THE TAX CLUB

“The New York Use Tax Nonresident Exemption and Its Impact on Art Collections Owned by Nonresident Aliens”

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I. **Introduction**

A relatively recent amendment to New York State's 2017-2018 budget narrowed the State Tax Law § 1118(2)'s nonresident exemption to its use tax. The use of property in New York by nonresident investment entities is no longer exempt from use tax, prompting taxpayers to restructure the manner in which art portfolios are brought into, and displayed in, New York.

For a while now, New York State has been particularly aggressive in its art industry investigation for alleged violations of the State's sales and use tax laws. New York tax authorities have been scrutinizing the art world to ensure that sales and use taxes are being paid.[1] There has been a wave of investigations into financial dealings in the robust art market. Soaring prices, secrecy in the art world and loose regulations in this field have permitted art collectors to dodge significant sales and use taxes.

Many art collectors have availed themselves from certain exemptions to acquire and display art without paying New York sales or use tax. Two strategies have been particularly exploited: (i) acquiring art for resale where sales tax is not due but subsequently displaying it in New York without paying a compensating use tax[2]; and (ii) incorporating a holding company

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1 "Aby Rosen Settles Tax-Evasion Inquiry for $7 Million" by Jennifer Smith. May 3, 2016. The Wall Street Journal. See also, "Art Buyers Face Scrutiny as New York Kicks Off Tax Probe" by Rebecca Spalding. May 3, 2016. Bloomberg News.

2 New York law requires sellers of goods, or vendors, to charge sales tax on sales of goods. Purchases that a vendor makes exclusively for resale are excluded from sales tax, if the vendor purchases retail property with the intent exclusively to resell that property. If, after a purchase, a vendor uses the item initially bought exclusively for resale, then the vendor must pay a compensating use tax at the same aggregate rate as the sales tax. Use tax applies when, among other circumstances, a vendor diverts inventory for use that was initially intended exclusively for resale and purchased with resale certificates. In dealing with sales and use tax audits pertaining to the art world the Attorney General has stated that: "[W]e are committed to rooting our tax abuses wherever we find them, especially in the art world, where the difference can be hundreds of thousands—if not millions—of dollars in lost tax revenue."

(usually in Delaware where sales tax is not imposed) solely to acquire and hold art and subsequently bring this into New York for display. Because such a passive entity is treated as "not doing business" it generally was not subject to use tax in New York. This second technique was aggressively challenged by the tax authorities and is the topic of this discussion.

Prior to the amendment to New York's tax law, taxpayers were quite successful in avoiding the imposition of use tax and in more than a few instances the authorities were amenable to resolve the use tax assessment favorably for the taxpayer. For example, in situations in which taxpayers were assessed use tax based on information provided by the United States Customs and Border Patrol indicating that the taxpayer had imported personal property to New York from abroad, the taxpayer would argue that the art was purchased from a dealer outside New York and subsequently lent (under a no consideration arrangement) into New York. On numerous occasions, the tax authorities would cancel the assessment.[3]

In an effort to target this activity, New York State expanded the reach of its use tax to apply to nonresident investment entities (such as a Delaware or non-U.S. investment company holding art), whereas such entities were previously exempt.

As addressed in this discussion, there are tax efficient structures that can still be implemented by nonresident aliens to avail themselves of New York's use tax nonresident

[3] In TSB-A-08(7)S, the State of New York Commissioner of Taxation and Finance concluded that New York sales and use taxes were not owed for art purchased from dealers located within or outside of New York by a nonresident and subsequently lent into New York for display. The Commissioner reasoned that: (a) the art's purchase outside of New York was not subject to the sales tax because the sales tax is a destination tax; and (b) since the purchaser was a nonresident at the time of the art's purchase, § 1118(2) indicates that it has no use tax liability.

exemption, provided certain requirements are satisfied. In this context, the nonresident alien must take into account: (i) local tax issues; (ii) U.S. estate tax (as the art collection would be located in the United States) and (iii) New York and U.S. Federal income tax considerations.

II. New York Sales and Use Tax

New York, like many U.S. states levies a tax on the gross amount paid for tangible personal property. The rate of tax varies by locality, reaching a maximum of 8.875 per cent for New York City. The sales tax is collected by persons who sell tangible personal property within the state in which it is located. The use tax is its backstop, reaching transactions that were not subject to sales on account of the seller's delivery of the property to a different state. The use tax, unlike the sales tax, is remitted by the property owner once they use the property in their state of residence.

"In defining what constitutes residency for New York use tax purposes, it appears that the statute has missed the mark. The challenge with reaching transactions that should be taxable but are not, on account of structuring, is defining the tax's reach with precision. Aim too low, and some purchases that don't pass the test get a free pass; aim too high, and other purchases that don't deserve to be taxed get caught."[4]

In defining who is treated as a resident with regards to individuals, anyone who maintains a "permanent place of abode" in-state is classified as a resident for this tax, even if this abode is only an infrequently visited pied-à-terre.

[4] Jason Kleiman, "A Whole New Ball Game" at www.STEP.ORG/JOURNAL | August/September 2017, P. 51.

New York State has long maintained that any company "doing business" in-state is a resident. Although it might be clear where operating companies do business, this is rather unclear with respect to holding companies. The State has long argued for a low threshold, reasoning that companies, by their very nature, are always engaged in business, and therefore, should be treated as doing business in New York even if their only local activity is the passive holding of art. Taxpayers have long argued for the contrary, reasoning that holding companies are passive by nature and, therefore, should not be treated as engaged in business anywhere. Hence, the New York State use tax did not apply to the use of property in New York if the user was not a New York "resident" as defined in the New York sales tax regulations at the time the user purchased such property. This exemption was known as the "nonresident exemption".

Taxpayers have succeeded with their preferred interpretation, winning major court victories. Court rulings have determined that holding companies do not do business anywhere and such findings have limited the taxability of art portfolios held by investment entities. Not surprisingly the State would eventually use its legislative authority to address this situation.

III. Amendment to the New York Use Tax Nonresident Exemption

Effective April 10, 2017, the nonresident exemption no longer applies to the use within New York of property purchased outside of New York by a nonresident *that is not an individual*, unless such nonresident entity has been doing business outside of New York for at least six (6) months prior to the date such nonresident brought such property into New York. The use tax statute does not define "doing business", and a passive investment is generally insufficient for a finding of doing business. Therefore, generally speaking, investment entities no longer qualify for the nonresident exemption.

The applicable New York use tax statute provides:

Tax Law § 1118. Exemptions from use tax.

> The following uses of property and services shall not be subject to the compensating use tax imposed under this article:
>
> * * *
>
> *(2)(a) In respect to the use of property or services purchased by the user while a nonresident of this state, except in the case of tangible personal property or services which the user, in the performance of a contract, incorporates into real property located in the state. A person while engaged in any manner in carrying on in this state any employment, trade, business or profession, shall not be deemed a nonresident with respect to the use in this state of property or services in such employment, trade, business or profession.*

Effective April 10, 2017, the following language was added by Part CC of Chapter 59 of the laws of 2017.

> *(b)Notwithstanding any provision of this article to the contrary, the exclusion in paragraph (a) of this subdivision shall not apply to the use within the state of property or a service purchased outside this state by a nonresident that is not an individual, unless such nonresident has been doing business outside the state* ***for at least six months*** *prior to the date such nonresident brought such property or service into this state."*

On August 14, 2017, the New York State Department of Taxation and Finance issued Technical Memorandum TSB-M-17(4)S, providing additional guidance on the legislative change. The relevant portion of that memorandum states:

> ***Amendment regarding the use tax exclusion for purchases by nonresident businesses*** *With certain Exemptions, Tax Law § 1118(2) provides an exclusion*

from the imposition of use tax for the use of property and services purchased by the user while a nonresident of New York State. Part CC amended Tax Law § 1118(2) to narrow the exclusion from use tax for purchases made by nonresident business entities. As a result of the amendment, use tax is now imposed when a nonresident business brings tangible personal property or a taxable service into New York State for use here ***unless*** *the nonresident business has been doing business outside of New York for* ***at least*** *six months prior to the date that the property or service is brought into New York State.*

Doing business means that the business is actively engaged in normal operating activities, such as hiring employees, having a payroll, and making routine purchases and sales. Merely being organized as a legal entity is ***not*** *a sufficient* indication of doing business absent other normal operating activities.

Example 2: *X Corporation was formed in Delaware on January 15, 2017. X Corporation is a nonresident of New York State. X Corporation remained dormant until March 17, 2017 when it hired employees and purchased a number of computer servers for use in its business. On June 24, 2017, X Corporation opened an office in New York State and brought some of the servers to New York for use here. Because X Corporation had been doing business outside New York for* ***less*** *than six months prior to bringing the servers into New York (i.e., March 17 - June 24), X Corporation owes use tax on the servers.*

Example 3: *Same facts as in Example 2, except that X Corporation does not open its New York office and bring some of the servers to New York until October 4, 2017. Since X Corporation had been doing business outside New York for* ***at least*** *six months prior to bringing the servers into New York (March 17 - October 3), the exclusion from use tax provided in Tax Law § 1118(2) applies and X Corporation does not owe use tax on the servers.*

Example 4: *XYZ Corporation is a resident of New York. On May 1, 2017, XYZ Corporation forms PQR, Inc., a Delaware corporation wholly owned by XYZ Corporation. On June 1, 2017, PQR, Inc., purchases a large sculpture for installation in the lobby of XYZ Corporation's New York City offices. PQR, Inc., conducts no other business activity, and has no employees or offices. On February 1, 2018, PQR, Inc., brings the sculpture into New York and delivers*

> *it to the installation site. Even though PQR, Inc., was in existence for more than six months when it brought the sculpture into New York (May 1, 2017 - February 1, 2018), PQR, Inc., was never doing business as required by the statute. Therefore, PQR, Inc., will owe use tax on the sculpture when it is brought into New York.*

This new restriction on the New York use tax exclusion does not apply to individuals. Given that non-resident aliens would be exposed to U.S. federal estate tax if they were to hold art upon their passing, many existing passive holding company structures implemented as a U.S. estate tax blocker would have to be revisited pursuant to the amendment to the "nonresident exemption".

Because investment entities often do not conduct business activities, the foregoing change to the New York Tax Law could have substantial consequences for any investment entity owning personal property, such as art, when such entity brings property into New York. For example, under the former statute if a British Virgin Islands company ("BVI Company"), utilized as an investment holding structure, purchased art outside New York in a state such as Delaware and subsequently brought the art into New York, there would have been an argument that no New York use tax was due because the BVI Company was exempt from use tax. Under current law, however, New York use tax will be owed when the BVI Company brings its art collection into New York for display because the nonresident exemption no longer applies to investment holding structures.

IV. Potential Double Taxation for Art Acquired Outside the U.S. Which Was Previously Subject to "Value Added Tax"

Collectors purchase artworks in countries where a value added tax is imposed on such transactions. A value added tax could be significant in most jurisdictions.

Nonresident aliens who have implemented an investment entity structure to acquire personal property, including an art collection, might be subject to double taxation as a result of the amendment to the nonresident exemption. Prior to April 10, 2017, if such investment entity is incorporated in a jurisdiction which imposes value added tax on the purchase of the property and subsequently the personal property was transferred to New York to be displayed, the transaction would be covered and exempt from New York use tax. After the amendment to the New York tax law, the art purchase by a non-U.S. investment entity which already paid value added tax at the time of the acquisition would be subject to New York use tax if the art is subsequently shipped to New York.

However, if the ultimate beneficial owner of the non-U.S. investment entity structure were to purchase the art collection in her/his individual name, no New York use tax would be due as this is not imposed on individuals. As illustrated above, the amendment to the New York use tax presents an inconsistency in the treatment of property purchased outside the United States. To avoid possible double taxation, ownership structures of property bought outside the United States should be carefully evaluated before re-locating personal property into New York. The structure under consideration should also contemplate the potential exposure to U.S. estate tax for the nonresident alien who is planning to bring the art into New York for display.

Thus, a potential structure to bring art owned by a nonresident alien into New York must satisfy the following two-fold purpose: (i) act as a blocker for U.S. estate tax purposes; and (ii) satisfy the "doing business" threshold imposed by the new use tax law *without* inadvertently creating a U.S. trade or business and net income taxation on "effectively connected income" generated by the nonresident alien investment company.

V. <u>Structuring Alternatives</u>

Per the statutory change made effective in April of 2017, an entity now qualifies for the nonresident exemption only if it has been engaged in business outside of New York for six (6) or more months before bringing property into the State.[5] As a result, individuals can no longer structure around the State's use tax by purchasing goods through a nonresident holding company.

For nonresident aliens the foregoing poses a challenge on how to structure the ownership of an art collection. On many occasions, nonresident alien art collectors might have bought their portfolio in their individual name for enjoyment in their home country where an estate or death tax might not be an issue and thus, owning art in the individual's name is not inefficient. The issue arises when the nonresident alien purchases a home in places like New York and wishes to display the collection in the State. In such a scenario, the artworks cannot be owned directly as these would be subject to U.S. estate tax if the nonresident alien were to pass while holding the art collection. To benefit from the amended "nonresident exemption," the art should be owned by an entity that is "doing business" for at least six (6) months before it is brought to New York.

[5] New York Tax Law § 1118(2)(b).

In choosing the right type of entity to *do business* and satisfy the foregoing requirements, a nonresident alien must consider the following factors: (i) local tax considerations; (ii) protection from U.S. estate tax; and (iii) undertaking of an active business *outside* the United States to avoid the likelihood that the entity would be treated as carrying on a trade or business in the U.S. or the creation of a permanent establishment and the risk that income could be subject to U.S. income taxation if this is treated as "effectively connected income".

A. <u>Use of a Foreign Corporation</u>

A non-U.S. corporation could be a desirable vehicle that would protect the nonresident alien from the imposition of U.S. estate tax (the shares of the non-U.S. corporation are not a U.S. situs asset for U.S. estate tax purposes). However, if the property (*i.e.*, art collection) is held individually by the nonresident alien and the relevant jurisdiction of the taxpayer treats the contribution of the art portfolio into a corporation as a taxable transfer, and the property has increased in value (which often is the case), the contribution into a non-U.S. corporation would trigger taxable gain which would be an undesired tax result.

If, however, there has not been much appreciation of the art collection, the use of a non-U.S. corporation could be a viable alternative. This type of transaction should be carefully evaluated with local tax counsel to ensure that it is tax efficient. Local counsel should also be consulted about the manner in which the transfer should be effected (*i.e.*, contribution, sale, etc.).

B. Use of a Trust

An inadvertent consequence of this statutory amendment is that personal property purchased by a trust appears to become subject to tax when the property is moved into the State, because the trust is unlikely to be characterized as ever having engaged in business outside of New York.[6]

"Because the use tax amendment is silent with respect to trusts, Trustees will need confirmation that, notwithstanding the statutory change, New York use tax will not be imposed on a trust due to its beneficiaries' use of trust-owned personal property (*i.e.*, art) in New York. Technical Memorandum TSB-M-17(4)S issued by the Department of Taxation and Finance references to "business entities" when discussing the nonresident exemption for use tax. The term "business entities" arguably includes companies but not trusts. Accordingly, careful consideration should be given to utilizing a trust structure for a nonresident alien who wishes to display her/his art collection in New York without incurring use tax. Without clear guidance on this point, it would be preferable to discard a trust structure as the vehicle to own art that subsequently is displayed in New York without being subject to use tax."[7]

C. Use of a Hybrid Structure

A third alternative could be the use of a reverse hybrid entity whereby this is treated as a

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[6] Business undertaken by trust subsidiaries is not counted for this purposes. See, Jason Kleinman, "New Legislation Sends Mixed Messages on Trusts' New York Use Tax Liability". P.2.

[7] Id.

transparent vehicle for local law purposes and as a corporation for U.S. income and estate tax purposes. Such a structure can function very efficiently (as described below, *see*, Section VI, *infra*) assuming that its tax transparent status is respected in the jurisdiction of the nonresident alien (to avoid taxation on potential gain arising from the transfer by the individual of the art collection to the investment entity).

VI. **Potential Structure**

High net worth nonresident individuals who own real estate in New York and would like to display their art collection in the State[8], generally have sister structures whereby one of the structures holds the real estate through a non-U.S. blocker corporation to eliminate exposure to U.S. estate tax, and the art collection is held through a parallel non-U.S. blocker structure owned by the same ultimate beneficial owner. Typically, New York real estate is *solely* for the nonresident alien's personal use during a few weeks during the year and the nonresident alien does not intend to become a U.S. resident by either applying for a green card or satisfying the substantial presence test.

As a result of the amendment to the New York nonresident exemption for use tax, existing structures must be revisited or on occasion, a new tier of entities must be formed to satisfy the thresholds discussed above. In addition, local law requirements must also be considered given that the transfer of the art individually owned by a nonresident alien into an entity could trigger income and transfer taxes.

8 The collection's value is usually quite significant.

To achieve the desired tax consequences from a local law perspective (*i.e.*, the jurisdiction of the nonresident alien) and from a U.S. income and estate tax standpoint, the use of an entity that is transparent in the local jurisdiction, and which can function as a blocker corporation for U.S. estate tax purposes, would be the recommended avenue for displaying art in New York and eliminating the likelihood that New York use tax be imposed as follows.

Ontario and Manitoba limited partnerships ("Canadian LP") are considered by some jurisdictions as tax transparent and therefore, according to the tax laws of such countries, the tax consequences flow to the owners of the Canadian LP. Provided that *all* of the following requirements are satisfied, the Canadian LP will be treated as tax transparent (*i.e.*, conduit/pass through) and distributions made, and capital gains derived, by the Canadian LP *would not be* subject to Canadian income tax:

- *All* the limited partners are *non-Canadian* residents/taxpayers

- The general partner(s) is *non-Canadian* (Canada is tax neutral as to the jurisdiction of residency of the general partner)

- The Canadian LP *does not* carry on operations (*i.e.*, trade or business) in Canada (an agent for service of process does not account to carrying on a trade or business); and

- The Canadian LP does not own Canadian real estate (certain investments in REITs may be permitted)

Non-resident limited partners and the general partner of a Canadian LP that is treated as transparent *will not* be subject to Canadian income tax on their distributive share of income or capital gain (whether arising from the disposition of an underlying investment or from the sale of the Canadian LP).[9]

If the foregoing is satisfied, no Canadian filing/reporting requirements are imposed on the Canadian LP, the limited partners or the general partner.

There are no Canadian succession duties or estate taxes imposed on nonresident limited partners or the general partner (if this is an individual).

The general partner of the Canadian LP generally would be a company organized in Bermuda or the British Virgin Islands and would own a *de minimis* interest therein. The nonresident alien individual(s) will be the limited partner(s) and will hold a majority interest in the Canadian LP.

The Canadian LP will make a check-the-box election to be treated as a corporation *solely* for U.S. tax purposes (it will remain a transparent/flow through entity for Canadian and local tax purposes (*i.e.*, the jurisdiction of the nonresident alien individual)). By checking the box, the Canadian LP will function as a U.S. estate tax blocker with respect to investments in the U.S. should the limited partners be individuals.

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[9] Canadian tax commentators are of the view that Canada does not have a force of attraction rule. Hence, to the extent that a Canadian Limited Partnership is treated as transparent, other activities that the general partner and/or limited partners might be conducting separately in Canada, will not be attributed to the Canadian LP.

Once the Canadian LP has been formed and the check-the-box election has been made, the art collection will be transferred thereto. Because the Canadian LP should be transparent in the nonresident alien's jurisdiction, the contribution by the latter to the former should be disregarded and no taxation should be accorded to the transaction. Generally, the nonresident alien's transfer of the artwork to the Canadian LP would be treated as a capital contribution (but local tax counsel must be consulted). The transfer should be effected *outside* the United States. The Canadian LP will obtain title to the collection of artwork through a contribution agreement together with other formalities required under local law that affect the contribution.

To ensure that for federal tax purposes there is no effectively connected income in the United States, the Canadian LP will create an entity that will be disregarded as a separate entity for U.S. federal income tax purposes ("DRE"). DRE could either be a Delaware limited liability company or a non-U.S. entity classified as a disregarded entity for U.S. federal tax purposes. The Canadian LP will lend the artwork to the DRE for no consideration; that is the shipping, insurance, packing security and monitoring services and other expenses will be paid by the Canadian LP to avoid issues of transfer pricing or attribution of income. It is also important that the loan be for a limited time period (subject to potential renewals).[10]

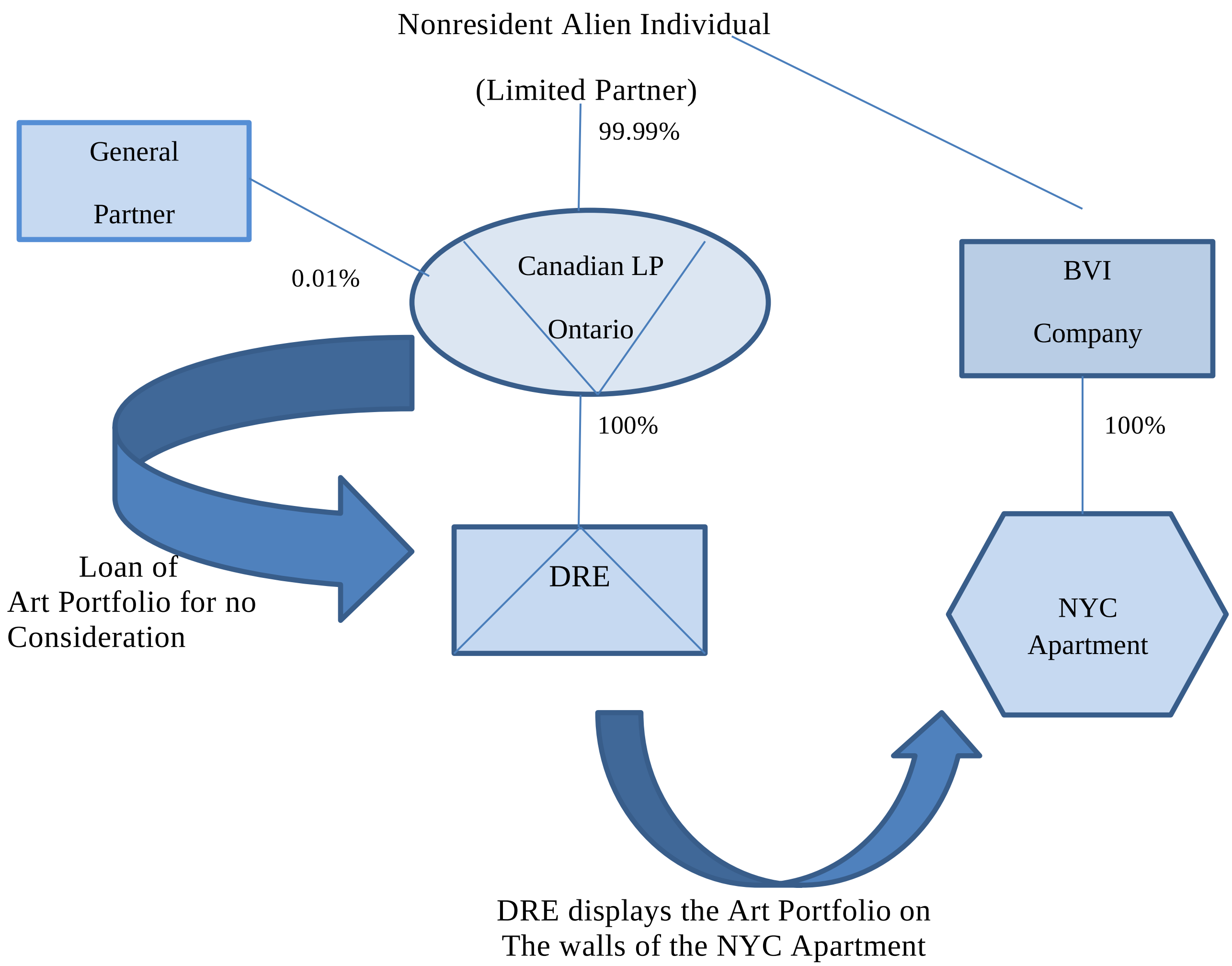
To satisfy the "doing business" requirement set forth in the new nonresident exemption for use tax, the DRE will have at least one employee who will be located *outside the United*

[10] The foregoing to avoid the loan being treated as perpetual which is not positively viewed by the New York taxing authorities.

Sates and will receive a salary and benefits from the DRE as required under local law.[11] The employee ideally should have an art background or degree and will be dedicated to the purchase and sale of pieces (even if these are of moderate value as compared to the overall value of the collection) with a view toward making a profit from sales to customers and due to future appreciation. All the activities related to purchases and sales of such artwork will be performed outside of the U.S. To avoid creating a U.S. trade or business (as addressed below), while dealing with potential customers, the DRE must not display the art in the United States and will not carry on any activities relating to the purchase or sale of such artwork in the United Sates. It is critical that the artwork owned by the Canadian LP be characterized and recorded on its books either: (i) as inventory which relates to art acquisitions that must be kept *outside the U.S.*; or (ii) investment property which will refer to art pieces that are on loan to the DRE for display in New York.

At least six (6) months after the artwork is loaned to DRE and the employee has been hired and engaged in the above described activities, the artwork would be brought into New York and will be displayed at the apartment ultimately owned by the nonresident alien (who is the limited partner of the Canadian LP).

[11] Because the DRE is transparent, the employee is deemed as hired/compensated by the Canadian LP.



VII. <u>New York State Tax Considerations</u>

The sales tax applies to taxable tangible personal property delivered in New York[12] and the use tax applies to taxable items delivered elsewhere and used in New York.[13] Prior to the amendment of 2017, an entity that did not have nexus to New York could bring tangible personal property into the State without incurring a use tax liability. Nonresident aliens typically would utilize a non-U.S. corporation to hold their art portfolio and also function as a

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[12] Tax Law § 1105.
[13] Tax Law § 1110.

U.S. estate tax blocker. In the past, the non-U.S. entity would display the artworks in New York and take advantage of the nonresident exemption as drafted before the 2017 modification.

The amendment enacted in 2017 requires that a nonresident entity[14] do business *outside* of the State for at least six (6) months prior to the date such nonresident brought such property or service into the State".[15] TSB-M-17(4)S (the "TSB") appears to add an additional threshold by stating that "doing business" means that "the business is actively engaged in normal operating activities". The TSB, unfortunately, does not include clarification on the extent of this *active business* requirement.

The lack of comprehensive guidance requires us to rely on the plain language of the statute in complying with the "doing business" threshold. Such language, as drafted, "is the clearest indicator of legislative intent and courts should construe unambiguous language to give effect to its plain meaning."[16]

As interpreted by the courts, such language "must be read in [its] context, and words, phrases, and sentences of a statutory section should be interpreted with reference to the scheme of the entire section."[17]

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[14] The amendment does not apply to individuals.

[15] Tax Law § 1118(2)(b).

[16] *Matter of DaimlerChrysler Corp. v Spitzer*, 7 NY3d 653, 660 (2006). *See also, New York Yankees Partnership v. O'Cleireacain,* 83 NY2d 550 (1994); *Patrolmen 's Benevolent Assn. of City of New York v. City of New York,* 41 NY2d 205 (1976).

[17] McKinney's Cons Laws of NY, Book 1, Statutes § 97.

The Court of Appeals also has reiterated that deference to an administrative body's reading of a statute is not required where the question is one of pure statutory reading and analysis.[18] "When construing a statute, we seek to discern and give effect to the Legislature's intent, and the starting point for accomplishing this is the statute's language."[19]

Based on the plain language of the New York statute and interpreting rulings issued by the courts, hiring a qualified employee (by the DRE) to purchase and sell art for profit and who is entrusted with caring for the collection should satisfy the doing business exemption to the 2017 nonresident use tax. However, the "actively engaged requirement" set forth by the TSB is a question of "facts and circumstances" for which a clear threshold has not been established and where the only authority available relates to case law settled before the 2017 amendment. The relevant case law sets out a low threshold that must be satisfied in order to meet the "actively engaged" test.

In *Matter of Sunshine Developers, Inc.*[20], ("Sunshine") the petitioner, a New Jersey resident who maintained a rented apartment in New York, was the president of Sunshine, a closely held corporation owned entirely by his brother and his nephew. The company had no employees, no activities in New York and merely held title to vessels that were used by the corporate shareholders and officers for personal entertainment and pleasure. Respondent, New York State Department of Taxation and Finance, assessed a compensating use tax against

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18 *Roberts v. Tishman Speyer Props.*, 13 NY3d 270, 286 (2009).

19 *(Carney v. Philippone,* 1 NY3d 333, 339 [2004] and *(Matter of DaimlerChrysler Corp. v. Spitzer*, 7 NY3d 653,660 [2006]." *Roberts*, supra, 286.

20 New York State Tax Appeals Tribunal Decision, May 2, 1991.

petitioner for two cabin cruisers purchased by the corporation outside of New York and allegedly used by him on his individual business in State waters. Although owning no stock in Sunshine, petitioner asserted control over the corporation and his responsibility for the tax was upheld by disregarding the separate corporate entity under the doctrine of piercing the corporate veil. Because of his leasing of a New York apartment, it has been held that petitioner, although a New Jersey resident, could not claim the nonresident's exemption from the use tax.[21] On appeal, the decisive question was whether the Tax Appeals Tribunal and Appellate Division properly sustained the assessment against petitioner on the theory of piercing the corporate veil.

The Tribunal did "pierce the corporate veil" and found the officer of the corporation liable for use tax because he maintained a permanent place of abode in New York. Respondents sought to collect the tax directly from petitioner because, unlike Sunshine, he maintained a rental apartment in New York and asserted was deprived of his nonresident exemption. But, to pursue petitioner under the doctrine of piercing the corporate veil presupposes that "the corporation is liable".[22] The Court of Appeals found that holding petitioner liable by piercing the corporate veil for a debt Sunshine did not owe would be inconsistent with the essential theory of the doctrine.

The Court of Appeals was not persuaded by respondents' argument that the corporate entity should be disregarded under the theory articulated in federal tax cases relating to piercing the corporate veil.[23] In general, in matters relating to revenue, a corporation will be recognized as

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21 see, Tax Law § 1118 [2].

22 " (1 Fletcher Cyc Corp, § 41, at 603 [Perm Ed]; see, e.g., *National Labor Relations Board v Greater Kansas City Roofing*, __ F2d __ [10th Cir 1993], LEXIS No 20690, at 10; *Transamerica Cash Reserve, Inc. v Dixie Power and Water Inc.*, 789 P2d 24, 26 [Utah]; *Anderson v Durbin and Renovations, Inc.*, 740 SW2d 417, 418 [Tenn]).

23 see, e.g., *Moline Properties, Inc. v Commissioner of Internal Revenue*, 319 US 436, 438-439; *Nelson v Commissioner of Internal Revenue*, 281 F2d 1, 6-7 [5th Cir 1960]; *Jackson v Commissioner of Internal Revenue*, 233 F2d 289, 290 [2d Cir 1956]; *Paymer v Commissioner of Internal Revenue*, 150 F2d 334 [2d Cir 1945]

having a separate taxable identity unless it is shown to have had no legitimate business purpose either in its formation or its subsequent existence or that it was a sham or set up for tax avoidance purposes (see, *Moline*, at 438-439; *Nelson*, at 6). Notwithstanding that this is an analysis of New York state rules relating to sales and use tax, the findings in federal cases would be the same, as it appears that Sunshine had a legitimate business purpose in its formation and was engaged in the business of owning and chartering boats. There is no showing that it was set up as a sham or for the purpose of tax avoidance.

The Court of Appeals concluded that the corporation was not a New York resident as it did not carry a business in the State and hence was exempted from use tax with respect to the use of the boats by its officers in this State.[24]

Similarly, in *Matter* of *Rochester Amphibian Airways, Inc.*[25], a corporation owned two aircraft purchased outside New York and stored in New York for a period of five months. The tax department asserted use tax on the aircraft based upon two theories. First, that the corporation by virtue of the presence of the aircraft in New York was doing business in the State. The Tribunal rejected that claim stating that "mere ownership and maintenance of the P-51 Mustang, purchased in another state, did not constitute doing or carrying on a business in New York." The Second argument raised by the tax department suggested that the

[24] The Tribunal stated that the tax department, "argues that so long as the corporation's activities are in accord with its stated purpose, it may be deemed to be carrying on a business. Under this interpretation, a corporation could never qualify for the exemption. We reject this interpretation because it wholly ignores the statutory scheme for establishing entitlement to the nonresident exemption. Section 1118(2) explicitly conditions such entitlement on, *inter alia*, a factual determination of whether the taxpayer was engaged in carrying on a business not on whether the taxpayer was a corporation."

[25] New York State Tax Appeals Tribunal Decision, August 6, 2009.

corporate veil be lifted. This second proposition was rejected by the Tribunal by ruling that the tax department had failed in showing any evidence of wrongdoing, fraud or tax abuse.

The New York Court of Appeals has set a very high standard for piercing the corporate veil in the context of sales and use tax.[26] Both *Sunshine* and *Rochester Amphibian Airways* demonstrate that the standard for "doing business" is a relatively easy to satisfy and, unless the corporation is a sham, or is engaged in fraud or wrong doing, the courts will respect the corporate existence as a standalone entity.

Based on the Courts' findings in *Sunshine* and *Rochester Amphibian Airways*, a foreign entity, such as DRE, should be treated as a separate entity as long as it has a legitimate business purpose. In both *Sunshine* and *Rochester Amphibian Airways*, the corporations were found not to be doing business in New York, but had been organized in corporate form under the laws of a state other than New York, had statutory offices outside New York and satisfied all corporate formalities to be treated as separate entities. Accordingly, the courts in their rulings found that the corporations were nonresidents so that their later use of the personal property in New York was not subject to use tax.

DRE's art related business, the hiring of an employee(s), and adequate booking of the relevant inventory and investment property acquired by the entity should be characterized as sufficiently active. The more frequent the purchases and sales of art, the better to substantiate the existence of an active business. If the nonresident entity (*i.e.*, the Canadian LP) also

[26] *Matter of Joseph Morris v. NY State Department of Taxation and Finance*, 82 N.Y.2d 135.

undertakes additional activities, the better. However, this might be unusual as different lines of business generally are kept separate and art collections are typically segregated from other personal property.

To avail from the new nonresident exemption the foregoing activities must be performed during a six (6) month period before the art portfolio can be displayed in New York and in order to avoid creating a U.S. trade or business (as addressed in the next section), the art business must be undertaken *outside* the United States.

Even though there is no authority on point on whether a closely held entity that merely holds and loans out artwork is treated as an active business, as long as: (i) purchases and sells of artwork are undertaken on a regular basis for profit and such artwork purchases and sales are managed by an employee who has some knowledge of the art market; (ii) these buy/sell activities take place *outside* the United States (and hence outside of New York); (iii) the art pieces which are displayed in New York are recorded as investment property[27]; and (iv) the business activities are performed for at least six (6) months before the artwork is brought into New York, the relevant entity should be treated as nonresident and no use tax should be due.[28]

Another issue involving the New York sales and use tax is whether the loan of the

27 The artworks *not displayed* in New York will be booked as inventory.

28 Prior to the April 2017 amendment, the sole issue was the entity's corporate existence and ownership before property was brought into New York. The statute added a requirement that the entity be "doing business outside the state for at least six months prior to the date such nonresident brought such property or service into this state." The TSB issued for additional guidance requires the entity to engage in some activities such as having an employee and making purchases or sales.

artwork by the Canadian LP to DRE would be a taxable event. A loan constitutes a sale under Tax Law § 1101(b)(5) if it is supported *by consideration*. A rental or license to use artwork was supported by consideration when the borrower pays expenses such as transportation or insurance.[29] In a situation where an art dealer made a loan to a New York museum, the Department stated, "[s]ince there is no consideration provided by the [borrower] to Petitioner for the use and display of the artwork . . . there is no sale as defined in Tax Law § 1101 (b)(5).[30] To the extent that the Canadian LP pays all expenses for monitoring, security, packing, shipping and insuring the artwork and not DRE, the loan should not be supported by consideration and therefore should not be subject to New York sales and use tax.

DRE, as borrower, is entitled to display the art at the location of its choice (*i.e.*, the New York apartment indirectly owned by the nonresident alien individual who also is the limited partner of the Canadian LP). Because the art collection has been sufficiently insured the location of its display is irrelevant.

VIII. U.S. Federal Income Tax Considerations – U.S. Trade or Business

The amended New York use tax "nonresident exemption" requires that the entity owning the art collection be "doing business" for at least for six (6) months before the property is moved to New York. It is critical that the "doing business" threshold required by the State statute *does not* run afoul the Federal "U.S. trade or business" rules.

[29] TSB-A-16(17)(S).
[30] TSB-A-08(7)S.

To satisfy the State "doing business" test, the Canadian LP will hire and compensate an employee with an art degree or expertise in this field. The employee will visit art exhibits and will place and accept offers to buy and sell art *outside* the United States. The art that is for resale and constitutes inventory will be kept outside the United States and will be reported as such on the books of the Canadian LP. The art that will be displayed on the walls of the New York City apartment will be recorded as an investment of the Canadian LP.

To avoid being subject to U.S. income tax on a net basis, the Canadian LP holding the art should not be deemed as having a trade or business in the United States by virtue of the activities undertaken to satisfy the New York State threshold.

In general, absent application of a U.S. income tax treaty, a foreign corporation that is engaged in a trade or business within the United during the taxable year is subject to U.S. federal income tax on its net income that is "effectively connected" with such trade or business ("effectively connected income" or "ECI").[31] Accordingly, in order to determine whether a foreign corporation's income constitutes ECI, it is first necessary to determine whether such corporation is engaged in a trade or business within the United States.

With a few notable exemptions, the term "trade or business within the United States" is not defined in either the Code or Treasury Regulations but must be determined based on all of the facts and circumstances.[32] The focus is both on the <u>person</u> conducting the activity and the <u>activity</u> itself. To be treated as having a trade or business, a foreign person must be *actively* involved in a

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[31] Code § 882(a). *See also* Treas. Reg. § 1.864-2; Treas. Reg. § 1.864-4.

[32] Code § 882(a)(1). <u>See also</u>, Rev. Rul. 88-3, 1988-1 C.B. 268.

profit-oriented activity in the United States.[33] A taxpayer generally is characterized as engaged in a U.S. trade or business where its business contacts with the United States are "considerable, continuous and regular."

Courts generally hold that a U.S. trade or business exists if a foreign corporation has business contacts with the United States that are "considerable, continuous and regular." Pinchot v. Commissioner;[34] Jan Casimir Lewenhaupt;[35] Inez de Amodio;[36] and FSA 1998-217 (January 17, 1992). Generally, this requires either that (i) the foreign corporation maintain a U.S. office; (ii) the foreign corporation conducts business through dependent agents who maintain an office in the United States or (iii) the performance of personal services within the United States at any time within the taxable year.[37]

In United States v. Northumberland Ins. Co., Ltd.,[38] the Court found that a foreign corporation had a U.S. trade or business resulting from the undertaking of the following activities: (i) it occupied office space in the U.S.; (ii) hired agents and employees; and (iii) maintained assets and bank accounts in the United States.

In Handfield v. Comm'r,[39] a manufacturer of greeting cards consigned inventory to a U.S. agent to sell to customers; in addition to selling cards, the agent stocked shelves, collected funds

[33] See Snell v. Comm'r, 97 F.2d 891, 892 (5th Cir. 1938) ("The word ['business'], notwithstanding disguise in spelling and pronunciation, means busyness; it implies that one is kept more or less busy, that the activity is an occupation.").
[34] 113 F.2d 718 (2d Cir. 1940).
[35] 20 T.C. 151 (1953).
[36] 34 T.C. 894 (1960).
[37] Code § 864(b).
[38] 521 F. Supp. 70 (D.N.J. 1981).
[39] 23 T.C. 633 (1955)

and returned unsold merchandise to manufacturer. The Court held that the foreign corporation was engaged in a U.S. trade or business.

Conversely, in other situations the level of activity did not give rise to a U.S. trade or business. In Spermacet Whaling & Shipping Co. S/A v. Commissioner,[40] the Tax Court addressed the issue of whether the taxpayer was engaged in a trade or business within the United States by virtue of activities performed by a 40% shareholder in the United States The taxpayer itself entered into contracts to provide management services for whaling boats. The Court held that the "business in which . . . [the taxpayer] was engaged was that of managing the [whaling] expedition" and that the taxpayer's "activities which produced the income in question took place almost entirely on the high seas or in Norway."[41] Additionally, the Court held that the activities that were performed for the taxpayer within the United States were "without substance."[42] The Court stated that “the actions in the United States … were ministerial and clerical in nature, involving very little exercise of discretion or business judgment necessary to the production of the income in question.[43] Finally, "[t]he holding of the directors' meetings in New York City solely for the personal convenience of the directors was of no particular consequence."[44] Accordingly, the court stated that "we are convinced that . . . [the taxpayer] was not engaged in any substantial, regular, or continuous ordinary business activity in the United States."[45]

40 30 T.C. 618 (1958).
41 Id. at 633.
42 Id.
43 Id. at 633-634.
44 Id. at 634.
45 Id. at 634.

In Pasquel v. Comm'r,[46] a joint venture between a U.S. ship builder and a Mexican financier, pursuant to which the ship owner purchased two surplus military landing ships in a single transaction and sold those four months later to a single purchaser was not sufficient to cause the Mexican financier to be engaged in U.S. trade or business.

In the suggested Canadian LP structure and to satisfy the *New York nonresident exemption's "doing business threshold*", at least one employee will be hired to perform recurrent purchases and sales of art (even if these are smaller in value of the overall art collection) and undertake art related functions. Albeit a low threshold, it should provide enough substance to satisfy the "doing business" test incorporated by the 2017 amendment to the New York use tax.

It is important that satisfying the "doing business" State requirement (to be eligible to the nonresident exemption) does not run afoul the Federal U.S. trade or business rules. Therefore, as long as the employee(s) ***does not***: (i) keep an art inventory in the U.S.; (ii) engages in transactions with customers located in the U.S.; and (iii) perform activities in the U.S., the Canadian LP should not be deemed as carrying on a U.S. trade or business and any income generated thereby should not be treated as ECI.

It would be prudent formulating stewardship guidelines for the employee to have a framework on how to record purchases and sales, the permitted jurisdictions where customers have to be located to avoid creating a U.S. trade or business, how to deal with logistic and clerical functions such as temporary warehousing of the art, insurance, transportation, maintenance of

[46] 12 T.C.M. (CCH) 1431 (1953)

books and records and the like. The employee(s) of the Canadian LP should be required to sign the foregoing stewardship guidelines.

The loan arrangement between the Canadian LP and the DRE is a disregarded transaction given that DRE satisfies the requirements to be treated as a "disregarded/transparent" entity and thus the transactions between the foregoing entities are ignored assuming that the DRE is not treated as an alter ego of the Canadian LP by virtue of which the Canadian LP could be viewed as having a permanent establishment or fixed place of business in the United States. The Canadian LP structure anticipates a loan for no consideration and for a limited period (with potential for renewals) between the Canadian LP as lender and the DRE as borrower. The DRE, as borrower, should be allowed to display the artworks at the location of its choice. Such arrangement should not constitute an activity that should be treated as giving rise to a U.S. permanent establishment or trade or business and hence should be ignored for U.S. federal income tax purposes.

IX. Conclusions

Although the 2017 nonresident exemption imposes additional requirements on a holding company owning an art portfolio that contemplates displaying in New York without incurring a New York use tax, it is still possible to implement structures that should be efficient from a State and Federal standpoint.

The 2017 amendment to the nonresident exemption sounds plausible given the perceived abuse from the State tax authorities. However, the policy seems a bit incongruent given that in cases where an individual holds the art collection the use tax does not apply *vis-à-vis* when an entity is the owner the requirements are different.

Nonresident alien individuals must own personal property located in the United States through a foreign blocker corporation to eliminate exposure to U.S. estate tax which is a legitimate and typical manner in which to hold art. After the modification to the New York nonresident exemption for use tax, the requirements to avail from this just became more onerous.