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MoFo New York Tax Insights

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Editors' Note:

With this issue, Morrison & Foerster introduces a new monthly publication: **New York Tax Insights**. It will be a companion to our State & Local Tax Group's longstanding publication, **State & Local Tax Insights**, and will, as its title promises, focus on recent decisions, advisory opinions and other developments in New York State and New York City taxation. We hope you find it a useful source of information on the many important tax matters in New York, and we welcome your comments and suggestions for future issues.

ALJ Rejects New York State Attempt to Tax Research and Consulting Services as Information Services in *Nerac*

By Irwin M. Slomka

It is no secret that the New York State Department of Taxation and Finance has become more aggressive in its application of the sales tax on information services. However, in a recent case (in which Morrison & Foerster represented the taxpayer), an Administrative Law Judge rejected the Division's attempt to treat the furnishing of technical research reports as a taxable information service.

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The determination, while not binding precedent, is noteworthy for its application of the "primary function" test, and as an indication of the obstacles that the Division faces in seeking to expand the scope of the tax administratively. *Matter of Nerac, Inc.*, DTA Nos. 822568 & 822651 (N.Y.S. Div. of Tax App., July 15, 2010).

Under Tax Law § 1105(c)(1), sales tax is imposed on:

> [t]he furnishing of information by printed . . . matter . . ., including the services of collecting, compiling or analyzing information . . . and furnishing reports thereof to other persons, but excluding the furnishing of information which is personal or individual in nature and which is not or may not be substantially incorporated into reports furnished to other persons. . . .

Existing regulations provide only limited guidance as to what constitutes an information service (*e.g.*, a weekly newsletter containing commodities prices or the furnishing of a list of potential customers' telephone numbers).

Nerac is a research and advisory firm that provides technical, scientific and engineering research and tracking services to its clients. As part of those services, it furnishes written reports in response to specific client requests for solutions and advice. The reports are prepared by the firm's team of scientists, engineers, and other professional analysts, most of whom have notable professional credentials and advanced educational degrees. Nerac charges clients a flat subscription fee to be able to consult with these analysts, and in most cases the analysts prepare a written research report at no extra charge. The reports are prepared in response to specific client inquiries. In conducting their research, Nerac's analysts have access to more than 100 public and private databases.

The Division assessed sales tax against Nerac, claiming that sales tax should have been collected on the total subscription fees. It argued that Nerac was providing its clients with a taxable information service, or at a minimum was providing them with *some* information services as part of a "bundled transaction" consisting of both taxable and nontaxable services. The Division claimed that since Nerac did not break down the allegedly taxable component of the total charge, the entire "bundled charge" was taxable.

The ALJ in *Nerac* held that the furnishing of the research reports was not a taxable "information service," but rather a nontaxable consulting service. While the reports necessarily contained "information," the ALJ concluded that the "primary function" of the reports was to provide solutions or advice in response to specific client problems and questions. Since this did not merely involve the retrieval, compilation and furnishing of information, it was not an enumerated taxable service under the sales tax:

> To be sure, [Nerac's] clients receive information, in the form of citations to scientific and technical papers, studies and reports derived from the Analyst's research efforts. . . . However, to conclude that the client's receipt of information in this fashion is enough to make [Nerac's] business a taxable information service leaves the Analysts as mere conduits who simply find and funnel raw data or information to the clients. This view ignores the critical role of the Analysts and the value of their expertise, education and experience in the process of resolving clients' problems.

The ALJ also held that even if Nerac was furnishing "information" – which he held it was not – the services would still not be taxable because it qualified for the exclusion for information that is "personal or individual in nature" and not capable of being "substantially incorporated" into the written reports furnished to other clients. The ALJ rejected the Division's contention that the "personal or individual" exclusion did not apply because the information was obtained from "common databases," and therefore was capable of being furnished to more than one client. The ALJ noted that each client inquiry was unique and specific. Moreover, to impose sales tax based on the *possibility* that information furnished in response to one client inquiry might appear in a report furnished in response to another client inquiry would have the effect of completely removing the word "substantially" from Section 1105(c)(1) (which excludes from sales tax information that is not capable of being "*substantially* incorporated" in another client's report).

NERAC CAN BE VIEWED AS A SIGNIFICANT REJECTION OF THE DIVISION'S ATTEMPT TO EXPAND THE DEFINITION OF TAXABLE "INFORMATION SERVICES" TO WHAT ARE ESSENTIALLY CONSULTING SERVICES.

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The Division did not file an exception with the Tribunal, so the ALJ determination is final. *Nerac* can be viewed as a significant rejection of the Division's attempt to expand the definition of taxable "information services" to what are essentially consulting services. The determination takes on added significance in light of the Division's somewhat

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Consulting Services Not Taxable

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controversial recent pronouncement regarding the taxation of information services, released just days after *Nerac* was decided. "Sales and Compensating Use Tax Treatment of Certain Information Services," TSB-M-10(7)S (N.Y.S. Dep't of Taxation & Fin. July 19, 2010).

The holding in *Nerac* may call into question the position taken in the TSB-M that under the "primary function" test, the purpose for which the purchaser seeks the services is irrelevant. Indeed, *Nerac* suggests that it is necessary to look to the function as a whole, and therefore one cannot ignore what the purchaser is seeking. That view seems fully consistent with the Tribunal's decision in *Matter of SSOV '81 Ltd.*, DTA Nos. 810966 & 810967 (N.Y.S. Tax App. Trib., Jan. 19, 1995), where a dating referral service's furnishing of print-outs of member profiles containing information was found not to be an information service because the taxpayer's primary business function was not the furnishing of information. While TSB-M-10(7)S contains a list of taxable information services (*e.g.*, the furnishing of stock market reports and forecasts), it leaves unanswered the important question of how the "primary function" test should be applied with respect to those enumerated services.

Also seemingly inconsistent with *Nerac*, and questionable as a matter of law, is the statement in TSB-M-10(7)S that "furnishing information created or generated from a common database, or information that is widely accessible, is a taxable information service." It is doubtful that the use of a common database, without more, should be sufficient to support a finding of a taxable information service. ■

Executives Beware: Responsible Officer Liability

By Hollis L. Hyans

In *Matter of David Steinberg*, DTA No. 822971 (N.Y.S. Div. of Tax App., Sept. 9, 2010), an Administrative Law Judge held the petitioner, a founder and Chief Executive Officer of a publicly traded company, to be personally liable for the company's outstanding sales and use tax. While the legal principles may be unremarkable, the case stands as a reminder to senior executives that they remain personally liable for unpaid taxes, even in a large company with many employees, and the risks of responsible officer liability are not limited to those who operate small businesses.

New York law, like that of most other states, imposes personal liability for any sales tax that was or should have been collected. The class of persons who can be held personally liable "include[s] any officer, director or employee of a corporation or of a dissolved corporation, any employee of a partnership, any employee or manager of a limited liability company, or any employee of an individual proprietorship who as such officer, director, employee or manager is under a duty to act for such corporation, partnership, limited liability company or individual proprietorship . . . and any member of a partnership or limited liability company." Tax Law § 1131(1). The many cases dealing with responsible officer liability provide that simply holding the title of corporate officer does not necessarily impose personal liability, and that each case must be determined based upon the particular facts and circumstances. The cases have considered such factors as whether an allegedly responsible person was authorized to sign the corporation's tax return; was generally able to manage the corporation; was responsible for maintaining books and records, paying bills, hiring and firing; and could have ensured that the proper tax was collected and remitted, whether or not he or she actually did so. It is also well established under New York law that someone who has sufficient authority to be considered a person under a duty to collect and remit tax cannot delegate that responsibility.

In *Steinberg*, the petitioner was the founder of InPhonic, Inc., an online phone and service provider that sold devices and accessories, as well as service plans on behalf of the major telephone carriers. Before 2004, it had been a privately held company, and Steinberg had owned or controlled 25% or more of its stock. After an initial public offering in November 2004, Steinberg's ownership decreased to approximately 15% and later to 10%. Steinberg served as the company's chief executive officer and board chairman, and was a member of its mergers and acquisitions committee. He acknowledged responsibility for day-to-day management, had access to books and records and was authorized to make bank deposits, sign tax returns and checks, and hire and fire employees. Thousands of checks were issued during the two-year period at issue; those over $50,000, and later $100,000, required Steinberg's signature in addition to that of another employee. The company had an in-house tax department and relied upon large outside accounting firms. The tax personnel reported to the CFO who in turn reported to Steinberg.

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Responsible Officer Liability

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While conceding his ultimate authority over the company's operations, Steinberg pointed out that, given the size of the company and the volume of transactions, he could not as a practical matter personally oversee all aspects of the company's operations, and he relied upon those who reported to him. He also argued that, under the Sarbanes-Oxley Act of 2002, the company's internal audit functions and tax firms were handled by different outside firms, and that his direct interaction with the operating finance employees was "discouraged if not prohibited."

The ALJ gave short shrift to the argument that Steinberg was relying on others. He found that the petitioner clearly had a duty to act on behalf of the corporation to ensure that taxes were collected and remitted, and that "[h]is decision to rely on others and not be directly involved in tax matters does not relieve him of liability." While the company was a large organization, the ALJ found no evidence that Steinberg lacked authority, that information was withheld from him or that he was misled, or that he was "thwarted or precluded" from exercising his responsibilities. He was therefore held personally liable for the unpaid tax.

NO SENIOR COMPANY EXECUTIVE – NO MATTER HOW LARGE OR SECURE THE COMPANY SEEMS – SHOULD FORGET THAT THE TAX LAW IMPOSES PERSONAL LIABILITY FOR UNPAID SALES AND USE TAXES.

Additional Insights

No senior company executive – no matter how large or secure the company seems – should forget that the tax law imposes personal liability for unpaid sales and use taxes. While the decision does not provide any information on why the company failed to pay the underlying sales and use taxes, press reports indicate that InPhonic, which had been heralded as Number 1 on the 2004 *Inc. 500* list of the nation's fastest-growing private companies, filed for Chapter 11 protection in November 2007 after agreeing to sell its assets to a private equity firm. Jason Del Rey, *Former Inc. 500 Standout InPhonic Files for Bankruptcy*, Nov. 9, 2007. The fact that it was a large company, with many layers of staff and outside experts responsible for assuring compliance with the sales tax law, provided no protection against personal liability for the person in charge. It remains very difficult to establish that a senior executive not only did not but *could not* have ensured that the taxes were collected and remitted. The circumstances of one recent case where such a showing was successfully made involved a demonstration that organized crime had so dominated and controlled the company's operations that the former owner literally had no ability to properly pay the taxes, *Matter of Frank A. Marchello*, DTA No. 821443 (N.Y.S. Div. of Tax App., Nov. 19, 2009) – a rare circumstance and a set of facts unlikely to provide much benefit to a corporate executive charged with personal responsibility for unpaid sales taxes. A request has been made for an extension of time to file an exception to the *Steinberg* decision, so there may be further developments. ■

Hair Restoration Services Do Not Constitute the Taxable Sale and Maintenance of Tangible Personal Property

By R. Gregory Roberts

In Matter of Hair Club For Men, LLC, DTA No. 822686 (N.Y.S. Div of Tax App., Aug. 19, 2010), the Division of Tax Appeals was presented with a case of first impression involving the issue of whether Hair Club's "Bio-Matrix" process constituted non-taxable hair restoring services or, as the New York State Department of Taxation and Finance asserted, the sale and maintenance of tangible personal property.

Hair Club is one of the largest providers of hair restoration services in the United States offering various hair restoration alternatives, including: (i) hair therapy; (ii) hair transplants; and (iii) the Bio-Matrix process. The Bio-Matrix process involves the cutting, styling and blending of an individual's own hair with new hair that is added by Hair Club in a process that is designed to enable individuals to create a new look and image and to be undetectable. Customers entered into a membership agreement to receive the various services in exchange for a monthly membership fee based on the service level chosen.

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Hair Restoration Services

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Customers would meet with one of Hair Club's hair stylists, who would work with the individual to achieve the individual's desired look, a process that involves taking detailed measurements of the thinning area on the individual's head as well as hair samples so that Hair Club can match the individual's hair in the same diameter, thickness, density, texture and color. Approximately four to six weeks later, the individual would return to receive the new hair, which consists of hair that matches the individual's own hair and is woven into a fine matrix that is blended into the individual's own growing hair. Depending on the service level selected, a member could receive new hair several times throughout the year and could return to a Hair Club facility for shampooing, styling and additional services other than those provided when they receive new hair.

Hair Club also emphasized client service. Individuals could receive services at any Hair Club facility throughout the United States, facilities would open early or close late to accommodate client needs and Hair Club would send stylists to client locations if a client was unable to come into a facility for service.

In response to a severe economic crisis in the early 1970s, the New York State Legislature vested New York City with the right to impose its sales tax on certain personal services, including "hair restoring services," Tax Law § 1212-A; N.Y.C. Admin. Code § 11-2002(h), and Hair Club for Men collected such tax for New York City. The Legislature, however, did not provide the State with similar authority.

The primary issue before the DTA was whether Hair Club's Bio-Matrix process constituted "hair restoring" services that were taxable in New York City, but not in New York State.

In support of its position that the Bio-Matrix process constituted the sale and maintenance of tangible personal property, and not hair restoring services, the Division asserted that Hair Club was merely selling wigs or toupees and that "hair restoring services" encompassed only surgical procedures. The Administrative Law Judge initially reviewed the plain language of the statute and the dictionary definition of the term "restoration" and concluded that "hair restoring" is a service, not performed by a physician, which seeks to put the scalp back in its former position. Citing to the New York Court of Appeals' decision in *People v. Rubin*, 424 N.Y.S.2d 592 (1979), in which the court noted that hair transplantation included wigs, toupees, hair weaves and hair transplantation, as well as witness testimony that "hair restoration" was a catch-all term in the industry which included all therapies used to replace hair, the ALJ concluded that the Bio-Matrix process fell within the many diverse interpretations of the term "hair restoring" and therefore did not constitute one of the enumerated services under the Tax Law.

The ALJ also rejected the Division's argument that the Bio-Matrix process was nothing more than the sale of tangible personal property (*i.e.*, a wig or toupee). Noting that, if the client's goal was to purchase a wig or toupee, he or she would not enter into a membership agreement which placed such an "overwhelming emphasis" on service, the ALJ explained that the Bio-Matrix process was, instead, "a creative process that strives to deliver something more than just a wig, be it a personal dream, quest for youth or something as simple as regaining a part of one's persona lost with age" and that "it cannot be said that what is primarily being sold . . . is tangible personal property." Although noting that there was no dispute that tangible personal property (*i.e.*, the new hair) was transferred as part of the Bio-Matrix process, the ALJ concluded that, based on cases such as *Atlas Linen Supply Co. v. Chu*, 149 AD2d 834 (3d Dep't 1989), because the new hair was not a stock product but was created after consultation with hair loss specialists and designed to precisely match the client's own head and desired look, the transfer of the new hair was merely incidental to, and inseparably connected with, Hair Club's Bio-Matrix process and therefore did not constitute a separate transaction for tax purposes.

Additional Insights

The position taken by the Division in *Hair Club* represents yet another attempt by the Division to make an end run around the Legislature's decision to tax only specifically enumerated services. The Division's position was especially questionable given that the Legislature recently rejected legislation that would have expressly provided for the taxation of "hair restoring services" and other personal services now taxable only in New York City. S.B. 60-A, Part V, § 1. The ALJ's decision recognizes and reaffirms the long-standing principle that only enumerated services are taxable in New York State and that services must be analyzed in their entirety and not broken down into their component parts, some of which may be taxable. Since the Department did not appeal the case, the decision is now final. Morrison & Foerster represented Hair Club in this matter. ■

State Tribunal Clarifies Taxpayer's Burden of Proving Day Count for Statutory Residence

By Irwin M. Slomka

As many practitioners representing clients in New York residency audits have found, it can be a daunting task to convince a New York State auditor that the taxpayer spent a day outside the State (or City) without furnishing a third party document conclusively establishing the out-of-State presence. Indeed, even undocumented weekend days for non-New York domiciliaries are routinely treated as New York days (or, at best, as undocumented days) by State auditors for purposes of the 183-day rule. A recent decision of the Tax Appeals Tribunal involving statutory residency is instructive because it reaffirms earlier Tribunal case law – often ignored by auditors – regarding a taxpayer's burden of proof on the 183-day rule. *Matter of Julian H. Robertson*, DTA No. 822004 (N.Y.S. Tax App. Trib., Sept. 23, 2010).

A New York State "resident" includes an individual who maintains a permanent place of abode in the State and spends more than 183 days of the year in the State, including any part of a day (a "statutory resident"). A resident is taxed on all of his or her income from all sources. New York State taxes nonresidents only on their New York State source income. There is no New York City tax on nonresidents.

The *Robertson* case involved the applicability of the New York City resident income tax to a hedge fund manager. It was undisputed that his domicile was outside New York City, in Locust Valley, Long Island. However, because the taxpayer also maintained a permanent place of abode in New York City, statutory residence was squarely in issue. Robertson had been fully aware of the 183-day rule, and his assistant kept track of his daily whereabouts and regularly advised him of his day count to make sure he would not be present in New York City more than 183 days in the year. After the audit, the parties agreed that Robertson was present in the City on 183 days in the year 2000. The Division agreed that Robertson was outside the City on 179 days. In other words, since the year 2000 was a calendar leap year, there remained only four days in dispute. If Robertson was in the City on any one of those four days, he would by his own admission be considered a New York City resident.

After a hearing, the Administrative Law Judge ruled in favor of the taxpayer, holding that he had established that he was outside the City on all four days, and therefore he was not a New York City statutory resident because he was not present in the City more than 183 days that year. The Division filed an exception, but dropped its disagreement with two of the disputed days, meaning that only two days were before the Tribunal, which is authorized to review the facts *de novo*.

On one of the two days that remained in dispute (Saturday, April 15), at issue was whether the taxpayer was at his New York City apartment that evening with his wife, where there was evidence of both a telephone call made from his Long Island home to the apartment, and a call from the apartment to his Manhattan office. On the other disputed day (Sunday, July 23), the taxpayer initially believed that he had flown into LaGuardia Airport from overseas at 2:15 a.m. on Monday (July 24), but later discovered that because of the time zone difference, his flight actually landed at 9:15 p.m. on Sunday night (July 23), early enough for him to have gone straight to his apartment since he worked at his Manhattan office the next day.

At the hearing, Robertson presented a combination of both his testimony, and that of family, friends and colleagues. None of the witnesses could testify with specific recall regarding Robertson's whereabouts on the two disputed days. But, taken together with other documents also in evidence, and based on their familiarity with his established patterns of activity, they were able to testify that Robertson was in all likelihood outside the City on those days.

The ALJ ruled that the taxpayer met his burden of proof, and therefore was not taxable as a New York City statutory resident. The Division argued on appeal that the ALJ misapplied the burden of proof, the proper test being the "clear and convincing evidence" standard. The Tribunal, in a rare 2-1 split decision, affirmed the ALJ's determination that the taxpayer met his burden of proof with respect to the two disputed days. It is not so much the result, but the Tribunal's rationale for the result, that makes the decision noteworthy.

The Tribunal first traced what it referred to as "well-developed case law" regarding a taxpayer's burden of proof with respect to the 183-day rule. Perhaps most significantly, the Tribunal clarified language from its 2008 decision in *Matter of R. Michael Holt*, DTA No. 821018 (N.Y.S. Tax App. Trib., July 17, 2008), in which it held that a taxpayer must provide "specific evidence *through substantiating contemporaneous records* to show a

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Statutory Residence

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taxpayer's whereabouts on a day-to-day basis" (emphasis added). The Tribunal in *Robertson* considered whether this language meant that, as a matter of law, a taxpayer must furnish documentary proof for every day he or she claimed to be outside the City. The Tribunal held that it did not, stating:

> [T]he standard as to counting days . . . is not that there must be an objectively verifiable piece of documentary evidence establishing an individual's whereabouts *on every day in question* . . .
>
> [T]here are days for which such objectively verifiable documentary proof simply does not exist. In fact, requiring such evidence for all days would leave the taxpayer's burden of proof to be "beyond all doubt," higher even than the criminal conviction standard of "beyond a reasonable doubt" and far above the standard of "clear and convincing" proof as is required in matters of statutory residence.

(Emphasis added) (citation omitted).

The Tribunal noted that where there is no definitive document establishing one's whereabouts on a particular date (which it referred to as the "gold standard"), the evidence to be considered is a combination of testimony evaluated in light of surrounding events and other evidence which aid the person in recalling the events on a particular date.

In light of this standard, the Tribunal first concluded that on April 15, while the witnesses had no specific recollection of Robertson's whereabouts that day, their non-specific recollections were consistent with other documentary evidence placing him outside the City. For July 23, the testimony of the witnesses was supported by other facts, such as a call made by the taxpayer's wife from their Manhattan apartment to their Long Island home early the following morning, which would not have been made if Robertson had stayed in the Manhattan apartment the previous night. Moreover, the Tribunal noted that the Division did not offer anything to contradict this factual determination. According to the Tribunal, "[c]redible testimonial evidence becomes clear and convincing when it is backed up by documentary evidence." Since the Division cannot appeal Tribunal decisions, the decision is final and controlling.

The Tribunal's decision was not, however, unanimous. In a sharply worded dissent, the dissenting Commissioner pointed out that the witnesses did not have a specific recollection of the April 15 date, and did not testify to a clear "pattern of conduct" by the taxpayer that would have made their non-specific testimony credible. As for July 23, the dissent viewed the evidence as conflicting – since the taxpayer's initial calendar submission erroneously showed him to be out of the country – and therefore the record did not contain "clear and convincing evidence" to support the taxpayer's position.

Additional Insights

The *Robertson* decision provides the first meaningful guidance in some time on how a taxpayer can meet the statutory burden of proof regarding the 183-day rule. Although the majority suggests that it was merely following its own precedent, the decision is a breath of fresh air in addressing the approach of many auditors that a taxpayer must furnish a dispositive written "record" for each claimed non-New York day in order to meet the 183-day rule. It also calls into question the tendency of some auditors to disregard even a third-party affidavit regarding a taxpayer's whereabouts on a particular day.

Although the Tribunal's decision hinged on the taxpayer having produced both testimony *and* supporting documentary evidence, the Division's current Nonresident Audit Guidelines address the use of "credible testimony" *even in the absence of corroborating documentary evidence*. The Audit Guidelines "strongly encourage" that auditors conduct personal interviews with taxpayers to determine whether there is an overall living pattern to explain undocumented days. Curiously, the guidelines go on to say that this is not always possible because "representatives may bar access to the taxpayer." Whether or not that statement is generally true, auditors should give taxpayers *the opportunity* to be interviewed to explain their patterns of conduct regarding undocumented days. Provided adequate guidelines are in place to insure that the interviews are conducted thoroughly but fairly, and provided the auditors are instructed to give appropriate weight to the results of the interviews, many representatives and their clients would welcome interviews as an opportunity to ease the audit burden. ■

Related Parties Found Not To Be Shams

By Hollis L. Hyans

An Administrative Law Judge has held that a company that owned two aircraft and leased them to officers and family members of a related company was not a sham and should not be disregarded for sales and use tax purposes. *Matter of WRBC Transportation, Inc.*, DTA No. 822722 (N.Y.S. Div. of Tax App., Sept. 16, 2010). The ALJ rejected the arguments of the Division of Taxation that the Petitioner was so dominated and controlled by its parent corporation that the use of the Petitioner's aircraft by its parent and the parent's officers and employees amounted to "self use" rather than commercial use.

WRBC Transportation ("Transportation") was a wholly owned subsidiary of a privately held financial services company, W.R. Berkley Corporation, Inc. ("WRBC"). Transportation owned all the shares of Interlaken Capital Aviation Holdings, Inc., which in turned owned all the shares of Interlaken Capital Aviation Services, Inc. ("Interlaken"). The companies had interlocking boards of directors and officers. During the audit period, Transportation owned a helicopter and a jet, which were registered in its name and stored in a hangar in New York State owned by Interlaken. Transportation charged WRBC for all flights. The charges were considered revenue to Transportation and expenses to WRBC on their respective books and records, although no funds were transferred. The charges were computed by multiplying the number of flight hours by a fixed rate, which was based upon certain of the costs of operating the aircraft for the previous year. Revenue and expenses were reported via journal entries, which were eliminated when the entities' federal returns were consolidated. Transportation had no bank accounts of its own. Interlaken paid all of the bills related to the operation expenses of the aircraft, and treated the management fees owed to it by Transportation as an item of revenue, while Transportation treated the fees as an expense, but again no funds moved between the two entities. Interlaken provided all of the services needed to maintain, manage and operate the aircraft, including all accessory equipment, and had approximately 26 employees to perform those services. Interlaken was responsible for hiring all of the pilots and other personnel, approving all flights, administering scheduling and documentation and providing dispatch services. The only uses of the aircraft were for the officers, directors, employees and family members of WRBC. No sales or use tax was paid by Transportation on the aircraft.

New York's law provides an exemption from the sales and use tax for commercial aircraft primarily used in intrastate or interstate commerce, and an exemption from the tax otherwise due on the service of maintaining or repairing tangible personal property for services rendered with respect to commercial aircraft. Tax Law §§ 1115(a)(21), 1105(c)(3)(v). During the years in issue, "commercial aircraft" was defined as aircraft used primarily to transport persons or property for hire, as well as to transport passengers' tangible personal property. Tax Law § 1101(b)(17) (in effect during the years in issue).

The ALJ held that Transportation's aircraft met the definition of commercial aircraft, and that adequate compensation was paid by WRBC for its use, so that Transportation was entitled to the sales and use tax exemption. He then considered – and rejected – the Division's argument that the corporate form of the entities should be disregarded, whether that argument was framed as "piercing the corporate veil" or "substance over form" or "alter ego." He found that the company had a legitimate business purpose, and that its desire to limit liability made business sense. Transportation carried on its business, and there was no evidence it was set up as a sham or for the purpose of tax avoidance. The ALJ stated that, while courts will disregard the corporate form when necessary to "'prevent fraud or to achieve equity,'" no such situation was present. The facts that the aircraft were used exclusively by officers, directors, employees and family members of WRBC, that the compensation paid covered only the operating costs and that WRBC had funded the purchase of the aircraft did not require that the corporate form be disregarded. While the ALJ noted that the Division "seems to allege" that Transportation was formed for the purpose of tax avoidance, there was no evidence in the record to support such a contention, and the history of the company indicated otherwise: Transportation had been in existence since 1983; it owned various aircraft since 1996; and it had a service contract with Interlaken, which had also entered into similar service agreements with third parties. The ALJ also did not appear to be troubled by Transportation's lack of a bank account, noting that its contractual arrangement with Interlaken obviates the need for one.

Additional Insights

Since the years at issue in this case, the definition of exempt "commercial aircraft" has been amended, and it now excludes aircraft used primarily to transport employees, officers, members and others associated with affiliated persons. *See*

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Related Parties

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"Amendments Affecting the Application of Sales and Use Tax to Aircraft, Vessels and Motor Vehicles," TSB-M-09(4)S (N.Y.S. Dep't of Taxation & Fin. May 12, 2009). However, the principles articulated in this case are still of great interest. In many areas of the tax law, including Article 9-A, the Division's auditors have argued that related corporations should be disregarded, and often the facts cited are very similar to the facts in this case: interlocking officers and directors; intercompany payments made via journal entry, without actual transfer of cash; and all transactions of the taxpayer conducted with related parties. Here, the ALJ reviewed all of those facts and realized that they are normal indicia of business relationships; without other, real evidence that a company is a sham or was formed for tax avoidance rather than business purposes, its existence should be respected. ■

Appellate Division Rejects Challenge to City Hotel Tax "Permanent Resident" Regulation

By Irwin M. Slomka

The Appellate Division, First Department, affirming a 2009 New York City Tax Appeals Tribunal decision, has upheld a New York City hotel tax regulation which limits the exemption for "permanent residents" to hotel rooms actually rented for 180 consecutive days, and denies the exemption for additional rooms rented for a shorter duration. *Matter of American Airlines, Inc. v. New York City Tax App. Trib.*, 2010 NY Slip Op. 7264 (1st Dep't, Oct. 14, 2010).

The New York City hotel room occupancy tax is imposed on the occupancy of hotel rooms in the City. The tax is not imposed, however, on a "permanent resident," defined as "any occupant of any room or rooms in a hotel for at least [180] consecutive days." N.Y.C. Admin. Code § 11-2502(a). The hotel tax regulations contain the following limitation:

> Where a permanent resident rents additional rooms on a temporary basis, that person is not considered a permanent resident with respect to such additional rooms *unless such rooms are occupied for 180 or more consecutive days*.

19 RCNY 12-01(2) (emphasis added).

American Airlines leased blocks of rooms in several hotels throughout New York City for use by its pilots and flight attendants with layovers between flights. Its occupancy agreements with hotels varied, but generally provided that the hotels would furnish an indefinite number of rooms, sometimes limited in number, based on the airline's room needs. Under the prescribed procedure for the permanent resident exemption, the hotels collected hotel tax from American on all the rented rooms until the rooms were rented for 180 consecutive days, at which point they refunded the hotel tax back to American with respect to those rooms.

However, American also filed refund claims with New York City seeking the recovery of hotel tax paid for *all* rooms it rented at each hotel during the 180 day period, even for rooms not rented for at least 180 consecutive days. American took the position that once it qualified as a "permanent resident" with respect to at least one hotel room during the period, the law exempted it from the tax for all rooms it rented in the hotel. American argued that the regulation (19 RCNY § 12-01) contravened the statute.

The Administrative Law Judge agreed with American, and held that it was entitled to a refund of hotel taxes paid for all rooms rented at each hotel during the 180 day period. The City Tribunal reversed the ALJ, holding that the "permanent resident" exemption provision should be narrowly construed against the taxpayer. After examining the legislative intent and the wording of the "permanent resident" provision, and after concluding that the taxpayer's interpretation "produces an absurd result," the Tribunal held that the exemption was not conferred upon the person, but upon the person's actual occupancy. Thus, even though American was a "permanent resident" with respect to at least some rooms, the Tribunal held that the law required that the exemption be applied on a room-by-room basis, so that the exemption would not apply to any room rented on a temporary basis until it was consecutively rented for at least 180 days.

The Appellate Division has now confirmed the Tribunal's decision, finding the decision "reasonable," and the City's regulation "consistent with the [hotel tax] enabling legislation and the . . . Administrative Code." Thus, under the court's decision, a person can be a "permanent resident" of a hotel only with respect to those hotel rooms actually rented for at least 180 consecutive days.

Additional Insights

The court's decision, if not overturned on appeal, would presumably be relevant to the separate New York State and City sales tax on hotel room occupancies, which contain a substantively similar consecutive occupancy rule regarding the "permanent resident" exemption. ■

Insights in Brief

New York City Loses in Effort to Tax Diplomatic Missions

The Second Circuit Court of Appeals reversed the decision of the District Court and held that New York City could not collect over $50 million in property tax it asserted was due on the portions of embassy buildings used as residences for employees and their families. *City of New York v. The Permanent Mission of India to the United Nations*, Dkt. Nos. 08-1805-CV & 08-1806-CV (2d Cir. Aug. 17, 2010). The court found that a June 2009 notice issued by the United States Department of State establishing an exemption for this type of property was within the powers permitted by the Foreign Mission Act, and preempted state and municipal tax laws. According to published reports, the City intends to seek review by the United States Supreme Court.

Right to Foreclose Against Oneida Indian Nation Headed to U.S. Supreme Court

The U.S. Supreme Court has agreed to hear the appeal of Madison County and Oneida County from a decision of the Second Circuit Court of Appeals, which had held that the counties were barred by the principle of tribal sovereign immunity from proceeding with a foreclosure action against the Oneida Indian Nation for unpaid county taxes, even though the taxes were properly assessed. *Madison County v. Oneida Indian Nation of New York*, Dkt. Nos. 05-6408, 06-5168 & 06-5515 (2d Cir. Apr. 27, 2010, *cert. granted*, __ U.S. __ (No. 10-72) (Oct. 12, 2010). The counties argued that the Second Circuit decision results in a legal right – to tax the property – without any enforceable remedy.

Department Bound by its Regulation

In *Matter of Xerox Corporation*, DTA No. 822620 (N.Y.S. Div. of Tax. App., Oct. 7, 2010), a State ALJ held that Xerox's receipts from financing transactions with government entities should be treated as income from investment capital rather than business capital, since the regulatory definition of "other securities" included in investment capital clearly encompassed "debt instruments issued by governmental entities." 20 NYCRR 3-3.2(c)(2). The ALJ rejected the Division's attempt to rely on language contained in a former version of the regulation, which would have required the securities to be of a type customarily sold in the open market. While the Division argued that the old regulation had never been explicitly or affirmatively "disavowed," the ALJ noted that the former language was not contained in the amended regulation and could not be relied upon. In addition, the ALJ held that the Division could not apply to *governmental* debt instrument restrictions in the current regulations providing that *corporate* debt instruments do not qualify as investment capital if acquired by the taxpayer for services rendered or for the sale or rental of property.

Buyer of Only Part of Liquidating Business Held a Bulk Sale Purchaser

An ALJ held that a purchaser of only a portion of the assets of a business in liquidation was a bulk sale purchaser, and therefore was liable for the seller's sales tax liabilities to the extent of the purchase price or value of the assets sold. It was irrelevant that only three motor vehicles were purchased, and that the Division had determined that there was another bulk sale purchaser with respect to the same business. *Matter of Prestige Pool & Patio Corp.*, DTA No. 822713 (N.Y.S. Div. of Tax App., Aug. 19, 2010).

Legislation Nullifies Court Decision, Excludes Enrolled Agents from Tax Preparer Registration Requirements

After a New York County Supreme Court Judge upheld as constitutional the requirement under Tax Law § 32 that "enrolled agents" comply with New York State tax return preparer registration and annual fee requirements (*New York State Assn. of Enrolled Agents, Inc. v. New York State Dep't of Taxation & Fin.*, 905 N.Y.S.2d 856 (Sup. Ct. N.Y. County July 6, 2010)), the Legislature amended the law to exclude enrolled agents from the definition of "tax return preparers." Therefore, enrolled agents are no longer subject to the registration and fee requirements, beginning on or after July 30, 2010. Laws 2010, ch. 242. ■