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THE BR STATE + LOCAL TAX SPOTLIGHT

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CONTENTS

1. Note from the Editors
2. Unlike a Fine Wine, Tax Issues Do Not Get Better with Age
3. New Jersey Tax Court Sets Aside Sales Tax Assessment Based on Estimated Sales
4. Oregon Tax Court Finds Taxpayers Not Bound by Incorrect Federal Adjustments
5. Everyone Wins: Pennsylvania BF&R Grants a Partial Refund to a Manufacturing Company Before the Commonwealth Revamps its BF&R Tax Dispute Process
6. What's Shaking: Blank Rome State + Local Tax Roundup

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Note from the Editors

By Joshua M. Sivin and Melanie L. Lee

Welcome to the November 2024 edition of *The BR State + Local Tax Spotlight.* We know the importance of remaining up-to-date on State + Local Tax developments, which appear often and across numerous jurisdictions. Staying informed on significant legislative developments and judicial decisions helps tax departments function more efficiently, along with improving strategy as well as planning. That is where *The BR State + Local Tax Spotlight* can help. In each edition, we will highlight important State + Local Tax developments that could impact your business. In this issue, we will be covering:

- Unlike a Fine Wine, Tax Issues Do Not Get Better with Age
- New Jersey Tax Court Sets Aside Sales Tax Assessment Based on Estimated Sales
- Oregon Tax Court Finds Taxpayers Not Bound by Incorrect Federal Adjustments
- Everyone Wins: Pennsylvania BF&R Grants a Partial Refund to a Manufacturing Company Before the Commonwealth Revamps its BF&R Tax Dispute Process

We invite you to share *The BR State + Local Tax Spotlight* with your colleagues and visit Blank Rome's State + Local Tax webpage for more information about our team. Click here to add State + Local Tax to your subscription preferences.

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Unlike a Fine Wine, Tax Issues Do Not Get Better with Age

By Eugene J. Gibilaro

In a recent decision, the New York State Tax Appeals Tribunal ("Tribunal") upheld notices of deficiency issued by the New York State Department of Taxation and Finance (the "Department") totaling approximately $15 million in additional tax, plus interest and penalties for tax years dating as far back as 2002. *In the Matter of the Petition of Cushlin Limited,* DTA No. 829939 (TAT Oct. 10, 2024). The notices of deficiency came on the heels of an audit that lasted a decade and at the end of which the Department computed additional corporation franchise tax due "based on the information it had available" inasmuch as the information provided by the company over the 10-year audit was "incomplete and/or unsubstantiated."

This case is a cautionary tale for taxpayers and a reminder that tax issues do not get better with age, and delaying or putting off addressing known issues only makes the situation worse in the end.

The company was a corporation organized under the laws of the Isle of Man and was in the business of acquiring and refur-bishing three- and four-star hotels. The company also owned equity interests in 13 limited liability companies ("LLCs") that were doing business in New York. In 2008, the Department began an audit of one of the LLCs and discovered that it had sold real property in New York but did not file a New York State partnership tax return. As a result of its ownership interest in the LLCs, the Department determined that the company was required to file New York corporation franchise tax returns on which it was required to report the gains and losses of the LLCs. The audit of the company initially covered the tax years 2002 through 2006 and was later expanded to include 2007 through 2009.

From 2010 through 2013, the company and the Department communicated multiple times, and the company repeatedly stated that it was preparing tax returns for the audit years for the LLCs and the company and that it required more time to prepare those returns. In 2013, the company provided the Department with draft tax returns for the company and the LLCs. In May 2016, after another three years passed without final tax returns being filed, the Department informed the company that it was assessing additional corporation franchise tax computed based on the amounts in the draft returns plus interest and penalties. In June 2016, the company filed final tax returns for all of the audit years, and the final returns reflected income and deductions that were larger than the amounts previously included in the draft returns.

The Department then issued three information document requests over the next two years that requested information substantiating the deductions claimed on the filed returns. In response to these requests, the Tribunal found that the company "provided only partial responses that lacked any externally verifiable substantiation" and repeated Department requests were "met with partial, inconclusive responses." Finally, in 2018, the Department issued the notices of deficiency that assessed the amount of additional corporation franchise tax that the Department had previously computed using the company's draft returns plus updated additional interest and penalties. The company appealed and the Administrative Law Judge ("ALJ") sustained the notices finding: (1) that the company had failed to meet its burden of proving that the notices were incorrect; and (2) that penalties were properly imposed as the company also failed to demonstrate that its failure to file timely returns was a result of reasonable cause and not willful neglect.

The Tribunal agreed with the ALJ, concluding that there was a rational basis for the notices because "[w]orking without returns or supporting documentation more than six years after it began, the [Department] used the available information provided by petitioner, verified by other information contained in the [Department's] own database, to arrive at a computation of tax due from petitioner." Moreover, the Tribunal reasoned, the Department provided the company with numerous opportunities to substantiate the amounts that the company reported on its filed returns and the company's failure to provide substantiating information left the Department with "little choice" but to "use another method to arrive at a determination of tax liability." Finally, the Tribunal concluded that the ALJ correctly determined that penalties were properly imposed as the company did not meet its burden to demonstrate reasonable cause.

KARA M. KRAMAN
OF COUNSEL

New Jersey Tax Court Sets Aside Sales Tax Assessment Based on Estimated Sales

By Kara M. Kraman

A pizzeria operator successfully challenged a sales tax assessment made by the Division of Taxation ("Division") in which the auditor estimated the sales tax due. *La Troncal Food Corp. and Vicente Intriago v. Director, Division of Taxation,* N.J. Tax Court, Dkt No. 013472-2017 (October 2, 2024).

The Facts: Plaintiffs, La Troncal Food Corp. ("La Troncal") and Vincente Intriago (together, "Taxpayer"), operated a small pizzeria in the Ironbound section of Newark, New Jersey. Mr. Intriago and his father-in-law were the principals and operators of the business from 2005 through 2013. In January 2014, La Troncal and Mr. Intriago sold the pizzeria to Mr. Intriago's father-in-law and San Gerardo Food Corporation ("San Gerardo"). After the sale, Mr. Intriago and La Troncal ceased being involved with the restaurant in any capacity.

The Division began its audit of Taxpayer in September 2014, after the sale of the business to San Gerardo. As part of the audit, the auditor and his supervisor visited the restaurant, which at that time was owned and operated by San Gerardo, had different seating, employed more people, and had a different menu than the restaurant being audited. At the conclusion of the audit, the auditor determined that the Taxpayer had not provided adequate records and estimated the taxes owed based on the San Gerardo-owned restaurant that he visited.

The Decision: While there was some dispute about whether the Taxpayer had provided adequate records, the Tax Court recognized that the Division is permitted to estimate sales when a taxpayer's records are incomplete. The Court also noted that the Division's assessments are entitled to a presumption of correctness. However, the Court observed that a taxpayer may rebut the presumption of correctness through "cogent evidence," which must focus on the "reasonableness of the underlying data used by the Director and the reasonableness of the methodology used."

In this case, the Court found that the Taxpayer's credible testimony about the invoices provided to the auditor, the differing nature of the business before it was sold, and the expert testimony of Taxpayer's witness reconciling the Taxpayer's books and records with the amount of tax owed, overcame the presumption of correctness afforded to the Division's assessment.

In support of the assessment, the Division offered the testimony of the assistant field audit chief who supervised the audit but did not participate in or have personal knowledge of the audit. (The auditor was no longer employed by the Division and did not testify.) The Taxpayer objected to the supervisor's testimony on the grounds that the supervisor did not have the requisite personal knowledge to provide the testimony offered. The Court sustained the Taxpayer's objection, noting that, if admitted, a supervisor's opinion could permit the Division "to boot strap the proofs [justifying the auditor's actions in making an estimated assessment] with improper testimony that constitutes nothing more than speculation." The Court also rejected the Division's submission into evidence the auditor's original documentation under an exception to the hearsay rule because of concerns about the auditor's unexplained methodology and the unreliable nature of the data used in determining the assessment.

As a result, the Court found no basis on which to uphold the validity of the assessment and set it aside. Instead, it found that the taxpayer was liable for a lesser amount of sales tax based on its own expert's credible testimony.

> **This case is a good reminder that while auditors are permitted to estimate sales tax due when records are inadequate, those estimates must be reasonable and based on reliable data. When they are not, they are subject to challenge.**

MELANIE L. LEE
ASSOCIATE

Oregon Tax Court Finds Taxpayers Not Bound by Incorrect Federal Adjustments

By Melanie L. Lee

The practice of reporting federal level audit adjustments to state taxing authorities is as common as eating turkey on Thanksgiving. Often this reporting leads to state-level adjustments on previously filed returns. However, where the federal adjustments are wrong, even if agreed to by the taxpayer, should such adjustments impact a state return whose starting point is federal taxable income? The Oregon Tax Court, Magistrate Division, recently addressed this issue. ***Spears v. Dep't of Revenue***, TC-MD 230445G (Or. Tax Ct. Oct. 15, 2024).

On their original 2018 federal Schedule C, the Spearses understated the gross receipts from their eBay business by $38,938. However, because the Spearses also failed to include an amount on the returns line of the Schedule C, their net profit was correctly stated. To correct the errors, the Internal Revenue Service ("IRS") proposed increasing the gross receipts to the accurate number, and the Spearses separated their gross receipts from their returns—resulting in a net tax reduced by $893. The Spearses agreed to this net tax reduction, despite that "the adjustments by which the IRS achieved it were not accurate." Specifically, to achieve the agreed upon reduction, the IRS increased the Spearses' taxable income by $51,626 (the amount of their Schedule C profit plus their self- employment tax deduction) and then eliminated their $6,813 self- employment tax.

The Oregon Department of Revenue (the "Department") adjusted the Spearses' 2018 return to conform to the changes made by the IRS—the Spearses asked the tax court to reverse the Department's adjustments.

Despite agreeing that the IRS adjustments were wrong, the Department took the position that it was prohibited under Oregon law "from making further adjustments to the Oregon return that would go against the IRS adjustments…." In support of its position, the Department relied on Oregon Revised Statute 316.048 which provides:

> The entire taxable income of a resident of this state is the federal taxable income…as defined in the laws of the United States, with the modifications, additions and subtractions provided [under Oregon law].

Applying this statute, and corresponding Oregon case law, the tax court determined that the Department's arguments were "groundless" and "found no purchase in the courts." Rather, "while changes made to a federal return generally flow through to the taxpayer's Oregon return," the Department is under no obligation to apply changes where it makes a "different factual or legal determination" (internal citation omitted). Instead, the Department is charged with administering Oregon law, and must use its independent authority to "apply federal tax provisions as Oregon law." As a result of its findings, the tax court ordered the Department to reverse its adjustments in full.

Ultimately, the result in *Spears* was a victory for the taxpayers. However, its result should also serve as a reminder to taxpayers that reporting federal audit adjustments may lead to further state inquiries.

> **Taxpayers should ensure that any federal audit adjustments they agree to are accurately calculated and are not agreed to solely for reasons of expediency.**

STEPHANIE N. TERINONI
ASSOCIATE

Everyone Wins: Pennsylvania BF&R Grants a Partial Refund to a Manufacturing Company Before the Commonwealth Revamps its BF&R Tax Dispute Process

By Stephanie N. Terinoni

The Pennsylvania Board of Finance and Revenue (the "BF&R") determined that Aero Aggregates of North America LLC ("Aero Aggregates") was entitled to a partial refund of sales tax that it paid on natural gas, as such natural gas was used to power equipment directly used in its manufacturing operations. *In Re: Aero Aggregates of North America LLC,* Dkt. No. 2334167 (Bd. Fin. & Rev. Aug. 29, 2024).

The Facts: Aero Aggregates manufactures ultra-lightweight foamed glass aggregates from consumer recycled glass. Aggregates are used as building material in infrastructure construction projects, such as lightweight fill for highways, bridge abutments, and retaining walls.

To turn the recycled glass into the foamed glass aggregates, the glass powder is mixed with a foaming agent that is sent through kilns to be softened. The foaming agent creates bubbles within the softened glass that ultimately form the foamed glass aggregates. In this process, Aero Aggregates uses certain equipment that is powered by natural gas. For the periods at issue, Aero Aggregates paid sales tax on its natural gas purchases but subsequently filed a petition for refund with the Board of Appeals (the "BOA"), claiming such purchases were exempt from sales tax because the natural gas was directly used in manufacturing operations.

The BOA granted partial relief because it determined certain equipment powered by natural gas was not directly used in exempt manufacturing activities. Aero Aggregates appealed the BOA's decision to the BF&R, asserting the equipment the BOA denied relief on was all used as part of its manufacturing process.

The Law: Machinery, equipment, and supplies used directly in manufacturing are exempt from Pennsylvania's sales and use tax. In determining whether certain property is exempt from tax, Pennsylvania's administrative code provides examples of property that is directly used and property that is not directly used in manufacturing. Relevant here, transporting property before such property is used in the first production stage is considered a preproduction activity, and equipment used to transport such property is subject to tax. In addition, maintenance, service, and repair work—but not replacement parts—are subject to tax.

The Decision: The BF&R ultimately granted Aero Aggregates additional relief and adjusted the percentage of exempt purchases as determined by the BOA. The BF&R held that equipment that removes and later reintroduces glass powder from the production line is part of the manufacturing process and is exempt from tax.

The BF&R agreed with the BOA on certain operations, however. It found that equipment that removes metals out of the glass powder is part of preproduction operations and thus subject to tax. It also found that maintenance equipment for onsite repairs was subject to tax.

Conclusion: Aero Aggregates did not appeal the BF&R's decision to the Commonwealth Court. If this case had come before the BF&R only a few months later, the outcome may have been different, as the BF&R was recently granted additional authority regarding tax disputes.

> **Under SB 1051, which was signed into law at the end of October, the BF&R has authority to initiate and oversee a formal settlement process.**

Under this process, the BF&R shall appoint a third party (who must be an attorney in good standing who has significant experience with Pennsylvania tax law) to preside over settlement conferences that can be requested by either party of the tax dispute or the BF&R itself. The new law was passed in hopes of permitting a faster resolution for tax disputes with the Department of Revenue and establishing a more equitable appeals process.

What's Shaking: Blank Rome's State + Local Tax Roundup

Blank Rome's nationally prominent State + Local Tax attorneys are thought leaders in the community as frequent guest speakers at various local and national conferences throughout the year. Our State + Local Tax attorneys believe it is necessary to educate and inform their clients and contacts about topics that will impact their businesses. We invite you to attend, listen, and learn as our State + Local Tax attorneys interpret and discuss key legal issues companies are facing and how you can put together a plan of action to mitigate risk and advance your business in accordance with state and local tax laws.

Institute on State and Local Taxation

- Blank Rome State + Local Tax partners Mitchell A. Newmark and Eugene J. Gibilaro will be speaking at the Institute on State and Local Taxation in New York, New York on December 16, 2024. Mitchell's speech is titled "Post Moor(tum) on Moore and Loper Bright" and Eugene's speech is titled "Top 10 SALT Cases – Away We Go." To learn more, please click here.

The National Multistate Tax Symposium

- Blank Rome State + Local Tax partner Craig B. Fields will be speaking at the National Multistate Tax Symposium in Orlando, Florida on February 6, 2025. Craig's speech is titled "M&A twists and turns: Transaction tips for multistate direct and indirect taxes."

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