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New York State Expands Audits of Federal Tax Issues

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Under the New York State Personal Income Tax, as well as the personal income taxes of most other states, individual taxpayers determine taxable income subject to state tax initially by reference to their income for Federal income tax purposes.¹ Taxpayers set forth on their state income tax returns the income from the relevant lines of their Federal personal income tax returns (Forms 1040), and then make various required adjustments to the federal taxable income (e.g., eliminate deductions for state taxes, eliminate income from New York municipal securities, account for differences in depreciation methods).

In general, the New York Department of Taxation and Finance (the “Department”) has focused its audit attention on matters peculiar to the New York State Tax Law, such as the required adjustments to income, status of an individual as a resident or nonresident, and the allocation of income of nonresidents. In recent years, however, the Department has begun to audit and challenge taxpayers on Federal income tax issues more frequently.² Department officials have stated that this shift in focus in New York State audits resulted

from the (correct) belief that the IRS has been auditing fewer “day-to-day” tax issues, as the IRS focuses its enforcement attention on offshore accounts and tax shelters. It is also likely that the increased audit of federal issues is expected to generate additional revenue.

Although the Department is within its legal rights to challenge a taxpayer on Federal income tax issues that affect a taxpayer’s New York State income tax, tax practitioners in New York frequently argue that the Department auditors lack the familiarity and expertise on Federal tax laws. Exacerbating this lack of expertise is that the Department has moved well beyond challenging day-to-day income tax issues, and instead decided to address Federal issues involving complex issues. *Claudel Chery*,³ a recent Division of Tax Appeals administrative law judge determination, demonstrates this march toward raising sophisticated issues. *Chery* involved issues that are challenging for the Federal tax auditors and practitioners who work with them every day, let alone state taxing authorities who rarely (if ever) confront such issues.

In *Chery*, the Department disallowed certain of petitioner’s deductions, attributable to his real property business, claiming that such deductions should be disallowed under Internal Revenue Code (I.R.C.) §469(a), as losses from a “passive activity.” The passive loss rules contain numerous exceptions, however.

Under I.R.C. §469(c)(7), the rental of real property will *not* be characterized as a passive activity, if the taxpayer is a “real estate professional,” which he would be if “more than one-half of [his] personal services [are] performed in [real property] trades or businesses” in the year and such services are at least 750 hours in that year.

For the year at issue, the *Chery* petitioner spent 2047 hours working at his day job as a postal inspector. In addition to his work as a postal inspector, petitioner was involved in several real estate businesses, including the management of his own rental real property and performing consulting services for other real estate owners. With respect to the properties that he owned, “[p]etitioner was usually working on [them] when he was not working his regular job, including most major holidays.”⁴ Petitioner described the many “hats” he wore with respect to his properties, including “file clerk, real estate broker, web site developer, bookkeeper, security guard, accountant, plumber, electrician, carpenter, superintendent, porter, foreman, general contractor, computer technician, architect, engineer and landscaper.”⁵ With respect to the properties for which petitioner consulted, he performed similar management and brokerage functions (though not necessarily the tasks requiring manual labor).

Petitioner provided the auditor with meticulous and voluminous records

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substantiating his involvement in his rental real estate. His vehicle log (which was maintained to substantiate his car expenses) supported that he had spent at least 1872.5 hours on his rental real estate in the year at issue (albeit a figure short of the more than 2047 hours petitioner would need to have more than half of his personal services rendered in real estate). However, he also produced other records (including his Outlook calendar) that substantiated that he spent additional time on his rental real estate, although such records do not as neatly quantify that time. Referring to the passive activity loss Federal guidelines, the auditor challenged petitioner's hour count largely on the grounds that petitioner was merely an investor and not actively involved in the management of his properties. Petitioner responded to this claim, explaining his active involvement with his properties, as well as substantiating time he spent on consulting other real estate owners (all of which time the Department disallowed, for reasons not explained in the determination, as a "hobby,"⁶ and not a business).

The Department asserted the application of I.R.C. §469 to petitioner's losses based on little more than the initial count of hours from petitioner's travel log, and the auditor's decision that hours spent consulting should be disregarded. The ALJ noted that, in addition, "the [Department] did not separate the categories [of contested hours] by assigning a specific number of disallowed hours to each of them, in order that petitioner could more accurately address the hours in each category." In response, the petitioner prepared detailed schedules and addressed the specific issues raised by the Department. The ALJ went through a robust analysis of the additional facts petitioner introduced, and applied IRC §469 and the regulations thereunder to such facts.

The auditor disallowed traveling hours relying on a short provision in the IRS Passive Activity Loss Audit Technique Guide, which noted that travel time is usually not counted unless "integral to operations." The ALJ noted that a footnote in the IRS guide stated that there was no statutory authority on travel and referred to U.S. Tax Court decisions. The ALJ analyzed relevant passive activity loss cases and concluded that travel hours should be included in this case, noting, among other things, that petitioner was decidedly involved in repairing his properties and his travel involved transporting tools and materials.

Another issue where the ALJ differed from the Department is in connection with the aggregation of activities issue. The Department dismissed petitioner's real estate consulting activities as a "hobby," with no explanation provided in the determination, and did not count petitioner's hours performing those activities. The ALJ found that such activities were a business (and not a hobby). The ALJ, setting forth a detailed discussion of the relevant regulations, carefully laid out the factors to consider when a trade or business activity may be aggregated with a rental activity, including, "(i) Similarities and differences in types of trades or businesses; (ii) The extent of common control; (iii) The extent of common ownership; (iv) Geographic location; and (v) Interdependencies between or among the activities."⁷ The ALJ held that "[g]iven the nature of petitioner's real estate consulting projects, their direct connection to the real estate market as either rental or sale, the common control by petitioner of his own condo and rentals, the common ownership interest in his sister's home and his own condo and rentals, the relative proximity of the properties involved, and the clear similarities of the endeavors as they all involved real estate analysis for either sale

or rental, tenant evaluations and similarly connected income and expense considerations, the rental activities and petitioner's [consulting] activities" could be aggregated.⁸ It is exactly this kind of challenging analysis that is required when analyzing a complex Federal income tax issue, such as passive activity losses.

This case demonstrates a frustrating aspect of a state taking up Federal issues: a facts and circumstances inquiry in areas in which a state is not a "native" expert. Although the New York has experience in a state-specific facts and circumstances analyses, such as residency or income sourcing,⁹ most New York auditors have likely never challenged (or analyzed) a passive activity loss.

The *Chery* case was largely a failure on the part of the Department to appropriately exercise its discretion. On the face of the vehicular records (which presented a clear quantitative piece of information), petitioner was short on the hours required to qualify as a real estate professional and deduct his real estate losses. However, on the facts and circumstances as a whole, which, for proper analysis, required a deeper understanding of the regulatory authority under I.R.C. §469, he qualified. The New York auditors, not familiar with the details of passive activity loss analysis, dealt with it in a mechanical fashion—and lost the case for not understanding that nuance.

New York uses as the base for its personal income tax Federal adjusted gross income.¹⁰ It is, therefore, unavoidable that some examinations of New York personal income tax returns will raise Federal issues. However, New York and its taxpayers will generally best be served by the state sticking to those areas of tax law in which it is an expert, and not endeavoring to be backup to the IRS.

¹ In New York, the calculation of the tax base for the state personal income tax begins with Federal adjusted gross income (which is defined in Internal Revenue Code §62). See N.Y. TAX LAW §§612(a) (residents) and 631(a)(1) (nonresidents).

In the case of the state corporate franchise tax, the starting point for the tax base "shall be presumably the same as the entire taxable income, which . . . the taxpayer is required to report to the United States treasury department." N.Y. TAX LAW §208(9)(i).

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- ² California has also been active in challenging like-kind exchanges under Internal Revenue Code §1031. *See, e.g.*, *In re Rago Development Corp.*, 2015-SBE-001 (Cal. St. Bd. of Equal., June 23, 2015) (where California challenged a “swap and drop” like-kind exchange).
- ³ *Claudel Chery*, DTA No. 825699 (N.Y. Div. Tax App., Dec. 3, 2015).
- ⁴ *Chery*, Findings of Fact ¶6.
- ⁵ *Id.*, Findings of Fact ¶9.
- ⁶ *Id.*, Findings of Fact ¶24.
- ⁷ *Id.*, Conclusions of Law ¶H (quoting from Treas. Reg. 1.469-4(c)(2)).
- ⁸ *Id.*, Conclusions of Law ¶H. The ALJ also held that aggregation was not prohibited, as the trade or business (consulting) activities were “insubstantial” compared to the rental activities (in accordance with Treas. Reg. §1.469-4(d)(1)(i)). *Chery*, Conclusions of Law ¶H.
- ⁹ Although, lately, New York has gotten overzealous in the cases that it brings in these areas as well. *See, e.g.*, *Gaied v. N.Y. St. Tax App. Trib.*, 22 N.Y.3d 592 (2014) (New York asserted taxpayer who occasionally slept on his parents’ couch had a “permanent place of abode” in state) and *Patrick J. Carr*, DTA No. 825989 (N.Y. Div. Tax App., July 23, 2015) (New York asserted that Florida resident’s income from Florida legal services was sourced to New York due to his New York law license).
- ¹⁰ *See* footnote 1, *supra*.