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REPORT BY THE ESTATE AND GIFT TAXATION COMMITTEE

MEMORANDUM IN RESPONSE TO NEW YORK STATE DEPARTMENT OF TAXATION AND FINANCE ADVISORY OPINION TSB-A-15(1)M

This memorandum is offered by the Estate and Gift Taxation Committee of the New York City Bar Association in response to New York State Department of Taxation and Finance (the "Department") Advisory Opinion TSB-A-15(1)M (the "May 2015 Advisory Opinion"). We respectfully request that the Department publish a revised advisory opinion taking into account the following analysis.

I. BACKGROUND

In accordance with New York Tax Law Section 960, a non-New York domiciliary's interest in real and tangible personal property situated in New York is subject to New York State estate tax. In contrast, intangible personal property owned by a non-New York domiciliary is not subject to the New York State estate tax.

In the May 2015 Advisory Opinion, issued on May 29, 2015, the Department concluded that where a single-member limited liability company ("SMLLC") is disregarded for federal tax purposes, the member is deemed to own the underlying property. Accordingly, where the SMLLC (with a non-New York domiciliary member) owns New York real estate, the underlying real estate is subject to New York State estate tax.

More specifically, in the May 2015 Advisory Opinion, the petitioner was a New York domiciliary who was considering forming a SMLLC to which he would contribute his New York condominium. He planned to move subsequently from New York State. The Department relied on federal income tax principles to determine that the SMLLC would be disregarded and the condominium accordingly would be treated as real property subject to the estate tax. In particular, the Department concluded: "[W]here a SMLLC is disregarded for Federal income tax purposes, it is treated as owned by the individual owner and the activities of the SMLLC are treated as activities of the owner. Therefore, under the circumstances described by the Petitioner, interest in the SMLLC…would not be treated for estate tax purposes as an intangible asset."

In a similar prior opinion, TSB-A-08(1)M (the "October 2008 Advisory Opinion"),[1] issued by the Department on October 24, 2008, the petitioner, a non-New York domiciliary, asked whether an interest in either an S corporation or a SMLLC owning New York real property would be includable in her estate for New York State estate tax purposes. There, the Department concluded that, while such an interest in an S corporation — an intangible personal property interest — would not be includable in the gross estate, an interest in a SMLLC would be includable. Notably, the Department also stated that an interest in a SMLLC that has elected to be taxed as a corporation under Section 7701 of the Internal Revenue Code would not be includable.

We respectfully submit that the analysis in the two advisory opinions departs from applicable state and federal precedent and ignores Section 601 of the New York State Limited Liability Company ("LLC") Law.

II. DISCUSSION

Case law instructs that, for determining tax liability, the character of property rights is to be evaluated under applicable state law. Thereafter, based on the state law characterization of the property rights, tax law is to be applied. The federal income tax characterization of an entity thus is not relevant in determining whether an interest in that entity constitutes intangible personal property or instead amounts to an interest in the entity's underlying real or tangible property.

In the May 2015 Advisory Opinion (and the October 2008 Advisory Opinion), however, the Department reversed the proper order of the analysis. Specifically, in determining estate tax liability, it first looked to federal income tax law, rather than applicable state property law, to determine the nature of the taxpayer's interest. We submit that the starting point instead should be an examination of the applicable property law principles, and then the tax law in question should be applied to the property interests.

A. Intangible Personal Property Owned by a Non-New York Domiciliary Is Not Subject to New York State Estate Tax.

New York law provides that, with respect to a non-domiciliary, only real and tangible personal property having a situs in New York is subject to estate tax.[2] Accordingly, a non-domiciliary's interest in intangible personal property is exempt. Indeed, the New York State Constitution states that intangible personal property belonging to a nonresident "shall be deemed to be located at the domicile of the owner for purposes of taxation," including the estate tax.[3] This rule applies even where the entity represented by the intangible personal property interest, in turn, owns real or tangible property situated in New York.[4]

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[1] New York State Tax Reporter (CCH) ¶ 406-279.

[2] N.Y. Tax Law § 960.

[3] N.Y. Const. art. XVI, § 3.

[4] *See In re* Estate of Havemeyer, 217 N.E.2d 26 (N.Y. 1966).

B. The Character of a Property Interest Is Determined by State Law.

It is well settled that "[s]tate law creates legal interests and rights" while the tax laws then "designate what interests or rights, so created, shall be taxed."[5]

Under Section 601 of the New York State LLC Law, "A membership interest in the limited liability company is personal property. A member has no interest in specific property of the limited liability company."[6]

In the 2009 Tax Court case of *Pierre v. Commissioner* ("*Pierre* I"),[7] the court found that gifts and sales of SMLLC membership interests did not constitute transfers of the entity's underlying assets. The court, among other things, relied on Section 601 of the New York State LLC Law and rejected the Internal Revenue Service's argument that Section 7701 of the Internal Revenue Code determines how a donor is to be taxed for federal gift tax purposes. The court explained that the Service's reasoning would be "'manifestly incompatible'" with the Supreme Court's interpretation of Section 7701 and that such a conclusion "would require that Federal law, not State law, apply to define the property rights and interests transferred by a donor."[8]

The starting point, therefore, must be a determination of the party's property rights under state law, irrespective of whether the entity at issue is disregarded for federal tax purposes. Thereafter, the tax law is to be applied to the property interests.

The Department, in other advisory opinions, implicitly has adopted this approach. For example, in a recent advisory opinion[9] regarding sales tax, the Department treated an income tax grantor trust as a separate and distinct entity from the grantor, even though the grantor trust is disregarded for tax purposes.[10] Since the grantor and the trust were different persons, a sale or substitution of tangible personal property, according to the Department, would give rise to sales tax, even though the parties to the transaction are considered the same person for income tax purposes. The Department could have reached that conclusion only after first determining that, for state law purposes, the grantor and a grantor trust are separate parties.

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[5] Morgan v. Commissioner, 309 U.S. 78, 80 (1940); *see also* Commissioner v. Estate of Bosch, 387 U.S. 456 (1967); Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938).

[6] N.Y. LLC Law § 601; *see* Moline Properties v. Commissioner, 319 U.S. 436 (1943), and its progeny, as to whether a corporate arrangement is recognized.

[7] 133 T.C. No. 2 (2009). The Tax Court bifurcated the various issues raised by the petitioner, resulting in a second opinion (commonly referred to as "*Pierre* II") addressing the applicability of the step transaction doctrine.

[8] 133 T.C. No. 2 at 20.

[9] Advisory Opinion TSB-A-14(6)S, New York State Tax Reporter (CCH) ¶ 408-012 (Jan. 29, 2014).

[10] I.R.C. § 671; Rev. Rul. 85-13.

III. CONCLUSION

In issuing the May 2015 Advisory Opinion, the Department did not take into account state property law principles — including Section 601 of the New York State LLC Law — and instead turned to federal tax law to determine the petitioner's property rights, thereby departing from *Pierre* I and well-settled United States Supreme Court precedent.

We respectfully request that the Department publish a revised advisory opinion confirming that an interest in a SMLLC recognized under applicable state law would constitute intangible personal property pursuant to Section 601 of the New York State LLC Law and therefore would not be subject to the New York State estate tax for a non-New York domiciliary.

Committee on Estate and Gift Taxation
Paul A. Ferrara, Chair

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