STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

STEVEN E. BREITMAN : DETERMINATION
DTA NO. 824268

for Redetermination of a Deficiency or for Refund of :
New York State Personal Income Tax under Article 22
of the Tax Law for the Years 2002 through 2005. :

Petitioner, Steven E. Breitman, filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under Article 22 of the Tax Law for the years 2002 through 2005.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 633 Third Avenue, New York, New York, on October 25, 2012 at 10:30 A.M., with all briefs to be submitted by February 6, 2013, which date commenced the six-month period for issuance of this determination. Petitioner appeared pro se. The Division of Taxation appeared by Amanda K. Hiller, Esq. (Peter B. Ostwald, Esq., of counsel).

ISSUE

Whether items of income, gain, loss and deduction, including most specifically gain realized on the sale of certain leasehold interests located in Pennsylvania, for SEBCO Laundry Systems, Inc., a New Jersey corporation doing business in New York and electing treatment as an "S" Corporation for New York State purposes, are properly allocable to New York to the extent of SEBCO's New York business allocation percentage, so as to be "flow-through" reportable by petitioner, the nonresident shareholder of SEBCO, on his New York State nonresident personal income tax returns for the years in issue.

FINDINGS OF FACT

1. Petitioner, Steven E. Breitman, is a New Jersey resident and is the owner and president of SEBCO Laundry Systems, Inc. (SEBCO). SEBCO is a New Jersey corporation created approximately 43 years ago by petitioner. SEBCO does business in a number of states, including New York, and has elected S corporation status for New York purposes.

2. SEBCO is engaged in the business of providing laundry facilities in apartment buildings and other multi-family housing settings. More specifically, SEBCO's business involves the installation, servicing and maintenance of metered (generally coin operated) laundry equipment including washers and dryers in these settings. In order to carry on its business, SEBCO enters into lease agreements with property owners to occupy a certain defined space within a given property, and pays a monthly, quarterly or annual rental amount to the property owner for the occupancy and use of that space. After entering into such a lease, SEBCO installs its laundry equipment, thus providing an on-sight laundry facility (or amenity) for the property's population. SEBCO functions in a manner similar to a coin-operated laundromat, with the distinction that its facility is available to the particular property's population as opposed to the general public.

3. SEBCO currently operates its business at over 4,000 locations in a number of different states. During the years in issue (2002 through 2005), SEBCO operated at approximately 3,000 locations including, as is relevant to this proceeding, locations in New Jersey, New York and Pennsylvania.

4. SEBCO operated at numerous locations in Pennsylvania during the years in issue, including four properties all owned by the same persons. These four particular locations at which

SEBCO held leasehold interests were Oak Lane Apartments in Trexlertown, Pa., Freedom Estates Apartments in Bethlehem, Pa., Santeee Manor Apartments in Bethlehem, Pa., and Powder Mill Apartments in Emmaus, Pa. The leasehold agreements were entered into in September 1997 and each was to run for an initial term of ten years. The annual lease payments for these four locations were $15,250.00, $20,275.00, $17,980.00 and $11,100.00, respectively.

5. In or about 2004, the owners of the four above-noted properties contacted SEBCO and advised that they were selling the properties. The owners further advised SEBCO that the purchaser did not wish to assume the leases pursuant to which SEBCO held space in the properties and operated its laundry facilities. The owners inquired about purchasing SEBCO's leases, and after negotiations, the parties reached agreement and the four leases were sold by SEBCO to the property owners for $500,000.00. This was the first instance in SEBCO's history where it sold a leasehold interest.

6. In conjunction with the foregoing sale, the parties executed a Sale of Leasehold Interests Agreement, dated January 21, 2005, and a Termination of Lease and Mutual Release Agreement.[1] SEBCO did not include its laundry equipment or any other tangible assets as part of the sale and, in fact, removed its washers, dryers and related laundry equipment from each of the leased premises within the time frame allowed for such removal pursuant to the terms of the parties' agreement. Under the terms of the parties' agreement, and pending closing on the sale of the properties, SEBCO did retain the right (in the event the sale did not close) to retake possession of the leased premises and reinstall its laundry equipment so as to continue providing its laundry services.

[1] A copy of the latter agreement is not included in the record, but is directly referenced in the Sale of Leasehold Interests Agreement (***see*** petitioner's Exhibit 1, ¶ 4).

7. The Division of Taxation (Division) conducted an audit of petitioner's New York State tax liability for the years 2002 through 2005. This audit included examining documentation to determine the proper allocation of petitioner's New York source income including, but not limited to, the proper allocation of Supplemental Income and Loss as reported on federal Schedule E. In connection with this review, the Division examined petitioner's federal income tax returns, forms K-1-1065 (Partnerships) and 1120S SCH K-1 (Shareholder's Share of Income, Credits, Deductions, etc.), and the tax returns of petitioner's flow-through entities filed with New York State.

8. Form CT-3-S-ATT, an attachment to SEBCO's New York State corporation tax report (Form CT-3-S), reflects at Part I the computation of SEBCO's New York business allocation percentage (BAP). SEBCO's BAP, calculated as the arithmetic average of the three percentages that result from comparing SEBCO's property, receipts and payroll in New York State to its property, receipts and payroll everywhere, for the years in issue were 40.73% for 2002, 37.28% for 2003, 39.60% for 2004 and 43.12% for 2005.[2]

9. SEBCO's New York State property factor, determined by comparing the average value of its property in New York State to the average value of its property everywhere, reports amounts for "real estate owned" (line 1) and "real estate rented" (line 2) of Form CT-3-S-ATT (Schedule A, Part I).[3] SEBCO reported the following amounts with respect to real estate rented for the years in issue:

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[2] Property, receipts and payroll are referred to as the three "factors" upon which the BAP is based.

[3] SEBCO reported no real estate owned for any of the years in issue except for 2002, in which SEBCO reported no real estate owned in New York State versus real estate owned everywhere in the amount of $155,743.00.

YEAR	NEW YORK STATE	EVERYWHERE
2002	$33,647,624.00	$58,451,688.00
2003	$26,624,632.00	$49,630,432.00
2004	$35,653,384.00	$63,108,336.00
2005	$38,909,000.00	$61,310,984.00

10. Petitioner received a Schedule K-1 from SEBCO, a flow-through entity, for each of the years in issue. These schedules reported, for federal income tax purposes, capital losses for the years 2002, 2003 and 2004 in the respective amounts of $107,503.00, $18,583.00 and $48,303.00, and a capital gain for the year 2005 in the amount of $500,000.00.

11. As the result of its audit, the Division adjusted petitioner's New York Schedule E (Supplemental Income and Loss) income allocation with respect to SEBCO based upon SEBCO's New York BAP for each of the years in issue. Applying SEBCO's BAP to the foregoing amounts reported per Schedule K-1 resulted in capital losses allocable to New York State for the years 2002, 2003 and 2004 in the respective amounts of $43,790.00, $6,928.00 and $19,128.00, and a capital gain allocable to New York State for the year 2005 in the amount of $215,600.00.[4]

12. The Division recalculated petitioner's taxable income for each of the years at issue upon the foregoing BAP based allocation and upon the additional determination that a portion of petitioner's wage income from SEBCO was also properly allocable to and taxable by New York State.

13. On August 3, 2009 the Division issued to petitioner a Notice of Deficiency (L-032376574) asserting additional tax due in the aggregate amount of $157,450.00 for the years

[4] Consistently, the auditor also applied SEBCO's BAP for each year in issue as the basis for allocating SEBCO's K-1 reported regular income and its taxable interest income, as well as its capital gain and losses.

2002 through 2005, plus interest and penalties. The additional amounts of tax for the respective years in issue were $19,238.00 for 2002, $31,569.00 for 2003, $36,600.00 for 2004 and $70,043.00 for 2005. Penalties were imposed for petitioner's failure to have timely filed returns for 2003 and 2005 (Tax Law § 605[a][1]), substantial understatement of liability for 2003 and 2004 (Tax Law § 685[p]) and negligence for 2002, 2003, 2004 and 2005 (Tax Law § 685[b][1], [2]).

14. Petitioner challenged the foregoing notice by filing a request for a conciliation conference with the Division's Bureau of Conciliation and Mediation Services (BCMS). The Division's review of additional information supplied by petitioner resulted in the conclusion that petitioner's wage income from SEBCO was not New York source income, and the Notice of Deficiency was modified (reduced) accordingly. However, the Division continued to maintain that petitioner's Schedule E income or loss from SEBCO was properly subject to allocation per SEBCO's BAP.

15. As set forth in a Conciliation Order (CMS No. 235562) dated January 7, 2011, the liability asserted by the August 3, 2009 Notice of Deficiency was recalculated to assert tax due in the respective amounts of $458.00 for 2002, $5,530.00 for 2003, $1,527.00 for 2004 and $47,253.00 for 2005, plus interest and penalties.

16. Petitioner continued the challenge to the Division's allocation of his Schedule E income or loss based on SEBCO's BAP. Petitioner has paid certain of the amounts remaining at issue as follows:

YEAR	TAX	INTEREST	PENALTY
2002	$458.00	$361.70	$0.00

2003	$5,530.00	$3,790.87	$0.00
2004	$1,527.00	$895.91	$0.00
2005	$0.00	$0.00	$0.00

CONCLUSIONS OF LAW

A. The New York income of a nonresident individual such as petitioner includes the sum of the net amount of items of income, gain, loss and deduction entering into the individual's federal adjusted gross income to the extent derived from or connected with New York sources, including the pro-rata share of items of income, gain, loss and deduction attributable to the individual's ownership of shares of an electing S corporation to the extent determined under Tax Law § 632 (Tax Law § 631[b][1][C]). Tax Law § 632, in turn, instructs that the portion of such S corporation's items of income, gain, loss and deduction derived from or connected with New York sources, and thus allocable to New York, is to be determined under regulations of the Commissioner of Taxation consistent with the applicable methods and rules for allocation under Tax Law Article 9-A (Tax Law § 632[a][2]). Thus, as the Division argues, the Article 9-A Business Franchise Tax Regulations are to be used for determining the proper allocation of the Schedule E items at issue generated by SEBCO's business activities and flowing through to petitioner by virtue of his ownership of the shares of SEBCO, an electing S corporation.

B. Under Tax Law Article 9-A, New York State imposes an annual franchise tax on all corporations for the privilege of exercising a corporate franchise, doing business, employing capital, owning or leasing property or maintaining an office in the state (Tax Law § 209[1]). The tax is usually based upon a taxpayer's "entire net income"(ENI), which is generally the same as the corporation's federal taxable income with certain modifications (not relevant here), less income from investments in subsidiary corporations (Tax Law § 209[1]; § 208[9]; 20 NYCRR 3-

2.2). Once ENI is determined, it is separated into two components, to wit, "investment income" and "business income." Investment income is defined as income from investment capital (Tax Law § 208[6]; 20 NYCRR 4-8.3), with investment capital, in turn, defined as investments in stocks, bonds and other securities not held for sale to customers in the regular course of business, exclusive of subsidiary capital and stock issued by the taxpayer (Tax Law § 208[5]). The other component, business income, is ENI less investment income (Tax Law § 208[8]; 20 NYCRR 4-8.2).

C. The portion of a corporation's business income, determined as above, that is allocable to New York State is calculated, per Tax Law § 210(3)(a), by multiplying the corporation's total business income by its "business allocation percentage" (BAP). Such allocation percentage is the resulting arithmetic average of the ratios of the corporation's property, receipts and payroll values within New York State to those of the corporate taxpayer as a whole (Tax Law § 210[3]; 20 NYCRR 4-2.2). The formula is intended to reflect a taxpayer's activities within New York (***Matter of Allied-Signal Inc. v. Tax Appeals Tribunal***, 229 AD2d 759 [1996], ***appeal dismissed***, 89 NY2d 859 [1996]). Tax Law § 210(8) grants the Commissioner of Taxation the discretion to vary the statutory formula if it does not properly reflect the activity, business, income or capital of the taxpayer in New York.

D. The Court of Appeals has outlined the Constitutional considerations of formula-based allocation as follows:

> The Due Process and Commerce Clauses of the United States Constitution prevent a State from taxing income of a nondomiciliary corporation arising out of extraterritorial activities unless there is a 'minimal connection' or 'nexus' between the outside activities and the taxing State, and a 'rational relationship between the income attributed to the State and the intrastate values of the enterprise.' Under a long and unbroken line of Supreme Court precedent, if the nondomiciliary corporation engages in business in the taxing State . . . , *the taxing State need not*

> *identify and select out its specific intrastate income-producing activities so long as the corporation is operating a unitary business enterprise and the income is derived from the unitary business; it may then apply an apportionment formula to tax an appropriate proportional share of the interstate income of the enterprise.* (***Matter of British Land (Maryland) Inc. v. Tax Appeals Tribunal***, 85 NY2d 139 [1995] [citations omitted; emphasis added].)

The foregoing principles are limited by the proposition that a State's apportionment formula may not tax income "which cannot in fairness be attributed to the taxpayer's activities within the State" (***Matter of British Land (Maryland) Inc. v. Tax Appeals Tribunal***, 85 NY2d 139, [1995, quoting ***Allied-Signal, Inc. v. Director, Div. of Taxation***, 504 US 768, 780 [1992]).

E. Review of the record in this case shows that SEBCO did not report investment capital, and hence did not report investment income. Consequently, gain from the sale of the leasehold interests is not investment income, but rather is business income. Since SEBCO did business in New York State, its business income is allocable to New York State based upon the foregoing three-factor formula and resulting BAP, and the Division so allocated as the result of its audit.

F. The issue presented is whether petitioner has established that the inclusion of the gain on the sale of the four leaseholds resulted in the improper taxation of extraterritorial values. More specifically in light of the foregoing case law, the primary question presented is whether including the gain from the sale of the four leaseholds results in an income allocation to New York that is grossly disproportionate to SEBCO's business activities in New York. Initially, there is no dispute that SEBCO is a unitary business and did business in New York during the years in issue. Petitioner, citing to ***Allied-Signal, Inc. v. Director, Div. of Taxation***, contends that the imposition of the tax is unconstitutional because the tax burden resulting from formula allocation is out of all appropriate proportion to SEBCO's business in New York. Petitioner further maintains that SEBCO's sale of the four leasehold interests in 2005 was "discrete and isolated," and was something that had never happened before throughout the entire history of the company. Petitioner also argues that since the leasehold interests in issue were located in Pennsylvania, there is no connection to New York State so as to justify subjecting the gain from their sale to New York taxation.

G. Petitioner's reliance on ***Allied-Signal, Inc.***, is misplaced. First, petitioner has not established that the gain in question resulted from an "unrelated business activity that constitutes a discrete business enterprise." ***(Id.)*** In fact, petitioner specifically admitted that SEBCO is not in the business of selling its leasehold interests. Contrary to petitioner's argument that the gain in question resulted from activities unrelated to those carried out in New York State, it is clear that SEBCO was a unitary business enterprise, and that leasehold interests such as those in question are an ongoing integral part of SEBCO's ordinary and necessary course of conducting its business in the jurisdictions where it operates. SEBCO entered into the 10-year leaseholds in question in September 1997 and utilized the same as a necessary component of carrying on its laundry business operations for a number of years thereafter until January 2005 when SEBCO agreed to the sale and termination of the leasehold interests. Presumably, SEBCO's annual leasehold expense (i.e., rent) for the four properties was a business expense deduction taken by SEBCO. Further, presumably, the value (as opposed to the sale price) of the four leaseholds was included in SEBCO's "everywhere" portion of the property factor, at least for the years preceding the sale of such interests, and thus impacted the resulting BAP based allocation ratio for such years.[5] Further, and notably, formula allocation resulted in allowing a portion of SEBCO's capital loss

[5] The dollar value of the four subject leaseholds presumably included in the property factor for pre-sale years was not specified. However, including such value in the "everywhere" portion of the property value fraction (i.e., in the denominator) has the mathematical result of reducing the fraction and, in turn, reducing the BAP and the amount of SEBCO's business gain allocable to New York State.

amounts for each of the first three years in issue to be allocated to New York State. In consistent result, then, it is appropriate that the capital gain for the final year in issue was likewise formula allocated for the final year in issue under the Division's audit result.[6]

H. In ***Matter of British Land (Maryland), Inc. v. Tax Appeals Tribunal***, the Court of Appeals agreed with the conclusion of the Tax Appeals Tribunal that petitioner's New York and Maryland real estate activities were part of a unitary business, a prerequisite to a constitutionally valid formula for the apportionment of income. The Court then addressed the more difficult question of:

> whether petitioner met its heavy burden of showing, by clear and cogent evidence, that application of the statutory formula attributes New York income to petitioner 'out of all appropriate proportion to the business transacted by [it] in that State' (citation omitted). Put another way, did petitioner establish that New York 'has applied a method [of apportionment], which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction' (citation omitted)? ***Matter of British Land (Maryland), Inc. v. Tax Appeals Tribunal,*** 85 NY2d 139 [1995].)

In examining the foregoing question the Court first concluded that the New York statutory formula was fair on its face. The Court also rejected the argument "that a tax on extraterritorial values can be established simply by showing that the taxpayer's formula-based interstate income is many times greater than the income reflected in a separate geographical accounting" (***id.***). Further, since the gain at issue, a portion of which was being subjected to New York tax via formula allocation, related to the sale of real property located outside of New York (i.e., in Maryland), the fact of such location did not itself serve as a bar to including any gain (***id***). Thus,

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[6] Petitioner did not describe the particular method by which the value of the four leaseholds, presumably represented by their sale price, was arrived at, or whether such sale value included any factors enhancing or increasing the amounts at which SEBCO had carried and reported as the values of the four leaseholds in determining the property factor portion of its BAP over the preceding years.

the fact that the leasehold interests in this case involved property locations outside of New York State does not, of itself, bar the gain on the sale of such business assets from inclusion in SEBCO's business income subject to allocation by formula.

I. As noted, in ***British Land*** the Court did not conclude its analysis with the finding that the real property was located in Maryland. Rather, the Court continued and explored whether the application of the statutory formula in fact attributed income "to petitioner 'out of all appropriate proportion to the business transacted by [it] in [New York State]' (citation omitted)" (***id.***). As a consequence, a simple finding that there is a tax liability resulting from formula allocation is not the same as concluding that application of the statutory formula produced a grossly distorted result, thus making application of the formula unconstitutional (***see Container Corp. of America v. Franchise Tax Bd.***, 463 US 159 [1983]). Nor is a showing of gross disproportionality alone sufficient to invalidate the application of the statutory allocation formula. Among other considerations, the Court in ***British Land*** concluded that because the "single gain from the sale of the [out-of-state] property so dwarfed petitioner's other net income," attributing by allocation some two-thirds of that gain "'cannot in fairness be attributed to [petitioner's] activities within [New York] State'" (citation omitted)." (***id.***) Thus, in ***British Land***, the Court found that the taxpayer had met its burden of proof to show that by applying the formula and allocating 64% of the out-of-state income to New York State, the state was taxing extraterritorial value. The Court did not hold that none of the out-of-state income should have been allocated to New York.

J. Petitioner's arguments essentially restate the uncontested facts that SEBCO was not headquartered in New York and that the leasehold interests in question were not located in New York. The question thus devolves to whether these uncontested facts support the conclusion that the application of the statutory formula in this case "attributes New York income to petitioner 'out of all appropriate proportion to the business transacted by [it] in [New York State]' (citation omitted)" (***Matter of British Land (Maryland), Inc. v. Tax Appeals Tribunal***). During the years at issue, SEBCO operated its business at some 3,000 or more locations. All of these locations were leased as opposed to owned, with the exception of a single owned location during the year 2002 (***see*** Footnote 3). The leases are an integral and necessary part of the operation of SEBCO's laundry business. As such, the sale of such a business asset, though uncommon and unusual, does not rise to the level of a discrete and unrelated business activity. There is no evidence or indication that SEBCO desired to sell the leases and cease operations at the four leased locations. Rather, SEBCO negotiated and presumably received value for the leases it sold commensurate to the income that would have been realized from the continued operation of its laundry facilities business at the four locations for the balance of the respective lease terms. This conclusion that the sale consideration for the leasehold interests presumably reflected the income forgone (or lost) by SEBCO's inability to continue in business at the four locations is consistent with the provision in the parties' sales agreement allowing SEBCO to retake possession and continue its business operations in the event the sale of the properties did not close (***see*** Finding of Fact 6). This, again, supports the conclusion that the gain on the sale of the leasehold interests was clearly tied to SEBCO's overall business operations. SEBCO's BAP (including the underlying property factor portion thereof) remained relatively consistent during each of the years in issue (***see*** Finding of Fact 8). Upon these facts, it is concluded that since SEBCO is a unitary business, and since the primary factor cited to in order to establish a tax on extraterritorial values is simply the out-of-state location of the leaseholds, petitioner has not met the burden of proving that the Division improperly included the gain on the sale of the leaseholds as part of SEBCO's items of income, gain, loss and deduction properly subject to formula allocation, or that the resulting amount of gain so allocated was unacceptably disproportionate to SEBCO's business in New York (***Matter of British Land (Maryland), Inc. v. Tax Appeals Tribunal***).

K. The last issue presented is whether petitioner has established reasonable cause sufficient to support the abatement of the penalties imposed for late filing, substantial understatement of liability and negligence under Tax Law §§ 605(a)(1), 685(p) and 685(b)(1), (2). The burden of proof to show reasonable cause is on the petitioner, and in establishing reasonable cause, the taxpayer faces an "onerous task" (***Matter of Philip Morris, Inc.***, Tax Appeals Tribunal, April 29, 1993). The Tribunal explained why the task is onerous as follows:

> By first requiring the imposition of penalties (rather than merely allowing them at the Commissioner's discretion), the Legislature evidenced its intent that filing returns and paying tax according to a particular timetable be treated as a largely unavoidable obligation [citations omitted] (***Matter of MCI Telecommunications Corp.***, Tax Appeals Tribunal, January 16, 1992).

Here, petitioner has advanced no specific bases for finding reasonable cause, and therefore the penalties imposed are sustained.

L. The petition of Steven E. Breitman is hereby denied and the Notice of Deficiency dated August 3, 2009, as modified (reduced) in accordance with CMS No. 235562 (***see*** Finding of Fact 15), together with penalties and interest thereon, is sustained.

DATED: Albany, New York
August 1, 2013

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE