

NEW YORK CITY TAX APPEALS TRIBUNAL
ADMINISTRATIVE LAW JUDGE DIVISION

In the Matter of the Petition	:	<u>DETERMINATION</u>
	:	
of	:	
	:	TAT (H)16-9(GC)
GOLDMAN SACHS PETERSHILL FUND	:	
OFFSHORE HOLDINGS (DELAWARE) CORP.:	:	
	:	

Rodriguez-Diaz, A.L.J.:

Petitioner, Goldman Sachs Petershill Fund Offshore Holdings (Delaware) Corp., timely filed a Petition with the New York City (City) Tax Appeals Tribunal (Tribunal). The Petition protests a Notice of Determination (Notice), dated July 30, 2014, which imposes General Corporation Tax (GCT) under Title 11 of the City Administrative Code (Administrative Code) on the Petitioner for the period January 1, 2010 to December 31, 2010, in the amount of \$4,029,688.00, plus interest computed to September 12, 2014, of \$1,221,002.47, for a total of \$5,250,690.47.

On April 14, 2017, the parties submitted a Joint Stipulation of Facts (Stipulation) and accompanying exhibits. The parties consented to have this matter determined on submission without the need for appearance at a hearing pursuant to the Tribunal's Rules of Practice and Procedure (20 RCNY) § 1-09 (f). Petitioner filed a Brief on June 9, 2017. The City Commissioner of Finance (Respondent) filed a Memorandum of Law on August 4, 2017. Petitioner filed a Reply Brief on September 5, 2017. Respondent filed a Sur-Reply Memorandum of Law on October 10, 2017. Petitioner was represented by Peter L. Faber, Esq., Alysse McLoughlin, Esq., and Kathleen M. Quinn, Esq., of McDermott Will & Emery LLP. Respondent was represented by

Andrew G. Lipkin, Esq., Senior Corporation Counsel, with the City's Law Department.

ISSUES

1. Whether the capital gain realized by Petitioner, a nondomiciliary corporation with no City business activities, on the sale of its minority interest in a City operating limited liability company (LLC) is subject to GCT.

2. Whether the imposition of GCT on the capital gain violates the Due Process Clause or Commerce Clause of the United States Constitution.

FINDINGS OF FACT

To the extent relevant to this matter, the stipulated facts are set forth below. Additional findings of fact were also made by the undersigned. Unless otherwise stated, all facts pertain to the period in issue.

Petitioner is a Delaware corporation. Petitioner's stock is owned by two entities: 96.42% by Petershill Offshore LP (Offshore LP) and 3.58% by Petershill PMD QP Offshore LP (QP Offshore LP). Petitioner's two owners will be referred to as "Petershill Offshore Entities." Goldman Sachs PH Offshore Advisors Inc. ("Offshore Advisors") is the general partner of both Petershill Offshore Entities.

Petershill Offshore Entities' investment strategy is to buy equity interests in alternative investment management companies.

These companies provide investment and management services to hedge funds and other alternative investment vehicles.

Petitioner formed Petershill U.S. IM Master Fund LP (Master Fund) to enable the Petershill Offshore Entities to make their investments in alternative investment management companies. Petitioner owns 88.91% of Master Fund's equity, solely as a limited partner.¹

The investment manager for Petershill Offshore Entities is Goldman Sachs Asset Management International (Investment Manager). The Investment Manager is wholly owned by Goldman Sachs Group, Inc. and is incorporated in England and in Wales.

The Investment Manager designated a team of its employees (Fund Investment Team) to identify and evaluate alternative investment management companies in which Master Fund could invest. All members of the Fund Investment Team were based in the Investment Manager's office in London, United Kingdom (U.K.).

The Fund Investment Team identified and evaluated Claren Road Asset Management, LLC (Claren) as a potential investment management company for Master Fund. The Fund Investment Team conducted all of its due diligence for the Claren investment in London, except for one meeting with Claren's management in New York City.

In 2008, Master Fund purchased 9.99% interest in Claren. Claren was established by several former employees of

¹ The remaining 11.09% ownership of Master Fund is as follows: Petershill PMD QP Fund, LPC, a Goldman Sachs employee investment fund, owns 1.43% of the equity, solely as a limited partner; and Goldman Sachs Group, Inc. owns the remaining 9.66% of the equity, both as general partner through its ownership of the disregarded entity, GS Petershill Fund Offshore Advisors, Inc., and as a limited partner through its ownership of the disregarded entity, Petershill Fund, LP.

Citigroup's credit trading department (Claren Founders). Unrelated persons owned the remaining interests in Claren.

After Master Fund purchased its interest in Claren, the Fund Investment Team managed Master Fund's investment in Claren on an ongoing basis. It conducted portfolio valuations, developed investment strategies, and monitored Claren's performance. The Fund Investment Team performed these activities in London.

Claren Founders managed the day-to-day operations of Claren, and made all its investment decisions. Claren operated as an investment management company that specialized in credit, event-driven, and capital structure arbitrage strategies. Claren engaged in business activities in New York throughout 2008, 2009, and 2010. Claren also engaged in business activities in New York City throughout 2008, 2009, and 2010 as established by the copies of Petitioner's filed GCT returns for 2008, 2009, and 2010, which were submitted as exhibits to the Stipulation. Master Fund was never a managing member of Claren. Neither Petitioner, Master Fund, nor any Goldman Sachs affiliate participated in the management, control, or operation of the day-to-day business affairs of Claren. Neither Petitioner nor Master Fund engaged in any transactions with Claren other than Master Fund's ownership of the minority interest in Claren.

In 2010, the Fund Investment Team determined that Master Fund should sell its investment in Claren to The Carlyle Group. The Fund Investment Team negotiated the sale from their London office. In 2010, Master Fund sold its interest in Claren to The Carlyle Group, which generated a capital gain of \$54,673,566.00 (Gain) for federal income tax purposes. The Gain flowed through from Master Fund to Petitioner. The Carlyle Group was not related to either Petershill Offshore Entities or Petitioner.

In 2010, neither Petitioner nor Master Fund owned any real or tangible personal property in New York. In 2010, neither Petitioner nor Master Fund had any employees in New York. Neither Petitioner nor Master Fund conducted any business activities in New York in 2010 apart from activities related to Master Fund's investment in Claren. In 2010, the only investment that Master Fund owned was its 9.99% interest in Claren. Also, in 2010, the only interest that Petitioner owned was its 88.91% interest in Master Fund.

The parties stipulated that neither Claren and Master Fund nor Claren and Petitioner are part of a unitary business.²

The parties further stipulated that if Petitioner was subject to the City GCT in 2010, it was solely due to Claren's business activities in the City, and that Petitioner timely filed its GCT return for that tax year. During the time that Master Fund held its interest in Claren, Petitioner reported and paid GCT on its share of Claren's income, deductions, gains, and losses.

Petitioner included the Gain in computing its federal taxable income for the 2010 tax year.

Petitioner excluded the Gain in determining its City entire net income [ENI]³ reported on its 2010 GCT return, stating:

² In general, the unitary business test is applied to determine whether the activities of a nondomiciliary taxpayer, which directly or indirectly conducts in-state activities, are properly connected to the State so that the State must include in the taxpayer's apportionate tax base all the income arising from the interrelated and interdependent out-of-state and in-state activities. In *F.W. Woolworth Co. v Taxation and Revenue Dept. of N.M.* (458 US 354, 364 [1982]) the U.S. Supreme Court held that the existence of a unitary business is evidenced by "functional integration, centralization of management, and economies of scale." See also § 11-91 (e)(2) of the Rules of the City of New York (19 RCNY [Rules]) for a list of factors that the Commissioner will consider in determining whether an entity is part of a unitary business.

"Petitioner is a limited partner in a limited partnership that received [City] source income from [partnership] doing business in [the City] . . . [T]he amount reported on schedule B line 1 is the [Petitioner's] federal taxable income taking into account only its distributive share of income, capital, gain, loss or deduction related to this partnership interest" (Exhibit C, Statement 3).

The parties stipulated that Petitioner, Petershill Offshore Entities, Offshore Advisors, Master Fund, or Claren are not "publicly-traded partnerships" as defined in § 7704 of the Internal Revenue Code (IRC) (26 USC § 7704) or "portfolio investment partnerships" within the meaning of Rules § 11-06.

Respondent audited Petitioner's 2010 GCT return. On July 30, 2014, Respondent timely issued the Notice. In the Notice Respondent explained the adjustments it made to the Petitioner's GCT return as:

"Gain from sale of a partnership interest is business income, [and] therefore[,] Capital Gain in the amount of \$54,673,566.00 was included in the computation of [ENI]. The corporate partner should include its proportionate share of the partnership'[s] property, receipts and payroll within and without [the] City in computing the business allocation percentage, [and] therefore[,] the business allocation percentage of Claren . . . was applied [a]ccordingly" (Exhibit D, page 3).

On or about August 6, 2014, Petitioner submitted a timely Request for a Conciliation Conference. On or about June 5, 2015, the Conciliation Bureau issued a Proposed Resolution to the Conciliation Conference. On or about February 4, 2016, a Conciliation Decision was issued discontinuing the Conciliation proceeding and sustaining the Notice since Petitioner did not

³ Administrative Code § 11-602.8 defines entire net income as "total net income from all sources, which shall be presumably the same as the entire taxable income . . . which the taxpayer is required to report to the United States treasury department"

execute and return the Proposed Resolution. On May 4, 2016, Petitioner timely filed the Petition with the Tribunal.

STATEMENT OF POSITIONS

Petitioner asserts that the Gain should not be included in its ENI because Petitioner owned a passive minority interest in Claren, and Petitioner and Master Fund were not part of a unitary business with Claren. Petitioner argues that Claren's City activities were entirely unrelated to Petitioner's extra-territorial investment activities that led to realizing the Gain.

Petitioner contends that, in the absence of a unitary business, including the Gain in Petitioner's ENI violates the Due Process and Commerce Clauses of the U.S. Constitution. It argues that the requisite connection or "nexus" between the City and the entity or activity being taxed does not exist. Petitioner states that its passive interest in Claren does not create sufficient nexus between Petitioner and the City, and that the nexus between Claren and the City cannot flow to the Petitioner because its Claren interest possesses the following features of common stock ownership: the taxing authority's lack of personal jurisdiction over a nonresident owner, limited liability, separation of ownership of property owned by an entity from the entity's owners, and separation of conduct of business activities by an entity from the entity's owners.

Petitioner relies upon the Supreme Court decision in *Allied-Signal, Inc. v Director, Div. of Taxation*, (504 US 768 [1992]) (*Allied-Signal US*). It argues that this decision effectively overruled the New York Court of Appeals decision in

Allied-Signal Inc. v Commr. of Fin., (79 NY2d 73 [1991]) (*Allied-Signal NYC*).

Petitioner further contends that the existence of a unitary relationship is mandatory for the apportionment of gain from the sale of a business interest. It supports this position by citing to *Matter of Just Born, Inc.* (TAT [E] 93-456 [GC] [Mar. 30, 1998], motion to vacate denied TAT [E] 93-456R [GC] [Feb. 22, 1999]), *Matter of Imperial Rental Investments, Inc.* (TAT [H] 06-20 [GC][April 1, 2009]), and *Matter of British Land (Maryland), Inc. v Tax Appeals Tribunal* (85 NY2d 139 [1995])⁴. As such Petitioner contends a unitary business test, rather than a nexus inquiry under *Allied-Signal NYC*, should be applied.

In the alternative, Petitioner argues that, even if the decision of *Allied-Signal NYC* remains valid, this Tribunal is not bound by its holding for the same reason that the case of *Allied-Signal Inc. v Tax Appeals Trib. of the State of N.Y.*, (229 AD2d 759 [1996]) (*Allied-Signal NYS*), is not binding on this Tribunal. That is, neither *Allied-Signal NYC* nor *Allied-Signal NYS* applies herein because each involves the inclusion of income and gain in a taxpayer's apportionable investment income tax base rather than their apportionable business income tax base as in the case here. Petitioner further argues that these two cases are distinguishable because in both cases the taxpayers themselves conducted business activities in the taxing jurisdictions.

Additionally, Petitioner submits that the decision by the New York State Tax Appeals Tribunal (State Tribunal) in the *Matter of the Petitions of Shell Gas Gathering Corp. #2 and*

⁴ *Matter of Just Born, Inc.* and *Matter of British Land (Maryland), Inc.* may be distinguished on their facts; and *Matter of Imperial Rental Investments, Inc.* is a City Administrative Law Judge Determination, which is not precedential.

Shell Gas Pipeline Corp. #2, (DTA 821569 and 821570, 2010 WL 7406928, State Trib., September 23, 2010 (*Shell Gas*) is also not binding. It argues that the State Tribunal limited its decision to the taxability of flow-through ordinary income, and did not address the taxability of flow-through gain. Accordingly, Petitioner argues that in this matter, this Tribunal does not need to apply the State Tribunal's *Shell Gas* decision to the facts presented.

For these reasons, Petitioner argues that the Gain is not properly includable in its City ENI, and requests that the Petition be granted, and that the Notice be cancelled.

Respondent argues that it properly imposed GCT on the Gain because the requisite nexus exists between the City and Claren's activities. It contends that the nonexistence of unitary business between Petitioner, Master Fund, and Claren is irrelevant because the Gain possessed a sufficient nexus to the City to permit the assertion of GCT. Respondent argues that the City conferred protection, opportunities and other benefits upon Claren, which led to the increase in the value of Petitioner's interest in Claren, and, ultimately, resulted in the Gain realization.

Respondent claims that imposing GCT upon the Gain does not result in the taxation of extraterritorial values. It argues that it properly included the Gain in Petitioner's ENI because it arose from Claren's connection to the City. Respondent submits that it apportioned the Gain according to Claren's City GCT business allocation percentage (BAP) and not according to Petitioner's income arising from Petitioner's connection to the City. It contends that Claren's presence in the City was sufficient nexus to satisfy the constitutional requirements of the Due Process and Commerce Clauses. Finally, Respondent

argues that *Allied-Signal NYC*, *Allied-Signal NYS*, and *Shell Gas* constitute applicable law in this matter.

For these reasons, the Respondent requests that the Petition be denied, and that the Notice be sustained.

CONCLUSIONS OF LAW

The City Charter § 170.d requires this Tribunal to apply precedent as follows:

"The tribunal shall follow as precedent the prior precedential decisions of the tribunal (but not of its small claims presiding officers), the New York State Tax Appeals Tribunal or of any federal or New York state court or the U.S. Supreme Court insofar as those decisions pertain to any substantive legal issues currently before the tribunal."

The decisions in *Allied-Signal NYC*, *Allied-Signal NYS*, and *Shell Gas* fall within the ambit of City Charter § 170.d.

This line of cases addresses whether a jurisdiction can tax a nondomiciliary entity's gain on a sale of interest in an entity operating within the jurisdiction. They provide that for such taxation to be proper, nexus must exist between the taxing jurisdiction and the entity in which the interest is being sold (*Allied-Signal NYC* at 81, *Allied-Signal NYS* at 762, and *Shell Gas* at 7). These cases clarify that this analysis exists separate from the unitary business test (*Allied-Signal NYC* at 78, *Allied-Signal NYS* at 762, and *Shell Gas* at 7). Based on *Allied-Signal NYC*, *Allied-Signal NYS*, and *Shell Gas*, Respondent properly assessed GCT on the Gain received by Petitioner because Claren possessed nexus with the City during the period that Petitioner held its interest in Claren.

I. Nexus Between the City and Claren

Determining that the requisite nexus existed between the City and Claren for the proper assessment of GCT on the Gain, requires analyzing the jurisprudence established in *Allied-Signal NYC*, *International Harvester Co. v Wisconsin Dept. of Taxation*, (322 US 435 [1944]), *Allied-Signal NYS*, and *Shell Gas*.

A. Allied-Signal NYC

Allied-Signal NYC, addressed whether the City may tax any portion of the dividend and capital gain income that a nondomiciliary corporation receives by reason of its investment in another corporation conducting City business, even in the absence of a unitary business relationship between the two corporations. The Court of Appeals concluded that the City may do so without offending either the Due Process Clause or the Commerce Clause of the Federal Constitution because "[t]he simple but controlling question is whether the [City] has given anything for which it can ask return" (*Allied-Signal NYC* at 82, quoting *Wisconsin v J.C. Penney Co.*, 311 US 435, 444 [1940])⁵.

In *Allied-Signal NYC*, the taxpayer was a nondomiciliary corporation that conducted limited activities in the City. It owned a minority interest in a corporation that had its commercial domicile in the City (City Business). There was no unitary business relationship between the taxpayer and the City Business (*Allied-Signal NYC* at 78, footnote 6). The taxpayer managed the City Business from outside of the City. In 1981, the taxpayer received dividends from the City Business, and

⁵ In *J.C. Penney Co.* the Court was guided by the principle that, "A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society" (*J.C. Penney Co.* at 444).

realized a capital gain from the sale of its stock in the City Business. The taxpayer excluded this dividend and capital gain income from its tax base on its 1981 City GCT return.

The Court of Appeals held that the City's power to tax does not need to be based on the taxpayer's own activities in the City and can be based on the privileges and opportunities that the City has afforded to a taxpayer's business entity operating in the City (*id.* at 82). The Court agreed that "[the City] . . . has given [the taxpayer] something 'for which it can ask return,'" and that as a result, the requisite nexus to support the City's tax was present (*id.*).

The *Allied-Signal NYC* decision applied the Supreme Court's decision in *International Harvester*, which "expressly rejected the principle that the State's taxing power had to be premised on the taxpayer's own activities within the State . . ." (*id.* at 83). The Supreme Court in *International Harvester* emphasized that,

"[A state] may impose the burden of the tax either upon the corporation or upon the stockholders who derive the ultimate benefit from the corporation's [state] activities. Personal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's [state] earnings as is distributed to them. A state may tax such part of the income of a non-resident as is fairly attributable . . . to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers" (*International Harvester* at 441-442).

In *International Harvester*, the taxpayers were nondomiciliary corporations doing business in Wisconsin. Those business activities generated earnings to the taxpayers that allowed them to declare and pay dividends to foreign

shareholders. The dividends were declared at directors' meetings held outside Wisconsin.

The Supreme Court held "that Wisconsin may constitutionally tax the Wisconsin earnings distributed as dividends to foreign stockholders" because Wisconsin "afforded protection and benefits to [the taxpayers'] corporate activities and transactions within the state[,] [t]hese activities have given rise to the dividend income of [the taxpayers' foreign] stockholders and this income fairly measures the benefits they have derived from these Wisconsin activities" (*International Harvester* at 442).

B. Allied-Signal NYS

In *Allied-Signal NYS*, the Appellate Division considered a case with facts similar to *Allied-Signal NYC*. Therein, New York State assessed corporation franchise tax on a nondomiciliary corporation's dividend and capital gains income, which was derived from investments in other corporations doing business in New York State.

The Appellate Division held that the tax was constitutional, even though there was no unitary business relationship between the taxpayer and the issuers. It reasoned that "[t]he need for such a unitary business relationship nexus in this situation has been rejected in [*Allied-Signal NYC*]" (*Allied-Signal NYS* at 762), and the New York corporations' capital appreciation shows that the State "has given [the taxpayer] something 'for which it can ask [in] return,'" (*Id.*, quoting *Allied-Signal NYC* at 82), which provided "a sufficient nexus . . . to support the [State's] tax" (*id.*).

The Appellate Division emphasized that the site of taxpayer's decision-making regarding "its corporate investments

is not relevant for . . . corporate franchise tax allocation [purposes] since [such] allocation is ultimately concerned with the locus of corporate business activities of either the taxpayer (BAP) or the issuer [investment allocation percentage] (IAP)" (*Allied-Signal NYS* at 762, quoting *Matter of Forbes Inc. v Dept. of Fin. of City of N.Y.*, 66 NY2d 243, 245-246 [1985]).

Both the Court of Appeals in *Allied-Signal NYC* and the Appellate Division in *Allied-Signal NYS* based their decisions on the City and State business activities of the entities owned by the taxpayers. The Courts applied the nexus analysis, disregarding the taxpayers' direct City or State activities. Therefore, Petitioner's contention that, since Petitioner in this matter, unlike in *Allied-Signal NYC* and *Allied-Signal NYS*, did not directly conduct any City activity, these cases do not bind this Tribunal, is rejected.

Additionally, the Court of Appeals and the Appellate Division included the income and gain in taxpayers' apportionable investment income. In each case the business entity being sold was a corporation, which falls under the definition of "investment capital" in Administrative Code § 11-602.4. Neither Court opinion expressly or indirectly precludes the inclusion of a gain realized by the sale of an unincorporated NYC business entity such as an LLC in a nondomiciliary taxpayer's apportionable business income.

C. Shell Gas

Finally, in *Shell Gas*, the State Tribunal followed *Allied-Signal NYC* when it decided that the State Division of Taxation properly imposed corporation franchise tax on the income indirectly received by non-domiciliary taxpayers from a New York

operating limited partnership (LP) (*Shell Gas* at 7). The State Tribunal reasoned that the required in-state presence was not that of taxpayers, but rather that of the LP (*id.*).

In *Shell Gas*, the taxpayers were Delaware companies and owned the LP. The taxpayers did not conduct any business operations in New York.

The State Tribunal expressly addressed the taxpayers' claim that *Allied-Signal NYC* was distinguishable because, in that case, the nondomiciliary taxpayer was directly doing business in the City. The State Tribunal stated that such claim overlooked the fact that in *Allied-Signal NYC* the rationale applied was that the City provided the City Business "an environment for which it could ask something in return" (*id.*). The State Tribunal concluded that the same rationale of *Allied-Signal NYC* permitted the imposition of the NYS franchise tax (*id.*).

In this matter, the Petitioner argues that *Shell Gas* does not bind this Tribunal because *Shell Gas* involved the imposition of tax on income and this matter involves the imposition of tax on gain. Petitioner's argument is flawed. Income includes gain under the provisions of Administrative Code § 11-602.8 (i), IRC §§ 61 (a) (3), 63 (a), and 317 (a). See also the decision of the U.S. Supreme Court in *ASARCO Inc. v Idaho State Tax Commn.*, (458 US 307 [1982]). In *ASARCO*, the Court stated that "[w]e also agree" with "[Idaho's and ASARCO's agreement] that interest and capital gains income derived from these companies should be treated in the same manner as the dividend income" (*ASARCO* at 330). Therefore, the imposition of tax on income in *Shell Gas* does not invalidate that case's binding authority on this Tribunal.

D. Allied-Signal US

Allied-Signal US does not impact the foregoing nexus analysis, and does not affect the weight to be accorded to *Allied-Signal NYC*, because the Supreme Court in *Allied-Signal US* addressed different arguments and facts. *Allied-Signal US* addressed the ability of a State to tax a nondomiciliary corporation's gain on the sale of an interest in an in-state business entity. Unlike the Court of Appeals in *Allied-Signal NYC*, the Supreme Court in *Allied-Signal US* did not consider the relationship between the State and the in-state business entity because New Jersey agreed with the nondomiciliary corporation that New Jersey's basis of taxation of the gain was not related to the presence in New Jersey of the New Jersey business.⁶

The Supreme Court in *Allied-Signal US* made reference to the same principle that the Court of Appeals in *Allied-Signal NYC* relied upon: a state may tax the income generated by individual's or corporation's activities when it has provided to them "protection, opportunities, and benefits" (*Allied-Signal US* at 778, quoting *J.C. Penney Co.* at 444).

The Supreme Court in *Allied-Signal US* held that the unitary business test remained the appropriate device for ascertaining whether a state transgressed constitutional limitations in taxing a nondomiciliary corporation's income. It declined to adopt a principle whereby any corporation within the State would subject all of its ENI, including income without the State, to

⁶ In *Allied-Signal US*, on reargument the Respondent argued that, "New Jersey base[d] its claim to tax a share of [the New Jersey business'] gain on a different theory, so that the presence of [the New Jersey business] in New Jersey [was] irrelevant" (*Allied-Signal US*, Brief for Respondent on Reargument, 1992 WL 525739 [U.S.][Appellate Brief], no. 91-615, October Term, 1991, April 10, 1992, on Writ of Certiorari to the Supreme Court of NJ, at 41, n. 29).

apportionment (*Allied-Signal US* at 784). Instead, the Supreme Court applied an apportionment standard based on whether the intangible asset serves either an operational function or an investment function in the taxpayer's business (*id.* at 785), and emphasized that, while "the payee and the payor need not be engaged in the same unitary business . . . the capital transaction [must] serve an operational rather than an investment function" (*Id.* at 787, quoting *Container Corp. of America v Franchise Tax Bd.*, 463 US 159, 180, n. 19 [1983]).

The Supreme Court further stated that "the existence of a unitary relation between the payor and the payee is one means of meeting the constitutional requirement" (*id.* at 787). Acknowledging that its prior decisions focused on the substance of the unitary relationship (see *infra*, *ASARCO Inc. v Idaho State Tax Commn.*, 458 US 307 [1982]; *F.W. Woolworth Co. v Taxation and Revenue Dept. of N.M.*, 458 US 354 [1982]), the Court stated that its prior decisions were not intended to "establish a general requirement that there be a unitary relation between the payor and the payee to justify apportionment, nor [does the Court does] so today" (*id.*). This recognition necessarily limited the holding of *Allied-Signal US*, permitting the survival of the nexus standard established under and applied in *Allied-Signal NYC*, *Allied-Signal NYS*, and *Shell Gas*.

Petitioner's reliance on *MeadWestvaco Corp. ex rel. Mead Corp. v Illinois Dept. of Revenue* (553 US 16 [2006]) to argue that whether the entity being sold has nexus with the taxing state is irrelevant to the determination of whether the State can tax the gain from its sale, is misplaced. In that case, the Court held that Illinois could not tax the gain because the taxpayer and the entity being sold were not part of a unitary

business. In *MeadWestvaco*, the Court provided that state tax apportionment might be constitutional even in situations where “the payee and payor [were] not engaged in the same unitary business” (*MeadWestvaco* at 28, quoting *Allied-Signal US* at 787).

In *MeadWestvaco*, the State asked that “a new ground for the constitutional apportionment of intangibles based on the taxing State’s contacts with the capital asset rather than the taxpayer” be recognized by the Court (*MeadWestvaco* at 30). However, the Court expressly rejected that invitation because that question asked the Court to address an issue that “was neither raised nor passed upon in the state courts,” and that “was not addressed in the State’s brief in opposition to the petition” (*id.* at 31).

The Court did not hold that the issue of whether the entity being sold has nexus with the taxing state is irrelevant, and therefore, Petitioner’s argument is incorrect. Instead, the Court emphasized the legitimate significance of that issue by stating that:

“The case for restraint is particularly compelling here, since the question may impact the law of other jurisdictions. The States of Ohio and New York, for example, have both adopted the rationale for apportionment that respondents urge us to recognize today Neither Ohio nor New York has appeared as an *amicus* in this case, and neither was on notice that the constitutionality of its tax scheme was at issue, the question having been raised for the first time in the State’s brief on the merits. So postured, **the question is best left for another day** (emphasis added)” (*Id.* See also *Allied-Signal NY* at 762).

Therefore, *MeadWestvaco* also left the door open to the nexus standard established and applied in *Allied-Signal NYC*, *Allied-Signal NYS*, and *Shell Gas*.

A jurisdiction's ability to tax turns on whether nexus exists between that jurisdiction and the taxpayer's business being sold. This inquiry does not call for the consideration of other factors, such as unitary business between the owner entity and the sold business, for taxation to be constitutional. Nexus is sufficient.

II. Petitioner's Interest in Claren is a Partnership Interest Through Which the Gain Flows to Petitioner's ENI

Claren was doing business in the City during the tax period in issue. Since Claren is an LLC, it is treated as a partnership under Administrative Code § 11-602.1. (c), Rules § 11-03 (a) (5) and IRC § 761 (a). Petitioner's ownership in Claren is deemed to be a partnership interest and is not considered "investment capital" under Administrative Code § 11-602.4.⁷

The Gain realized by the Petitioner upon the sale of Claren generated business income,⁸ flowing from Claren to Petitioner, and not investment income.⁹ The Gain is part of Petitioner's ENI as defined in Administrative Code § 11-602.8 (i)¹⁰ because the Gain is part of Petitioner's entire taxable income for federal income tax purposes under IRC §§ 61 (a) (3), 63 (a), and 317

⁷ Administrative Code § 11-602.4 defines investment capital as "investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business"

⁸ Administrative Code § 11-602.7 defines business income as "entire net income minus investment income."

⁹ Administrative Code § 11-602.5. defines "investment income" as "income, including capital gains in excess of capital losses, from investment capital" Furthermore, the Petitioner concedes on page 1 of its Reply Brief that, "whether the City's investment income apportionment regime is valid is of no import in this case because the City's *investment income* apportionment regime is not the subject of this case."

¹⁰ Administrative Code § 11-602.8 (a) provides a list of items that shall not be included in the entire net income but none of them is relevant here.

(a).¹¹ As a deemed partner, Petitioner is required under IRC § 702 (a) to account for its distributive share of income generated by Claren. Administrative Code § 11-604.3 (a) provides that Petitioner's portion of ENI that is to be allocated within the City is determined by multiplying its City business income by a BAP. That is, Petitioner's ENI, which includes the Gain, to be allocated within the City must be determined by multiplying Petitioner's City business income received from Claren's City business activities by a BAP. Claren's BAP must be used in this computation since Claren was the only entity generating City business income. Administrative Code § 11-604.9 provides that the Respondent has a discretionary authority to adjust any BAP "if it shall appear to the [Respondent]. . . that [it] . . . does not properly reflect the activity, business, income or capital of a [City taxpayer]" by, among other things, "(d) any . . . method calculated to effect a fair and proper allocation of the income and capital reasonably attributable to the [C]ity"

III. GCT Arising from Nexus Between Claren and the City Flows to Petitioner

Petitioner contends that its ownership of a passive interest in Claren should be treated the same as stock ownership for GCT purposes. Petitioner argues that the nexus between Claren and the City should not flow through to Petitioner as a mere interest holder because, under state law, a corporation exists as a separate legal person. Petitioner supports its argument by stating that the similar separation of owner and entity analysis applies to situations involving an LLC, even

¹¹ See *ASARCO* at 330. See also *Allied-Signal US* at 780 (the Court clarified the equal treatment of capital gains and dividend income by stating that in the past ". . . [it has] held that for constitutional purposes capital gains should be treated as no different from dividends.")

when, for federal income tax purposes, the LLC is treated as a flow-through entity. For this reason, the Petitioner concludes that the activities of an LLC in the U.S. should not determine whether its foreign member had taxable income in the U.S.

To support its conclusion, the Petitioner relies on the U.S. Tax Court case of *Grecian Magnesite Mining v Commr.* (149 TC 63 [2017]). In that case the Tax Court held that a U.S. LLC's office, which was treated as a partnership for federal income tax purposes, was not a material factor in the production of a non-U.S. corporation's gain on redemption of its partnership interest in the LLC, and therefore, the gain from the redemption was not attributable to the U.S. LLC's office and it was not subject to federal income tax as U.S.-source income that was effectively connected with a U.S. trade or business (*id.*).

Petitioner's contention that Petitioner's ownership interest in Claren should be treated the same as stock ownership for GCT purposes, and that the nexus between Claren and the City should not flow through to Petitioner is rejected. Petitioner's ownership in Claren is deemed to be a partnership interest, and under IRC § 702 (a) and Administrative Code § 11-603.1 the Petitioner is required to account for its distributive share of income generated by Claren. Petitioner appears to accept that the nexus between Claren and the City flows through to Petitioner because it stipulated that Claren's NYC activities subjected Petitioner to GCT in 2010 and it filed a 2010 GCT return to report the distributive income that it received from Claren.

Furthermore, Petitioner concedes nexus between Claren and the U.S., and the tax consequences, by including the Gain in its computation of its federal income tax return for the tax year in

issue. The inclusion contradicts Petitioner's reliance on the holding of *Grecian Magnesite*.

Petitioner excluded the Gain from its 2010 GCT return. However, there is no statutory or regulatory provision to exclude the Gain from the Petitioner's GCT return when the City business has a nexus with the City. It is puzzling to see that the Petitioner conceded that the Gain did occur within the U.S. but did not submit any evidence indicating that it reported the Gain instead in any city and/or state business tax return.

Petitioner's proposition that a state's personal jurisdiction over a non-resident taxpayer is an indispensable requisite for the state to tax the taxpayer is also rejected. In fact, the Court in *International Harvester* emphasized that,

"[T]he fact that stockholder-taxpayers never enter Wisconsin and are not represented in the Wisconsin legislature cannot deprive it of its jurisdiction to tax. It has never been thought that residence within a state or country is a sine qua non of the power to tax" (*International Harvester* at 443, quoting *Cf. Cook v Tait*, 265 US 47 [1924]).

* * *

"So long as the earnings actually arise there, and their withdrawal from the state and ultimate distribution, in whole or in part, to stockholders are subject to some state control, the conditions of state power to tax are satisfied" (*International Harvester* at 443-444).

Furthermore, the constitutional state taxation of a non-domiciliary taxpayer in certain circumstances was confirmed by the U.S. Supreme Court in *South Dakota v Wayfair, Inc.* (138 S. Ct. 2080, 2099 [2018]). In *Wayfair*, the Court held that the South Dakota's sales taxation of nondomiciliary corporations did not violate the Commerce Clause. The Court applied the

principle that "the physical presence rule is not a necessary interpretation of the requirement that a state tax must be 'applied to an activity with a substantial nexus with the taxing State'" (*Id.* at 2092, quoting *Complete Auto Transit, Inc. v Brady*, 430 US 274, 279 [1977]). The Court reasoned that, "[S]uch a nexus is established when the taxpayer [or collector] 'avails itself of the substantial privilege of carrying on business' in that jurisdiction.'" (*Id.* at 2099, quoting *Polar Tankers, Inc. v City of Valdez*, 557 US 1, 11 [2009]). Since the nondomiciliary corporations had extensive economic and virtual contacts via online retail sales with South Dakota, the Court found that the substantial nexus requirement was satisfied.

In *Wayfair*, the Court's substantial nexus analysis for Commerce Clause purposes impacts other state and local taxes such as the GCT since it follows the same rationale of constitutional taxation arising from the privileges and opportunities that the taxing jurisdiction has afforded to a taxpayer's business entity operating in that jurisdiction, which was applied in *Allied-Signal NYC*, *Allied-Signal NYS*, and *Shell Gas* (See *Supreme Court Abandons Physical Presence Standard: An In-Depth Look At South Dakota v. Wayfair*, 28-Sep J. Multistate Tax'n 14, 17, 2018 WL 3993429, 5).

IV. Constitutionality of GCT As-Applied

Petitioner's argument that, in the absence of a unitary business relationship between Petitioner, Master Fund and Claren, and of a nexus between the City and Petitioner, the inclusion of the Gain in Petitioner's GCT apportionable income tax base would result in violation of the Due Process and Commerce Clauses, merits a discussion of the constitutionality of the GCT statutory or regulatory provisions as applied to the

facts in this matter since this Tribunal cannot address the issue of the facial constitutionality of the GCT statutory or regulatory provisions. (See *In the Matter of Corwood Enterprises, Inc.*, TAT [E] 2000-39 [RP], New York City Tax Appeals Tribunal [2006]; *Siemens Corporation f/k/a Siemens Capital Corporation*, TAT [E] 93-237 [GC], New York City Tax Appeals Tribunal [1999]; *Matter of David Hazan, Inc.*, DTA 800824 and 800825, 1988 WL 168135, State Trib., April 21, 1988, *aff'd*, 152 AD2d 765 [3rd Dept. 1989], *aff'd*, 75 NY2d 989 [1990]).

Petitioner contends that the City's imposition of GCT on the Gain violates the Due Process and Commerce Clauses. This argument is similar to the one presented by the taxpayers in *Shell Gas*. In that case the nondomiciliary taxpayers argued that there was insufficient nexus because their only connection to New York was their passive ownership interest in an LLC that conducted business in New York, which held a general partnership interest in an LP that also did business in New York. The taxpayers did not conduct New York activities. They argued that the State failed to meet the four-part test established in *Complete Auto Transit*, "to determine whether a state can tax activities taking place in interstate commerce under the Commerce Clause" (*Shell Gas* at 7). But the State Tribunal in *Shell Gas* rejected this contention because the argument focused on the absence of direct nexus between taxpayers and New York, when the relevant inquiry was instead whether New York gave something to the taxpayers' business entity that conducted New York activities for which New York may impose a tax in return (*id.*). The State Tribunal emphasized that "New York has satisfied this standard because it has accorded privileges and immunities that led to [the LP's] income, which inured to the benefit of its shareholders, including [taxpayers]" (*id.*).

Indeed, in that case, the State Tribunal provided that the LP's activities in New York met the four-prong test established in *Complete Auto Transit (Shell Gas at 8)*.

In this matter, the imposition of GCT on the Gain does not violate the U.S. Constitution (*Allied-Signal NYC at 80 and 85*). Here the requirements of the Due Process Clause of the presence of "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax" (*Miller Bros. Co. v Maryland, 347 US 340, 344-345 [1954]*), and that a tax "premised on the presence in the taxing jurisdiction of an entity other than the taxpayer . . . must be fairly related to that entity's activities within the taxing jurisdiction" (*Allied-Signal NYC at 84*) have been met.

Petitioner has failed to meet its burden to show by clear and convincing evidence that the application of the GCT to tax the Gain results in extraterritorial values being taxed because it has not demonstrated that the GCT on the Gain lacks a rational relationship to the manner in which it was generated (*Allied-Signal NYC at 79*). Through its nexus with the City, Claren appreciated in value and enjoyed the protection, opportunities and benefits that the City conferred to it (*Allied-Signal NYC at 85, quoting International Harvester at 442*). The City provided Claren with a successful environment, which resulted in Claren's appreciation in value, and this created the City's right to receive something in return. Clearly, the benefits that the City provided to Claren had a rational relationship to the Gain that Petitioner realized on its sale of Claren. As a result, the Gain was mainly attributable to the benefits provided by the City to Claren and not to factors present somewhere else (*Allied-Signal NYS at 763*).

Further, taxing the Gain pursuant to the GCT statutory or regulatory provisions is a constitutional application, which meets the standards of the Commerce Clause. The imposition of GCT satisfies the four-part test of the Commerce Clause established by *Complete Auto Transit*, and endorsed by the Supreme Court in *Wayfair*. Claren had a substantial nexus with the City, and the GCT is being fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services and benefits provided by the City to Claren.

ACCORDINGLY, IT IS CONCLUDED THAT the Gain is subject to GCT through its inclusion in Petitioner's GCT business income to which Claren's BAP should be applied, and such imposition of the GCT on the Gain does not violate the Due Process or Commerce Clauses. Therefore, the Petition is denied and the Notice of Determination dated July 30, 2014 is sustained.

DATED: New York, New York
December 6, 2018

/s/
SANDRA M. RODRIGUEZ-DIAZ
Administrative Law Judge