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New York Tax Insights

Court Holds Shipping Supplies Furnished by UPS Qualify as Exempt Promotional Materials

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By **Irwin M. Slomka**

The Third Department, reversing a decision of the Tax Appeals Tribunal, has held that purchases of shipping supplies by UPS were exempt from sales tax as “promotional materials.” *Matter of United Parcel Serv., Inc. v. Tax Appeals Trib.*, Memorandum and Judgment, No. 512224, 2012 WL3481291 (App. Div., 3d Dep’t, Aug. 16, 2012).

United Parcel Service (“UPS”) is a common carrier that transports property for customers. At issue were its purchases of shipping supplies — principally, shipping envelopes, packaging and boxes, shipping labels, and shipping stickers — which it furnished to its customers free of charge. UPS paid sales tax on the shipping supplies, and then sought approximately \$2.7 million in refunds on the purchases on the grounds that they qualified as exempt “promotional materials” under Tax Law § 1115(n)(4). That section provides, in part, that printed “promotional materials,” furnished without charge to actual or prospective customers by common carrier, are exempt from sales tax. “Promotional materials” are defined to include “any advertising literature,

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Shipping Supplies Held Exempt as Promotional Materials

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other related tangible personal property,” and include “free gifts . . . with respect to such advertising literature.” Tax Law § 1101(b)(12).

UPS did not claim that the shipping supplies were themselves “advertising literature,” but rather that they constituted “other related tangible personal property.” The Department argued that the supplies were not promotional in nature, but were used to facilitate UPS’s delivery services, and were in the nature of taxable packaging materials.

Initially, an administrative law judge held in favor of UPS, finding that the shipping supplies were furnished as an inducement for customers to use UPS’s delivery services, particularly its overnight air delivery services, and thus were exempt promotional materials. The Tax Appeals Tribunal reversed, holding that UPS failed to carry its burden of proving that the shipping materials were either “advertising literature” or “related tangible personal property.” The Tribunal rejected the company’s argument that by branding the shipping supplies with UPS’s distinct logo, slogan, and colors, UPS was in effect engaging in advertising or marketing. This appeal followed.

The Appellate Division has now reversed the Tribunal, holding that the shipping supplies were exempt as “related tangible personal property,” concluding that they were distributed for advertising purposes. Employing a commonly used definition of the term “advertisement,” the court found that the shipping supplies qualified as promotional materials under the law “because they were designed and distributed for the purpose of promoting [UPS’s] business and contain[ed] a clear promotional message.”

The court took note of the testimony of two employee witnesses regarding the reasons UPS created and distributed the supplies. UPS had recently entered into the overnight air delivery market and at the time the supplies were purposefully designed to promote awareness of that new business, both to existing customers and to recipients of the shipped goods who may not have been UPS customers. According to the court, the Tribunal’s decision that the materials were merely branded with the taxpayer’s logo and did not constitute a form of solicitation was “so narrow and literal as to defeat the provision’s settled purpose.” The court also ruled in favor of UPS on the alternative grounds that the shipping supplies qualified as exempt promotional

materials under the “free gifts” category, holding that the Tribunal’s decision that there was “distinct mutual consideration” for the supplies was not supported by the record. Therefore, the court concluded that the shipping supplies were exempt promotional materials and that UPS’s interpretation of the exemption provision was “the only reasonable construction” of the statute.

[THE] SHIPPING SUPPLIES QUALIFIED AS PROMOTIONAL MATERIALS UNDER THE LAW “BECAUSE THEY WERE DESIGNED AND DISTRIBUTED FOR THE PURPOSE OF PROMOTING [UPS’S] BUSINESS AND CONTAIN[ED] A CLEAR PROMOTIONAL MESSAGE.”

One judge concurred as to the result, but only on the basis that the supplies were promotional “free gifts.” Another judge dissented, finding that the use of logos, color, and slogans on the packaging materials bore only a “tangential relationship to advertising,” and finding that the materials were not truly “free gifts” because they were only provided to existing customers.

Additional Insights. The court’s decision is significant, if for no other reason than Appellate Division reversals of Tribunal decisions are not commonplace. Such reversals are particularly unusual where, as here, the issue was the taxpayer’s interpretation of, and claimed entitlement to, a tax exemption provision in the law, for which taxpayers bear a heavy burden. The decision is also a reminder that the statutory definition of exempt “promotional materials” is not restricted to materials that are exclusively advertising, but is more broadly defined, and the fact that the printed materials also serve a utilitarian business purpose does not necessarily defeat the exemption.

ALJ Clarifies Method of Calculating Credit Against Use Tax on Use of Boat in New York

By Kara M. Kraman

When a resident purchases tangible personal property outside New York State, and then brings it into the State, use tax is due at the time of first use in the State. The Tax Law provides an exemption from use tax to the extent sales tax was paid on the same property in another state. A recent decision reveals that

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ALJ Limits Credit Against Use Tax Liability

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the method used by the Department for calculating the credit can yield unexpectedly harsh results. *Matter of Philip Cimino*, DTA No. 823748 (N.Y.S. Div. Tax App., July 19, 2012).

In 2003, Philip Cimino, a New York resident, purchased a boat in Florida for \$267,000, on which he paid \$16,000 in Florida sales tax. In 2007, Mr. Cimino moved the boat to Long Island, but did not report or remit any New York use tax on the boat. In 2009, the Department received information from the U.S. Coast Guard that the boat was being moored in New York State waters, and commenced a use tax audit.

When a New York resident's property is used outside of the State for more than six months before its first use in New York, the use tax is based on the current market value of the property at the time of first use in the State, rather than on the original purchase price. Tax Law § 1111(b)(1). The law contains an exemption from New York use tax to the extent that sales tax was paid on the property to another state. Tax Law § 1118(7)(a).

On audit, the Department determined the use tax due on the boat, using National Automobile Dealers Association guidelines to ascertain a fair market value of \$130,000. Applying the combined State and local tax rate of 8.625% to the \$130,000 valuation yielded a use tax, before credit, of \$11,234. In order to calculate the credit for the sales tax Mr. Cimino had already paid to Florida, the Department took the Florida sales tax rate of 6% and multiplied it by the \$130,000 fair market value of the boat at the time it was brought into New York, deriving a \$7,815 credit. After applying the \$7,815 credit against the \$11,234 use tax, the Department assessed additional use tax of \$3,419, plus interest and penalties.

Mr. Cimino first argued that the fair market value used by the Department was too high, but the ALJ found that the taxpayer did not provide any documentation regarding the proper value. Mr. Cimino then argued that the credit formula used by the Department was flawed. He claimed that no use tax was due because he should have been given a full credit for the \$16,020 in sales tax paid to Florida upon purchasing the boat, an amount that was greater than the use tax determined by the Department. According to the ALJ, the taxpayer's position was "without merit." The ALJ held that "[t]here is no provision in the statute or case law that allows the credit to be calculated in the manner suggested by [Mr. Cimino]." The ALJ also upheld the imposition of penalties, noting that nothing in the statute supported Mr. Cimino's belief that there was dollar-for-dollar credit.

Additional Insights. Buyers often assume that if sales tax is paid to another state on the purchase of property, no further use tax is due when the property is brought into New York. The ALJ's decision reveals that this assumption is often incorrect. Curiously, neither the law nor the regulation cited by the ALJ actually sets out the formula used by the auditor to limit the credit, and the result seems harsh inasmuch as the Florida sales tax paid by Mr. Cimino was greater than the New York use tax. The upholding of penalties under these circumstances is particularly surprising, given the lack of guidance provided by the statute or regulations.

Tribunal Reverses ALJ and Finds a Valid Business Purpose as Required by QEZE Statute

By Hollis L. Hyans

The New York State Tax Appeals Tribunal has overturned the decision of an Administrative Law Judge and held that the taxpayer properly claimed Qualified Empire Zone Enterprise ("QEZE") credits, since it established a valid business purpose for restructuring its business other than to obtain tax credits. *Matter of Ward Lumber, Co., Inc.*, DTA Nos. 823209 and 823163 (N.Y.S. Tax App. Trib., July 10, 2012).

Petitioner Ward Lumber conducted a family-owned business that had operated for approximately 120 years. In the late 1990s and early 2000s, it experienced serious financial problems, and incurred large operating losses. Its primary creditor, NBT Bank, N.A. ("NBT"), downgraded its credit rating, and repeatedly suggested shutting down the lumber mill that the business had historically operated. Eventually, the Empire State Development Corporation ("ESDC") and the New York State Energy Research and Development Authority ("NYSERDA") became involved, trying to find ways to allow the business to continue. The owners were encouraged by the ESDC and the NYSERDA to pursue Empire Zone benefits, as well as other grants and credits. The business eventually reorganized as a new entity, reincorporated in Delaware, and received economic development benefits from the ESDC, including a grant and certain Empire Zone benefits. It was able to reduce its losses, convince NBT to extend additional credit, acquire new equipment, and finance upgrades. Over a period of time, Ward Lumber returned to "modest profitability."

Ward Lumber claimed QEZE credits on its New York corporation franchise tax returns and, after an audit, the Department denied

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Tribunal Finds Valid Business Purpose as Required by QEZE Statute

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those credits for the years 2005 and 2006 on the basis that Ward Lumber did not have a valid business purpose.

Availability of QEZE Benefits. Under the QEZE program, qualified businesses receive certain tax credits and exemptions directly linked to job creation. As discussed in last month's *New York Tax Insights*, reporting on the decision in *Dunk & Bright Furniture Co. Inc. and James F. Bright*, DTA Nos. 823026 and 822710 (N.Y.S. Tax App, Trib., June 28, 2012), the possibility of an existing business simply forming a new entity to qualify for such benefits without actually creating any new jobs, a practice known as "shirt changing," had been identified as a potential problem by the Legislature, and the statute was amended in 2002 to provide that an entity "shall not be deemed a new business if it was not formed for a valid business purpose . . . and was formed solely to gain empire zone benefits . . ." Tax Law former § 14(j)(4)(B). A valid business purpose must "alone or in combination constitute the primary motivation for some business activity . . . which . . . changes in a meaningful way, apart from tax effects, the economic position of the taxpayer." Tax Law § 208(9)(o)(1)(D). The Legislature then added an additional requirement that businesses first certified as eligible to receive QEZE benefits prior to August 1, 2002, had to meet the business purpose test to retain those benefits for tax periods beginning on or after January 1, 2005.

In *Dunk & Bright*, the Tax Appeals Tribunal rejected arguments that the taxpayer could prevail by meeting either part of the test, and held that the statute imposes two requirements: the entity must establish that it was formed for valid business purposes, and that it was not formed solely to acquire Empire Zone benefits.

Tribunal Decision. In *Ward Lumber*, the Tribunal adhered to the legal standard it announced in *Dunk & Bright*, requiring the taxpayer to prove both that it was formed for valid business purposes and that it was not formed solely for QEZE benefits. However, unlike the situation in *Dunk & Bright*, where no valid business purpose was found, in *Ward Lumber* the Tribunal concluded that the taxpayer *had* met the test. First, the Tribunal found that the ALJ had erred by "viewing the reorganization in isolation as opposed to part of a larger plan." The ALJ focused only on testimony, and a statement attached to Ward Lumber's tax return, which did indicate that a purpose of the reorganization

was to acquire Empire Zone benefits. However, other parts of the record, disregarded by the ALJ, established that the reorganization was just one component of a larger plan to save the business, which included a grant from the ESDC, a loan from the NYSERDA, and the extension of credit by NBT.

[THE] RESTRUCTURING, WHILE UNDOUBTEDLY RESULTING IN THE ACQUISITION OF QEZE BENEFITS, ALSO ACHIEVED A NUMBER OF OTHER PURPOSES, AND, MOST IMPORTANTLY, PUT THE BUSINESS BACK ON A FIRM FINANCIAL FOOTING AND SAVED A CONSIDERABLE NUMBER OF JOBS, WHICH WAS EXACTLY THE PURPOSE OF THE QEZE PROGRAM.

The Tribunal found that the primary motivation for the reorganization was the acquisition of a credit extension from the bank, and that all the other elements "helped induce the credit extension." The Tribunal also found that the new business was not the same business it had been before: the reorganization resulted in a new entity with a new credit rating, and significant upgrades were made to the business's facilities which allowed it to improve efficiency, enter new markets, and save jobs.

The Tribunal also explicitly noted that, in light of the legislative purpose of the Empire Zones Program to stimulate investment and job creation, and the fact that the result in this case was the creation of a new business that saved a significant number of jobs in the specified region, it found "the position of the Division and the pursuit of this case by its Audit Department to be inappropriate."

Additional Insights: The contrast among the various cases decided by the Tax Appeals Tribunal involving QEZE credits demonstrates the importance of building as complete a factual record as possible, and the critical nature of the underlying facts. Here, the company was able to demonstrate that its restructuring, while undoubtedly resulting in the acquisition of QEZE benefits, also achieved a number of other purposes, and, most importantly, put the business back on a firm financial footing and saved a considerable number of jobs, which was exactly the purpose of the QEZE program. It was critical that the company was able to demonstrate the entire scope of its business restructuring, and the many varied activities that were all ongoing at the same time, as well as their successful conclusion. At times, auditors tend to focus solely on the tax-related motivations, and lose sight of the many other important concerns a business will be trying to manage simultaneously.

Tax Department Begins Posting Pending Advisory Opinion Issues on Its Website

By Irwin M. Slomka

The Department of Taxation and Finance has now begun posting pending Advisory Opinion issues on its [website](#) and is giving the public the opportunity to comment on those issues.

An Advisory Opinion is a written statement setting forth the applicability of the law and regulations to a specified set of facts relating to a New York State tax. An Advisory Opinion is issued at the request of any person, and is binding on the Department only with respect to the requesting party and only based on the facts presented.

We understand that Department officials were made aware of one or more instances where Advisory Opinions were issued based on legal analysis that was not fully developed by the requester and/or facts that were allegedly not presented in a full or accurate manner. In order to minimize this possibility, the Department has begun to post on its web site, by tax type, a listing of the specific issues that are currently the subject of pending Advisory Opinions. The Department will now give the public the opportunity to submit comments on those issues, either through the Department's website or by mail. For each issue, the Department provides a due date for comments to be submitted. The Department states in its website that all comments received by the specified due date will be reviewed and considered in drafting the Advisory Opinion, but that the Department will not be able to respond to individual comments. It is not necessary for public comments to be made on behalf of an identified person or entity.

Additional Insights. The furnishing of Advisory Opinions is a very valuable public service performed, free of charge, by the Department. Notwithstanding the submission of one or two requests that may not have fully and/or accurately presented the facts, it is not readily apparent why the new initiative for comments is necessary. Advisory Opinions are only binding on the Department with respect to the requester and under the precise facts presented. Nonetheless, if this comment period serves to assist the Department in continuing to issue well-reasoned Advisory Opinions, it is a welcome addition to the process.

The Department should consider making the public comments available to the requester to give the requester the opportunity to respond. It is also hoped that the new comment period will

not delay the Department in issuing timely Advisory Opinions, which by regulation must be issued within 90 days (or, at the Department's discretion, 120 days) of the submission of a completed request.

Insights in Brief

Nassau County Judge Rules MTA Payroll Tax Unconstitutional

In a suit brought by Nassau County, Suffolk County, and several municipalities challenging the legality of the Metropolitan Commuter Transportation District Mobility Tax, enacted in 2009, a Nassau County Supreme Court judge has ruled that the tax was enacted in violation of the New York Constitution. *Mangano v. Sheldon Silver, et al.*, Index No. 14444/10 (Sup. Court, Nassau County, Aug. 22, 2012). The judge held that the law was unconstitutional because it was a special law enacted by the New York State Legislature without complying with the "Home Rule" requirements of Article IX of the State Constitution. The MTA has announced that it intends to appeal the decision, and that the tax remains in effect for now.

Yoga Facilities Not Subject to NYC Local Sales Tax

The New York State Department of Taxation and Finance has issued guidance concluding that a facility offering nothing other than yoga instruction is not subject to the New York City local sales tax on receipts from "services by weight control salons, health salons, gymnasiums, Turkish and sauna bath and similar establishments." *Application of State and Local Sales Tax to Facilities that Provide Yoga Instruction*, NYT-G-12(1) (N.Y.S. Dep't of Tax. & Fin., July 24, 2012). The same company operates other facilities that provide both Pilates classes and instructions in yoga, and those facilities were found to qualify as "gymnasiums," since Pilates classes constitute exercise activities. Therefore, the company's charges for all services at those facilities were taxable. However, yoga was determined not to be an exercise activity, because "yoga generally includes...not simply physical exercise, but activities such as meditation, spiritual chanting, breathing techniques, and relaxation skills," and therefore the charges for yoga instruction at the facility that only provided yoga instruction were not subject to tax.

New Procedural Rules for Hotel Room Remarketers

As a part of the 2012-2013 New York State budget, the State Legislature enacted new procedural requirements for hotel room remarketers, which are required to collect and remit sales tax on their sales of hotel occupancy in New York State pursuant to legislation passed in 2010. According to a new TSB-M, the recent changes were enacted to make it easier for room remarketers to

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comply, and include the following provisions: a new method of computing the amount subject to sales tax, based on the price paid by the remarketers for the occupancy relative to the price for other components being sold, which will relieve the room remarketer of the obligation to separately state the rent portion; allowing room remarketers to provide receipts separately stating the sales tax on or before the completion of the occupancy, rather than at the time the sale occurred; and allowing remarketers to report and pay sales tax on the return due for the filing period in which the occupancy ends, rather than on the return due for the period in which they collected the consideration. *2012 Budget Legislation Affecting the*

Sales Tax Obligations of Hotel Room Remarketers, TSB-M-12(8)S (N.Y.S. Dep't of Tax. & Fin., July 26, 2012).

Governor Signs Legislation to Expand Tax Credit for Film and Television Industry

On July 24, 2012, Governor Cuomo signed legislation expanding the availability of tax credits for the film and television industry in New York by increasing the tax credits for post-production expenditures. S. 7244A-2011, A. 10244A-2011. Under the amended law, the Empire State Film Production Credit for post-production work performed in New York increases from 10% to 30% in the New York metropolitan commuter transportation region (New York City and seven surrounding counties), and to 35% elsewhere in the State.

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ABB v. Missouri
Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
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American Power Conversion Corp. v. Rhode Island
Citicorp v. California
Citicorp v. Maryland
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Consolidated Freightways v. California
Container Corp. v. California
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Current, Inc. v. California
Deluxe Corp. v. California
DIRECTV, Inc. v. Indiana
DIRECTV, Inc. v. New Jersey
Dow Chemical Company v. Illinois
Express, Inc. v. New York
Farmer Bros. v. California
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General Motors v. Denver
GMRI, Inc. (Red Lobster, Olive Garden) v. California
GTE v. Kentucky
Hair Club of America v. New York
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R.J. Reynolds Tobacco Co. v. New York
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Science Applications International Corporation
v. Maryland
Scioto Insurance Company v. Oklahoma
Sears, Roebuck and Co. v. New York
Shell Oil Company v. California
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Toys "R" Us-NYTEX, Inc. v. New York
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