is listed on the Form 5472, appended to Petitioner's 2002 Form 1120 U.S. Corporation Income Tax return, as a "related party" to Petitioner. Pet. Ex. 236; Resp. Ex. A. Adam Cohen, Paramount's Director of Taxation, testified that this was required by IRC §267C because of the "family relationship." Tr. 412.

[3] Petitioner made loans to its sole shareholder, Ingvild Goetz, and to a foreign affiliate. Pet. Ex. 50.

Income generated by the California Partnership was used solely by that partnership, either for the partnership's business purposes or for distribution to its partners. Income generated by each of the New York Partnerships was used only by each partnership, either for the individual partnership's business purposes or for distribution to its partners.

The New York and California Properties were mortgaged through arrangements with unrelated financial institutions, primarily certain German banking corporations. The loan documents for the mortgages contained restrictive covenants which essentially precluded any flow of value from one partnership to any of the other partnerships and from one property to any other property.

Paramount arranged for each Property to enter into service contracts with unrelated providers, the terms of which applied only to the provision of services to the specific property.

Before 2002, on its City GCT Forms 3L GCT Return ("GCT Returns") Petitioner included its proportionate share of the California Partnership's receipts and the value of its property and wages in its City Business Allocation Percentage ("BAP") factors, as well as its proportionate share of California Partnership income in its City Entire Net Income ("ENI").[4] For 2001, Petitioner reported $845,650 in rental income from the California Partnership.

In 2001, the California Partnership sold the California Property to Carlyle Realty III, L.P., an unrelated party (the "Sale"). The general partner of the California Partnership was

[4] From 1995 through 1999 (a period not in issue in this proceeding), Petitioner included in its GCT return factors attributable to and income from its investment in a Texas limited partnership, South Plains Mall Associates. Pet. Ex. 71.

responsible for the decision to sell the California Property, which was based on an anticipated downturn in the California real estate marketplace.

Adam Cohen, Director of Taxation for Paramount, testified credibly with respect to Petitioner's tax filings and other financial transactions. He testified that the Sale was originally intended to be a like-kind exchange under Internal Revenue Code ("IRC") Section 1031, but that such exchange could not be completed within the statutorily required time period because replacement property could not be found. Tr. 521-24. According to Mr. Cohen, the receipts from the Sale were treated as receipts from an installment sale for the subsequent period. Tr. 523. He testified that Petitioner's 2002 California franchise tax return was prepared in reliance on California Franchise Tax Board Legal Ruling No. 413, "Allocation and Apportionment Treatment of Installment Sales" (January 5, 1979), which stated: "the gain or loss from an installment sale should be apportioned on the basis of the factors of the year of sale regardless of the year in which such gain or loss is actually reported." Tr. 388.

In March 2002, the $84,200,000 net proceeds from the Sale were distributed to the partners of the California Partnership. Petitioner received $18,567,254, representing its proportionate share of the gain based on its limited partnership interest in the California Property. This gain was reported to Petitioner on its Federal Form K-1 as a "Net Sec. 1231 Gain." Petitioner's proportionate share of California Partnership net rental income or $1,747,946 and California Partnership interest income of $91,705 were also reported on the K-1.

Petitioner filed its 2001 GCT Return, using formulary apportionment to compute its City ENI. Petitioner computed a City BAP of 56.55% which reflected the relationship which its City income, property and wages bore to its total (New York and California) income, property and wages. Petitioner applied this BAP to its ENI, which resulted in a GCT liability of $156,861.

Petitioner filed its 2001 State of California Corporation Franchise or Income Tax Return, Form 100 ("California Return"), computing its taxable California income using formulary apportionment. On its 2001 California Return, Petitioner apportioned 48.7744% of the combined business income of the New York and California Partnerships to California.[5]

Petitioner filed its 2002 GCT Return calculating its tax liability by using a separate accounting method that excluded the gain from the sale of the California Property from ENI, and those factors that were attributable to the California Partnership from the BAP. Petitioner allocated 100% of its income from the New York Properties to the City and reported City GCT liability of $90,726.[6]

Petitioner filed a one-page attachment to its 2002 City Return ("Statement A") which listed income from the New York Partnerships as reported on Schedules K-1 and stated that:

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[5] Petitioner requests that an inference be made based on the testimony at hearing that for 2001 it allocated New York State ("State") ENI by a State BAP. However, the 2001 State Franchise Tax Report is not in the record and the testimony on the cited transcript page (which refers only to the 2002 Report) is insufficient to draw such an inference. T. 384.

[6] Based on this methodology, Petitioner reported an overpayment of $39,274, of which $39,226 was requested to be applied to the following year and $48 was paid for a self-assessed penalty for underpayment of estimated tax for quarterly payments made during 2002. Resp. Ex. B.

> The taxpayer has a small interest in each [New York] partnership and limited liability company, does not participate in the day-to-day management of either of the limited partnerships or the limited liability company, and does not have a unitary relationship with the partnerships or the limited liability company. Pursuant to *Allied-Signal v. Director, Div. Of Tax.*, June 15[sic], 504 U.S. 768, 112 S.Ct. 2251 (1992); *Matter of British Land (Maryland) Inc. v. Tax Appeals Tribunal of the State of New York*, 85 N.Y.2d 139; 647 N.E.2d 1280; 623 N.Y.S.2d 772; 1995 N.Y.LEXIS 137 (1995); and *Matter of Just Born, Inc.*, TAT(E) 93-456(GC) City of New York Tax Appeals Tribunal, 1998 N.Y. City Tax LEXIS 10 (March 30, 1998), the lack of a unitary relationship between the Taxpayer and the three partnerships limits the Taxpayer's City entire net income to its distributive share of income from the three New York City partnerships. Resp. Ex. B.

Statement A did not specifically refer to the California Partnership, although other schedules listed that investment.

Petitioner filed a 2002 State Form CT-3 General Business Corporation Franchise Tax Return ("2002 State Return") and reported a State Corporation Franchise Tax liability of $70,133. Petitioner allocated 100% of its State income from the New York Properties to the State, using a separate accounting method.

Petitioner included an attachment with its 2002 State Return, "Election by Foreign Corporate Limited Partner," which stated that:

> Imperial Rental Investments, Inc. ("Taxpayer") is a Delaware corporation that is a limited partner in two limited partnerships and a nonmanaging member in a limited liability company as listed below ("election partnerships") which are doing business in New York State.

> The Taxpayer is subject to tax under Article 9-A of the Tax Law solely as a result of application of [20 NYCRR] Sec. 1-03.2(a) [sic] and does not file on a combined basis for Article 9-A purposes. Additionally, the Taxpayer and election partnerships are not involved in a unitary business and there are no substantial intercorporate transactions between the Taxpayer and election partnerships.
>
> Pursuant to [20 NYCRR] Sec. 3-13.1, the Taxpayer elects to compute its tax by taking into account only its distributive share of income, capital, gain, loss or deduction of each such entity listed. Pet. Ex. 239.

The partnerships that made the election under 20 NYCRR §3-13.1 were the New York Partnerships. A document reconciling the amounts reported on Petitioner's State and Federal returns was also included with the State return.

On its 2002 California Return, Petitioner calculated the reported gain from the Sale according to the installment method as articulated in California Franchise Tax Board Ruling 413, applying the reported 2001 California Return apportionment factor of 48.7744% to its 2002 income.

In 2005, the Department commenced an audit of Petitioner's books and records for the Tax Years. Tax Auditor II Frank Wong (the "Auditor") performed the audit. The Auditor did not review Petitioner's returns for years prior to the audit period, although he testified that he reviewed Respondent's computer records to obtain prior period allocation information.

The Auditor testified that Petitioner did not request permission to change its accounting methodology for 2002 and that he did not see such a request in the 2002 GCT Return. However, the

Auditor admitted that he reviewed Statement A to that return and that it was his opinion that the statement was an explanation of Petitioner's separate accounting position. Tr. 187-88. The Auditor made no changes with respect to 2001, but rejected Petitioner's use of the separate accounting methodology for 2002, concluding that Petitioner should compute its 2002 GCT liability on the basis of a formulary apportionment method which included factors attributable to the California Partnership in the BAP and the gain from the sale of the California Property in ENI.

On August 17, 2005, Respondent issued to Petitioner a Notice of Determination of City GCT due for the Tax Years (the "Notice"). No deficiency was asserted for 2001. A deficiency in the base tax due amount of $927,939.41 was asserted for 2002. The Notice also asserted penalties for late filing of the return and for substantial understatement of GCT due in the amount of $324,772.30 and interest computed to August 31, 2005 in the amount of $167,343.50.

The deficiency was based on applying a BAP of 53% to City ENI. The BAP was computed including factors that were attributable to both the California and New York Partnerships and represented the auditor's judgment that it was appropriate to average the BAPs reported by Petitioner on its 1999, 2000 and 2001 GCT returns.[7] This averaged BAP was applied to an ENI base that included Petitioner's $18,567,254 distributive share of the gain from the sale of the California Property.

In 2005, based upon information received from Respondent, the

[7] The Auditor testified that the averaged BAP applied was based on information he obtained as a result of review of Respondent's computer records. Tr. 269-277. Pet. Ex. 129. Respondent did not offer a computation of Petitioner's GCT liability under formulary apportionment using only the BAP for 2002.

State Department of Taxation and Finance ("State DTF") performed a desk audit of Petitioner's 2002 State Report and issued an adjustment of $9,902. The State DTF accepted Petitioner's request for separate accounting and also required Petitioner to add back City taxes.

Matthew Mondanile was accepted at the hearing as an expert in the operation of commercial real estate and in real estate appraisal. A State-licensed real estate appraiser and real estate broker with over thirty years of professional experience, Mr. Mondanile is presently employed by the real estate firm of Cushman & Wakefield and works in that firm's valuation group in the City. Mr. Mondanile testified generally about the operations and management of commercial real estate buildings in the City. He also testified with respect to certain agreements between the Partnerships and Paramount concerning management fees and between the Partnerships and certain foreign banks with respect to financing agreements. Mr. Mondanile testified that while the management fee paid by the Partnerships to Paramount was above market rates, such an arrangement was not uncommon as between "the old families" who owned City commercial real estate. Tr. 581,607-8.

STATEMENT OF POSITIONS

Petitioner asserts that, as a constitutional matter, it must be permitted to use a separate accounting methodology to compute its 2002 City taxable income so as to exclude the gain from the sale of its interest in the California Property from ENI. Respondent argues that Petitioner is engaged in a unitary business with the Partnerships and therefore Petitioner's ENI should include Petitioner's proportionate gain from the Sale.

CONCLUSIONS OF LAW

Unitary Business and Allocation Issues. Petitioner Imperial Rental Investments, Inc. is a Delaware corporation whose sole activity was its direct and indirect investment in limited partnerships that owned real property in New York and California. During the Tax Years Petitioner held relatively small percentage interests in four entities: the New York Partnerships (which included investments in two limited partnerships and a limited liability company which owned an interest in a limited partnership) and the California Partnership.

Petitioner is subject to the City GCT as a result of its investment in the New York Partnerships. Code §11-603.1. Petitioner may allocate its entire net income to the City by application of a business allocation percentage. Code §11-604.3. (*See*, *e.g.*, Rules of the City of New York ("Rules") §11-61(b) which provides that "[E]very corporation is entitled to an allocation, of ... income, even if it transacts all of its business and maintains its only office in New York City." *See, also*, 19 RCNY §11-63.) The BAP takes into consideration the percentage that a taxpayer's City real and tangible personal property, business receipts and payroll bears to its total property, receipts and payroll. 19 RCNY §11-63(c)(1)(i)-(iii).

For approximately twenty years preceding the Tax Years, Petitioner computed CGT using formulary apportionment, applying a BAP comprised of New York and California 'factors'(*i.e.*, real and tangible personal property, business receipts and payroll) to a base which included income from New York and California sources. For 2002, however, Petitioner computed its City taxable income according to a separate accounting method which excluded income from

California sources from its ENI base, including its proportionate share of the gain from the Sale, and eliminated California factors from its BAP. Respondent asserts that for that period, Petitioner is required to include the gain from the Sale in the income base and continue to use the formulary apportionment method.

Under the Due Process and Commerce Clauses of the United States Constitution, the City may only tax Petitioner's proportionate share of the gain from the Sale if Petitioner's California activities have a minimal connection to the City. *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768 (1992). For that to occur, Petitioner's California activities must be part of a unitary business conducted in part in the City. *Allied-Signal, supra* at *778; Container Corp. v. Franchise Tax Bd.,* 463 U.S. 159 (1983)*;* *ASARCO Inc.* v. *Idaho Tax Comm'n,* 458 U.S. 307 (1982). Thus, the Commissioner can only require Petitioner to include income from non-City sources in ENI if the New York and California Partnerships, among themselves and with Petitioner, are involved in a unitary business. *Allied Signal, supra; Matter of British Land (Maryland*), 85 N.Y.2d 139 (1995). Moreover, even if the New York and California Partnerships were engaged in a unitary business, non-City income may be excluded from the ENI base where the apportionment to the City "attributes income to petitioner 'out of all appropriate proportion to the business transacted by [it]'" in the City. *British Land (Maryland), supra* at 148, *citing to Hans Rees' Sons v. North Carolina,* 283 U.S. 123, 135.[8]

[8] Respondent's argument that filing on a formulary apportionment basis (for City and for California purposes) is the equivalent of admitting to conducting a unitary business is rejected. On its City GCT returns prior to the Tax Years, Petitioner merely followed the specific statute and regulations and did not assert that there was a constitutional bar to the City taxing Petitioner's California income. See, *e.g.*, *Container Corp., supra.*

Although the New York and California Partnerships are engaged in the same line of business (ownership of commercial real property), they are not engaged in a unitary business. *Container Corp., supra* at 159, 179; *British Land (Maryland), supra* at 146-147. There is no functional integration; no unity of management; nor any economies of scale between and among the partnerships. Nor is there a unitary relationship between Petitioner and those partnerships in which it was directly or indirectly a small investor.

The New York and California Partnerships were established to own and manage one property each. The properties were separately mortgaged, through agreements with unrelated banking institutions. There were no loans or other financial transactions between these properties, between the Partnerships or between the properties and the Partnerships. Each partnership and each property was managed by an independent management company (Paramount) pursuant to a separate agreement and without economies of scale. Petitioner did not exercise any management role with respect to those limited partnerships. There was no other flow of value between the New York and California Partnerships or between Petitioner and those Partnerships. *Container Corp., supra; Matter of British Land (Maryland), supra.*

The fact that Mr. Otto, intending to benefit his children, chose to make investments through a series of percentage interests in limited partnerships which separately and together held various parcels of real property in the United States, does not establish that Petitioner and the New York and California Partnerships were engaged in a unitary business. Similarly, it is not determinative that Paramount, a separately incorporated company, managed the limited partnerships, the real properties and/or corporations such as Petitioner.

The Court of Appeals decision in *Matter of British Land (Maryland)* is instructive. In that case, as here, the taxpayer, British Land (Maryland), a Delaware corporation, acquired interests in real property located both inside and outside New York State for investment. The taxpayer decided to sell its non-New York (*i.e.*, Maryland) property using separate accounting to exclude the Maryland gain from its State taxable income. On audit, the State Department of Taxation and Finance included the Maryland gain in the State income base and, concommitantly, the Maryland factors in the State BAP. British Land (Maryland) protested the deficiency and the matter was initially heard before the State Tax Appeals Tribunal.

The State Department of Taxation and Finance requested a finding that the "operations" of the taxpayer (managing real estate in Maryland and New York) constituted a unitary business. Both the Administrative Law Judge and the State Tribunal found that the taxpayer was engaged in a unitary business and affirmed the agency's determination. *Matter of British Land (Maryland)*, DTA No. 806894 (New York State Tax Appeals Tribunal, September 3, 1992), affirming the State Administrative Law Judge's Determination.[9] On appeal, the Appellate Division, Third Department, confirmed the State Tribunal's finding of a unitary business and also concluded that no extraterritorial value was being taxed. *Matter of British Land (Maryland) v. Tax Appeals Tribunal*, 202 AD2d 867 (3d Dept. 1994).

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[9] Respondent appears to rely principally on the State Tax Appeals Tribunal's decision in Matter of British Land (Maryland). See, Resp. Br. 14-15; 21-22. Respondent does not discuss that the case was appealed twice and overturned, in part, by the Court of Appeals. Respondent relies on the State Tribunal's holding regarding the requirements for finding a unitary business (which holding was confirmed by the Court of Appeals), but does not address the ultimate conclusion of the Court of Appeals that the gain from the Maryland sale was extraterritorial value which the State could not constitutionally tax. In this regard, Respondent characterizes the Court of Appeals Decision as a "remand for a redetermination of the allocation percentage." See, Resp. Br. P. 15.

The case was appealed to the Court of Appeals, which agreed with the lower court and State Tribunal that the New York and non-New York operations of British Land (Maryland) constituted a unitary business and, therefore, the use of a statutory allocation formula would generally be appropriate under the United States Constitution. 85 NY2d at 147-8. However, the Court of Appeals found that the Due Process and Commerce Clauses of the United States Constitution precluded the application of the statutory allocation formula as it attributed to New York a disproportionate value in relation to the taxpayer's in-State activity. 85 NY2d at 148-149. The Court of Appeals held that the gain from the sale of the Maryland property was primarily attributable to Maryland factors stating: "the extremely marked differences in value inevitably had a distortive effect on the application of the statutory apportionment formula . . . .." 85 NY 2d at 150. The Court of Appeals further noted that the determinative factors material to the Maryland gain occurred before British Land (Maryland)'s acquisition of the New York property.[10] *Id.* The Court of Appeals concluded that the gain from the sale of the Baltimore property:

> ... so dwarfed petitioner's other net income, clear and cogent evidence supports the conclusion that [the gain] 'cannot in fairness be attributed to [petitioner's] activities within [New York] State' [citing to *Allied Signal, supra* at 780].

Unlike the situation in *British Land (Maryland)*, the fact that Paramount had management responsibilities for both Petitioner and

[10] The Court found the following factors material to the gain realized on the sale of the Maryland property: the improved economic condition of Baltimore, the sound management of the property by a Baltimore firm, the renovations to the property and the taxpayer's acquisition of the fee interest. 85 NY2d at 149.

the New York and California Partnerships and the New York and California Properties, does not establish that Petitioner was engaged in a unitary business. Paramount is an independent corporation and no assertion has been made that Paramount was engaged in a unitary business with Petitioner. Common management by a third party (even though it may have charged more than the normal management fees) does not support the finding of a unitary business between the managed entities. The finding of a unitary business must be between the taxpayers generating or reporting the income. *British Land (Maryland), supra* at 150. Petitioner and the New York and California Partnerships did not engage in a unitary business as there was no functional integration, centralization of management or economies of scale between them. Petitioner was only a relatively small investor in those entities.

Even if Petitioner and the New York and California Partnerships had been engaged in a unitary business, as the Court found with respect to British Land (Maryland), as in that case, the gain from the Sale is not constitutionally taxable as it is primarily attributed to California factors. *Butler Bros. v. McColgan,* 315 U.S. 501 (1942). *See, also, Sheraton Buildings, Inc. Realtor, v. Tax Commission of the State of New York,* 15 A.D.2d 142 (3d Dept, 1961). The California Property was located in that state and was managed and maintained by companies in the Los Angeles area. The "strategic decision" to sell the California Property was made by the California Partnership, taking into consideration the real estate market conditions in the area. *See, British Land (Maryland), supra* at 147. Petitioner, as limited partner, neither had involvement in the day-to-day operations of the California property nor input into its eventual disposition.

In accord with constitutional principles, in a published 1990 Statement of Audit Procedure, Respondent advised that under Code §11-604.8[11] an auditor may "treat the share of the income and loss from [a corporation's interest in a limited partnership] on a separate accounting basis where the facts in such case indicate that the business income allocated to the City would otherwise be distorted."[12] *See, e.g., Matter of National Bulk Carriers,* TAT(E) 04-33(GC) (City Tax Appeals Tribunal, November 30, 2007); *Matter of Just Born, Inc.*, TAT(E) 93-456 (GC) (City Tax Appeals Tribunal, March 30, 1998). On a separate accounting basis, Petitioner reported allocated ENI for 2002 of $1,025,152. The formulary basis applied on audit, which included in income Petitioner's $18,567,254 share of the gain from the Sale as well as other income not included in ENI,[13] resulted in an adjusted ENI of $21,678,089. There is a disproportionate difference between allocated income reported on a separate accounting basis and on a formulary apportionment basis

[11] Department of Finance Audit Division Statement of Audit Procedure AP/AU-15 (8/27/90). Code §11-604.8 provides: "[I]f it shall appear to the commissioner of finance that any [BAP] . . . does not properly reflect the activity, business, income or capital of a taxpayer within the city, the commissioner of finance shall be authorized in his or her discretion, in the case of a [BAP] to adjust it by . . .(c) excluding one or more assets . . . provided the income therefrom is also excluded in determining [ENI], or (d) any other similar or different method calculated to effect a fair and proper allocation of the income and capital reasonably attributable to the city . . .."

[12] See, also, State Franchise Tax Regulations which provide that a foreign corporation limited partner subject to the State tax ". . . solely as a result of the application of [NYCRR] § 1-3.2(a)(6) [where one or more of the limited partnerships has nexus to the State] and which does not file on a combined basis . . . may elect to compute its tax bases by taking into account only its distributive share of each partnership item of receipts, income, gain, loss and deduction . . . of each such limited partnership which is doing business, employing capital, owning or leasing property or maintaining an office in New York State . . .." 20 NYCRR §3-13.5(a).(1). And, see, 20 NYCRR §3-13.5(c) which states: "[T]he election is made at the time of filing. Once an election is made, it may not be revoked . . . and is binding with respect to that partnership interest for all future taxable years." This provision, originally 20 NYCRR §3-13.1, was renumbered 20 NYCRR §3-13.5 and amended in 2006 and 2008.

[13] Respondent also included in Petitioner's income $1,747,946 from "rental real estate activities" and $91,705 in interest income. These adjustments were not disputed by Petitioner.

which includes Petitioner's gain from the Sale since formulary apportionment results in an income base that is twenty times greater than the income determined using separate accounting. Therefore, requiring Petitioner to arrive at 2002 GCT liability by including its share of the gain from the Sale in ENI, and apportioning that income by a BAP which includes factors attributable to the California Partnership, is distortive and would result in a tax which is out of all appropriate relation to Petitioner's City business.

Judicial Estoppel. The Commissioner asserts that Petitioner is judicially estopped from changing its method of allocation. Although the doctrine of judicial estoppel applies to administrative proceedings as well as court cases (see, *e.g.*, *Rissetto v. Plumbers and Steamfitters Local 343*, 94 F3d 597 (9th Cir. 1996); *Tozzi v. Long Island Railroad Company, et al.*, 170 Misc 2d 606, 613 (Sup. Ct. Nassau Cty., 1996)), the doctrine is not applicable here. *Horn v. Bennett,* 253 App Div 630 (2d Dept. 1938). The doctrine is limited to estopping a party who takes a position and prevails in one legal proceeding, from taking a contrary factual position in another legal proceeding. *Stop & Shop Supermarket Co. v. Vornado Realty Trust,* 35 A.D.3d 231 (1st Dept. 2006). In *Prudential Home Mortgage Company, Inc. v. Neildan Construction Corp.*, 209 AD2d 394 (2d Dept. 1994), the Appellate Division Second Department stated:

> Judicial estoppel, or the doctrine of inconsistent positions . . . precludes a party who assumed a certain position in a <u>prior legal proceeding</u> and who <u>secured a judgment in his or her favor</u> from assuming a contrary position in

> another action simply because his or her interests have changed. Id. at 394, 395. [Emphasis supplied.][14]

This is the first time this controversy has been presented in an administrative or other legal proceeding and, therefore, there is no estoppel as between judicial actions.

The Duty of Consistency. Petitioner did not violate any duty of consistency allegedly owed Respondent when it changed the accounting methodology used to compute its GCT liability in its 2002 GCT Returns. *See, generally, Estate of Hilda Ashman v. Comm'r of Internal Revenue,* 231 F.3d 541 (9th Cir. 2000); *Herrington v. Commissioner of Internal Revenue*, 854 F2d 755 (5th Cir. 1988). *See, also, Matter of Frances Frankel,* TAT(H) 95-39 et al., (City Tax Appeals Tribunal ALJ Determination, September 18, 1996).[15] As the Court of Appeals for the Fifth Circuit noted in *Herrington:*

> The elements of the duty of consistency are: (1) a representation or report by the taxpayer; (2) on which the Commission has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation. 854 F.2d at 758. [Emphasis supplied].

In *Ashman, supra,* the Ninth Circuit Court of Appeals considered whether income from a pension plan distribution in a prior period,

[14] But see, *Johnson v. Oregon,* 141 F.3d 1361, (9th Cir. 1997) which seems to hold that an inconsistent position taken on applications for disability benefits might rise to the level of judicial estoppel where the "affront to the court" was serious. The Court refused to create a *per se* rule, however, and denied summary determination and remanded the case for further proceedings.

[15] *Matter of Frances Frankel,* TAT(E) 95-39 (UB) et al. (City Tax Appeals Tribunal, December 19, 1997), which in sustaining the Administrative Law Judge Determination, referred to the duty of consistency.

which was reported as a tax-free transaction but was not in fact rolled over into another qualified account, could be subsequently taxed when distributed. The Court of Appeals stated:

> The duty of consistency has nothing to do with tolling; it deals with the equitable insight that a person should be prevented from taking different positions about the same historical transactional facts in different years. 231 F.3d at 544 [Emphasis added.]

The 2002 Return, and specifically Statement A, reflect Petitioner's position that, for this reporting period, separate accounting is appropriate because it is not Constitutional for the City to tax the gain from the Sale.[16] This is not a situation, as in *Ashman*, where the prior filing contained false statements which could not be reviewed due to the running of the statute of limitations. Respondent does not allege that the prior filings contained false statements on which it relied to its detriment. Rather, Respondent avers that the methodology of formulary apportionment used on those prior returns is appropriate for all reporting periods. Finally, it is noted that the 'transactional fact' which ostensibly triggers the duty of consistency (the Sale) occurred subsequent to the prior periods and therefore had no effect on the earlier reporting or GCT liability.

Moreover, Petitioner's City GCT filings from 1979 to 2001 establish that any benefit from its filing position inured to the

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[16] There is no inconsistency of position between Petitioner's City and State reports, which use essentially the same methodology. See, Ex. 239, 2002 NYS Corporation Franchise Tax Report and the appended statement informing the State of its choice of a separate accounting method, which complied with 20 NYCRR §1-3.2(a)(6). As between Petitioner's City and California returns, it is accepted that Petitioner's filing position on its 2002 California return was based upon its interpretation of a California ruling with respect to installment sales. Beyond that, Petitioner's California filings are not material.

City. Had Petitioner used separate accounting, it would have paid overall $174,266 less GCT during that over twenty year period than it actually did on a formulary apportionment basis.[17] There has been no tax benefit to Petitioner based on its prior City reporting position with respect to the California Property. Therefore, Petitioner does not owe the City an alleged duty of consistency to maintain an accounting methodology to tax income which cannot be taxed Constitutionally.[18]

ACCORDINGLY, IT IS CONCLUDED THAT Petitioner correctly computed its 2002 GCT liability using a separate accounting methodology, excluding its proportionate share of the gain from the Sale from its ENI and excluding the factors attributable to its California investments in the BAP. Therefore, the Petition is granted and the Notice of Determination dated August 17, 2005 is canceled other than to the extent of the undisputed adjustments set forth in fn. 13, *supra*.

DATED: April 1, 2009
New York, New York

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ANNE W. MURPHY
Administrative Law Judge

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[17] Respondent accepts Petitioner's analysis that it paid more GCT to the City on a formulary apportionment basis, but argues that if Petitioner's reporting to California on a formulary apportionment basis is considered, Petitioner received a benefit from its California reporting of $370,329 which when adjusted for the overpayment of City GCT on the same formulary basis (*i.e.*, Petitioner's position), results in a "net benefit" of $196,063. Whatever California tax was properly or not properly paid is not an issue over which this forum has jurisdiction.

[18] All other arguments have been considered and are found to be without merit.