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# MoFo New York Tax Insights

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## New Policy Offers Partial Relief from Controversial Responsible Person Liability

By Irwin M. Slomka

The Department of Taxation and Finance has enacted a new policy that offers partial relief from personal liability for sales tax for qualifying limited partners and members of limited liability companies. "New Policy Relating to Responsible Person Liability Under the Sales Tax Law," TSB-M-11(6)S (N.Y.S. Dep't of Taxation & Fin. Apr. 14, 2011).

Under the New York sales tax law, certain shareholders, corporate officers, and employees can be personally liable for a corporation's sales and use tax liability if the individual is under a "duty to act" for the corporation. In contrast, the law imposes strict liability for the business's sales tax liability on every partner (whether general or limited) of a partnership, and on every member of a limited liability company, regardless of whether the partner or member was under a duty to act. In *Matter of Santo*, DTA. No. 821797 (N.Y.S. Tax App. Trib., Dec. 23, 2009), the Tax Appeals Tribunal upheld a sales tax

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# Responsible Person Liability

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assessment against an individual who formerly held a membership interest in a defunct restaurant operated as an LLC, even though he had no responsibility for the company's financial affairs, including its sales tax collection and filing obligations.

Recently, the Department declined to endorse legislation that would have removed these strict liability provisions for limited partners and LLC members who were not under a duty to act. Under one draft remedial bill, in exchange for the removal of strict liability for limited partners and members, partnerships and LLCs would be required to provide more complete disclosure of responsible persons, and the statute of limitations for assessment would be extended for undisclosed responsible persons.

While the tax law remains unchanged, the Department has now released this new policy memorandum to mitigate against what it acknowledges to be the "unfortunate consequences for certain partners and members who have no involvement or control of the business's affairs." Under the new policy, "eligible" persons will continue to be personally liable for sales tax owed by the business, but their liability will be limited to their pro rata share of the partnership's or LLC's liability for sales and use tax (and interest). Qualifying eligible persons will not be responsible for related penalties owed by the business.

The Department's new policy applies to:

> ***Limited partners*** (other than partners in a limited liability partnership) who demonstrate that they were not under a duty to act for sales tax on behalf of the partnership; and
>
> ***LLC members*** having an ownership interest and percentage share of LLC profits and losses of less than 50%, who demonstrate that they were not under a duty to act for sales tax on behalf of the LLC.

The new policy imposes two other conditions to obtain Departmental "approval" for partial relief:

> The limited partner or member "must cooperate with the [D]epartment" in identifying persons who were involved in the day-to-day affairs of the business; and
>
> In the case of a tiered ownership structure (such as a partnership that is a partner in another partnership), "the [D]epartment will expect the limited partner's or member's assistance in detailing the overall ownership structure, including information regarding out-of-state entities."

According to the memorandum, the new policy went into effect on March 9, 2011.

**Additional Insights**. Despite the fact that the harsh *per se* liability provision regarding partners and LLC members remains in the law, the Department's action is a welcome first step in affording some relief to what many believe to have been an unintended legislative glitch. Somewhat ironically, the Department has now determined that it has the legal authority under the tax law to provide some relief to certain partners and members, even though it previously took the contrary position, as evidenced by the *Santo* decision.

It should be kept in mind that the Department is offering *partial*, not complete, relief from liability. Moreover, the new policy includes the unusual, and inherently subjective, requirement that in order to qualify for relief, the person seeking relief must cooperate with the Department in making certain disclosures. This necessarily gives the Department's auditors considerable discretion as to who qualifies for the relief. Thus, while the Department's new policy is commendable, many believe that full remedial legislative relief should still be the goal.

# Successful Challenge to Assessment Does Not Entitle Taxpayers to Award of Costs

**By Hollis L. Hyans**

In a decision illustrating how high the standard is for obtaining an award of costs, the State Tax Appeals Tribunal has affirmed a determination that the petitioners who successfully challenged a sales tax assessment were not entitled to costs, since they failed to prove the notices of assessment were not substantially justified. *Matter of 33 Virginia Place, Inc.*, DTA Nos. 821181, 821182, 821183, 821290, 821291 & 821859 (N.Y.S. Tax App. Trib, Mar. 31, 2011).

### *Background*

The application for costs arose out of two sales tax audits of a bar and restaurant operated in Buffalo by one of the petitioners, a subchapter S corporation. The Department determined that the petitioner had failed to maintain adequate books and records, and that the Department needed to resort to outside sources to estimate the restaurant's sales. For the 2001–2002 period, the auditor used the 2002 edition of the *Restaurant Industry Operations Report* by the National Restaurant Association and Deloitte & Touche (the "2002 Report"). The auditor simply used median figures culled from

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# No Costs Awarded

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one exhibit to the report, but did not consider using the total sales per seat amount, which was a component of the schedules otherwise relied upon. If the auditor had calculated the median sales per seat, the Department would have arrived at taxable sales of nearly a million dollars *less* than what had been reported. Instead, the petitioner's sales were estimated to be $1.7 million *greater* than reported, based on markup percentages calculated to be at 281% for food and 285% for beverages. The auditor ignored the information in the 2002 Report that would have calculated the number of seat turns per day and amount of profit per seat.

For the second audit, for the 2003–2006 period, a different auditor also determined that records were inadequate, and resorted to the 2006/2007 edition of the same report (the "2006/2007 Report"). This time the auditor chose to rely on an exhibit regarding the ratio of income and expense to total sales, and arrived at markup percentages of 315% for food and 336% for beverages. Sales tax assessments were issued for all audit periods, and personal income tax assessments were also issued to the shareholders of the petitioner S corp.

In challenging the sales tax assessments, the petitioner introduced testimony from a certified sales tax specialist and an attorney specializing in sales and use taxation. The petitioner demonstrated, through an analysis based on table turnover rates, that the Department's calculations of markup percentages were not consistent with other exhibits within the same reports relied upon; that the Department had failed to conduct an observation test, which would have been valuable; that the Reports used were not the most reasonable studies because their purpose was for use as a benchmark to compare management operations and provide an informational resource; and that, with respect to the second audit, the auditor had even selected the incorrect category based on petitioner's total yearly sales. The petitioner's expert also established that, in order to generate the sales as assessed, it would have been necessary for the petitioner to achieve an unreasonably high seat turnover.

**PETITIONERS WHO SUCCESSFULLY CHALLENGED A SALES TAX ASSESSMENT WERE NOT ENTITLED TO COSTS, SINCE THEY FAILED TO PROVE THE NOTICES OF ASSESSMENT WERE NOT SUBSTANTIALLY JUSTIFIED.**

The ALJ held that, while the Department was "within its rights to resort to external indices," because the petitioner had failed to produce adequate records, and because precise accuracy was not required, "[w]hat resulted from the two sales tax audits…is far more than imprecision." *Matter of 33 Virginia Place, Inc.*, DTA Nos. 821181, 821182, 821183, 821290, 821291 & 821859 (N.Y.S. Div. of Tax App., Nov. 13, 2008). The auditors could not explain why the particular reports were used; they were not familiar with the contents; and they never bothered to check the reasonableness of their markup percentages. The ALJ found that the petitioner had shown the results of both audits were erroneous, and that the audit methods employed were unreasonable, "by clear and convincing evidence."

The Tribunal affirmed. *Matter of 33 Virginia Place, Inc.*, DTA Nos. 821181, 821182, 821183, 821290, 821291 & 821859 (N.Y.S. Tax App. Trib., Dec. 23, 2009). It noted that the lack of adequate records, while allowing the use of external indices, did not give the Department "carte balance to simply extract convenient numbers from an index and use them in a manner for which they were never intended to be used....Had consideration been given to other exhibits in that Report, it would have appeared obvious that petitioners may not have underreported sales in any respect." Accordingly, all the notices were cancelled.

### *Application for Costs*

The petitioner then applied for costs under Tax Law § 3030, which allows an award of costs to a prevailing party in certain cases, unless the Department establishes that its position was substantially justified. The ALJ denied the application, finding that the Department's failure to employ common sense checking in the audit calculation, while defeating the assessment, did not obviate its original justification in using external indices, and that the Department had established substantial justification for issuance of the assessments. *Matter of 33 Virginia Place, Inc.*, DTA Nos. 821181, 821182, 821183, 821290, 821291 & 821859 (N.Y.S. Div. of Tax App., July 22, 2010).

The Tribunal has now agreed, largely in reliance on federal precedent, noting that Tax Law § 3030 was modeled after Internal Revenue Code § 7430. The Tribunal repeatedly noted that the petitioner had not maintained guest checks or invoices, that it "willfully declined to do so" for even a short audit period, and that its conduct amounted to "willful and wanton disregard" for its statutory duty to maintain books and records. Although the Tribunal had already found that the Department failed to meet the threshold burden

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# No Costs Awarded

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of showing a rational basis for the assessment, because its auditors could not explain how they used the external indices, this failure was held not to invalidate the basis for the notices at the time of issuance.

**Additional Insights**. This decision demonstrates how difficult it is to obtain an award of costs under Tax Law § 3030. Here, an entire series of assessments, of both sales tax and personal income tax arising from the alleged additional sales, was completely annulled, and both the ALJ and the Tribunal held that the auditors could not demonstrate a rational basis for the assessment, had failed to use common sense, and presented "no articulated basis" for relying on one exhibit in the chosen reports rather than another. Nonetheless, because petitioner had not kept adequate records, thereby giving rise to a need to estimate its liability in the first place, both the ALJ and the Tribunal found that none of the glaring deficiencies in the chosen audit method prevented the Department from establishing "substantial justification" for issuance of the determinations. While the petitioner was contending that the ALJ's failure to award costs was inconsistent with the Tribunal's rather strongly worded decision setting aside the assessment, the Tribunal found no such inconsistency, stating that, while it was sufficient to cancel the notices at the hearing, the "evidentiary failure" did not invalidate the bases for the notices at the time of issuance.

# Update on *Barker* Vacation Home Case

**By Irwin M. Slomka**

In the February 2011 issue of New York Tax Insights, we discussed the recent Tax Appeals Tribunal decision in *Matter of Barker*, which involved the scope of the "permanent place of abode" requirement for statutory residency under the New York State income tax. In *Barker*, the Tax Appeals Tribunal held that a Connecticut couple's vacation home in the Hamptons constituted a "permanent place of abode" for income tax purposes, causing the taxpayer to be taxable as a New York resident because he was present in the State for more than 183 days.

The case also involved the imposition of negligence and substantial understatement of tax penalties on the resulting deficiency, on which the Tribunal declined to rule. Instead, the Tribunal remanded the case back to the Administrative Law Judge to determine whether the taxpayer had demonstrated reasonable cause for his filing position in which he answered "NO" to the question on the tax return, "Did you or your spouse maintain living quarters in New York State?"

The ALJ has now upheld the imposition of penalties, concluding that the taxpayer did not establish reasonable cause. *Matter of John J. and Laura Barker*, DTA No. 822324 (N.Y.S. Div. of Tax App., Apr. 7, 2011) (Determination on Remand). After noting that the taxpayer answered "NO" to the question of maintaining living quarters in the State on his returns for all three years in issue, the ALJ pointed out that only two weeks after filing his return for the third year, the taxpayer responded to a Nonresident Audit Questionnaire acknowledging that he did own a vacation home in the State. The ALJ concluded that this demonstrated that the taxpayer knew that by reporting on his return that he did not maintain living quarters in the State, the taxpayer was providing an erroneous answer that, "[a]t a minimum...would forestall any inquiry by the [Department] into the residency issue." The erroneous answer also allowed the taxpayer not to complete a schedule that would have disclosed his Hamptons home and the fact that he spent more than 183 days in the State each year. Thus, according to the ALJ, the record did not demonstrate a reasonable basis for the taxpayer's claim that he did not maintain a permanent place of abode in the State.

THE TAXPAYER WAS PROVIDING AN ERRONEOUS ANSWER THAT, "[A]T A MINIMUM...WOULD FORESTALL ANY INQUIRY BY THE [DEPARTMENT] INTO THE RESIDENCY ISSUE."

**Additional Insights**. The ALJ's decision on penalties is a reminder of the importance of the seemingly innocuous question on the tax returns regarding "living quarters" in New York. Indeed, the taxpayer's "NO" answer to the question caused the ALJ in deciding on the penalty waiver issue to focus on the response to that question, rather than on whether the taxpayer had reasonable cause to file as a nonresident based on his Hamptons vacation home.

The penalty issue in *Barker* is secondary to the far more important issue of whether a vacation home used sporadically by a taxpayer during the

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## Vacation Home

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year constitutes a permanent place of abode for residency purposes. The case will presumably now proceed to the Tax Appeals Tribunal for its review of the penalty issue, after which the taxpayer will have the ability to file an appeal with the New York courts on the statutory residency issue, and (if necessary) on the penalty issue.

# New York 2011-12 Executive Budget Signed Into Law

**By Irwin M. Slomka**

On March 31, 2011, Governor Cuomo signed into law the New York State fiscal year 2011-12 Executive Budget (Ch. 61, Laws of 2011). As he had promised, the Governor succeeded in enacting a budget that contained no new taxes. Among the more noteworthy tax provisions contained in the new budget are the following:

*Extends Investment Tax Credit for Financial Services Industry.* The investment tax credit for the financial services industry, which had been scheduled to expire in 2011, has been extended three years. As a result, it will continue to apply for qualifying property placed in service before October 1, 2015. The credit is available under the New York State corporate, bank, and personal income taxes for qualifying property principally used by a broker or dealer in connection with the purchase or sale of stocks, bonds, and other securities. Ch. 61, Part E, Laws of 2011.

*Makes Bank Tax Permanent and Extends Transitional Provisions Relating to Gramm-Leach-Bliley Act.* Since its original enactment in 1985, the New York State bank tax has been subject to "sunsetting" every two years, meaning that the New York State Legislature regularly had to vote to extend it, usually after the tax had technically expired. The bank tax law was scheduled to sunset again for taxable years after 2010. The new law now makes the bank tax permanent.

The budget bill also extends, until January 1, 2013, the transitional provisions under Article 9-A and the bank tax relating to the federal Gramm-Leach-Bliley Act, which were scheduled to expire after 2010. These provisions generally keep in place the New York State tax treatment in effect before Gramm-Leach-Bliley removed the limitations on affiliations of banks and investment banks. Under the New York transitional rules, certain corporations could continue to be taxed under Article 9-A, notwithstanding the changes brought about by Gramm-Leach-Bliley. The Governor's Memorandum in Support of extending the transitional provision specifically notes that the extension "allow[s] for the potential introduction of more comprehensive corporate tax reform in the future." This appears to be the first official acknowledgment by the new Governor of the Department's draft corporate tax reform legislation that, if eventually enacted, would merge Article 9-A and the bank tax. Ch. 61, Part J, Laws of 2011.

*Extends Tax Shelter Reporting Provisions.* The current tax shelter reporting and penalty provisions have been extended to July 1, 2015. These provisions, which require that taxpayers disclose on their New York State tax returns federal and New York reportable and listed transactions, and which impose substantial penalties for noncompliance, were scheduled to expire on July 1, 2011. The Governor had wanted to make the provisions permanent. Ch. 61, Part B, Laws of 2011.

*No Reenactment of New York State Income Tax Rate Increase on High Income Earners.* The temporary increased personal income tax rates for high income individuals (up to 8.97% for individuals with taxable incomes over $500,000), which went into effect in 2009, have not been reenacted. After 2011, the highest personal income tax rate will revert to 6.85%.

# E-Books Are Not a Taxable Information Service Under the Sales Tax

**By Irwin M. Slomka**

The Department of Taxation and Finance has issued a policy memorandum stating that the sale of e-books that meet certain conditions does not constitute the furnishing of an information service under the sales tax law, and will not be subject to sales or use tax. "Tax Department's Policy Regarding Whether E-Books Constitute Information Services Subject to Sales and Use Taxes," TSB-M-11(5)S (N.Y.S. Dep't of Taxation & Fin. Apr. 7, 2011).

While books sold to New York customers are subject to sales tax as sales of tangible personal property, the sales tax treatment of the growing sale of e-books delivered electronically over the Internet has been less clear. The Department's new policy memorandum states that, "until further notice," the sale of qualifying e-books will not be considered an information service subject to sales tax, thereby relieving

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# E-Books Not Taxable

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vendors of e-books from having to collect sales tax on the transactions.

Under the new policy, all of the following conditions must be met in order for the e-book to be nontaxable:

1. the purchase cannot entitle the customer to additional goods and services from the vendor, and any revisions to the e-book are made solely to correct errors;
2. the e-book must be provided as a single download;
3. the product must be advertised or marketed as an e-book;
4. if the intended use of the product requires that it be updated or revised, any updates or new editions cannot be issued more frequently than annually; and
5. the product must be designed only to work with software necessary to make the e-book readable.

**Additional Insights**. The memorandum indicates that the Department is still reviewing its policy on whether sales tax should be imposed on e-books, and the memo emphasizes that this represents the Department's "current policy." To the Department's credit, the new policy offers much-needed guidance to vendors of e-books on whether they should collect sales tax from the customer at the time of sale. There have been prior instances where the Department did not provide adequate advance guidance to vendors, particularly regarding sales of services that it considered taxable. As a result, some vendors were unaware that they should have collected sales tax, and when later determined to be liable for failing to collect the tax, were left unable to recover the tax from their customers.

The issue of whether an e-book constitutes a taxable information service under the current New York tax law may not be one that is easily answered. Applying the "primary function" test, arguably certain e-books could constitute the furnishing of information. Moreover, by its nature an e-book would not seem to qualify for the exclusion under the sales tax law for information services that are "personal or individual in nature." However, such an interpretation would lead to the undesirable and administratively difficult situation in which some e-books are taxable, while others are not. The Department's new policy prudently avoids having to implement such an unwieldy distinction.

# Entitlement to QEZE Credits Upheld

**By Hollis L. Hyans**

In *Matter of Bombardier Mass Transit Corp.*, DTA No. 822999 (N.Y.S. Div. of Tax App., Mar. 24, 2011), an Administrative Law Judge has held that the petitioner was permitted to claim qualified empire zone enterprise ("QEZE") credits for real property taxes, since it had successfully demonstrated it was a party to a qualifying written agreement.

Petitioner claimed entitlement to QEZE credits for real property taxes based on a payment in lieu of taxes ("PILOT") agreement. The Department argued that petitioner failed to meet the requirement under the statute that it had made payments in lieu of taxes "pursuant to a written agreement entered into between the QEZE and the state, municipal corporation, or public benefit corporation." Tax Law § 15 (former[e]). The petitioner was relying on an agreement dated May 1, 1998 (the "PILOT 3 agreement"), under which the petitioner assumed all rights and obligations of its parent to various properties in Plattsburgh, New York, and agreed to perform all of the obligations of its parent, including payment in lieu of taxes owed under previously existing agreements.

The ALJ rejected each of the Department's challenges to the PILOT 3 agreement. While the Department "repeatedly stressed" that a copy of the agreement had not been made available by the petitioner until relatively late in the audit, the ALJ held that the time of production was irrelevant. He also rejected the challenges to the specificity of the incorporation of earlier agreements and descriptions of the properties, finding that the agreement adequately identified the properties, and set forth the obligations of the parties, and that the petitioner's witness had established the relationships and background practices among the parties to the agreements. While the Department argued that, because the witness only worked for the petitioner for five years, she lacked personal knowledge of agreements that had been entered into before that time, the ALJ found the witness's testimony "credible and helpful" and noted that "relevant and probative hearsay is admissible in an administrative proceeding." The ALJ found all of the terms in the PILOT 3 agreement clear enough to establish that the petitioner agreed to make all of the payments in lieu of tax that its parent and predecessor had previously been obligated to make, and was entitled to the credits.

**Additional Insights**. While establishing entitlement to QEZE credits through supporting documentation ought to be a straightforward process, this case demonstrates that problems sometimes can arise, particularly when obligations are shifted between related parties.

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# QEZE Credits

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It is necessary to be sure that all documents track the proper transfer of obligations. Here, the ALJ also rejected the Department's complaints about late provision of the central document, holding the date of production irrelevant. However, in general, production of all relevant documents as soon as possible can help avoid problems. The decision also makes clear that testimony from witnesses, even those without personal knowledge, can be critical to establishing explanations for sometimes confusing collections of documents entered into over a series of years and involving numerous parties, and that the technical rules of evidence do not apply in administrative hearings.

# Insights in Brief

### Clarification on Applicability of Sales Tax to Bagels and Other Food Items

Following up on a state and local tax issue that was covered by *The New York Times* and *The Wall Street Journal*, the Department of Taxation and Finance has issued a series of Sales Tax Bulletins clarifying the application of New York sales tax to such items as beverages sold by food stores, beverage centers, and bars and restaurants; candy and confectionary; and bagels. *Sales Tax Bulletin* Nos. TB-ST-65, TB-ST-103, TB-ST-806 & TB-ST-835 (N.Y.S. Dep't of Taxation & Fin. Apr. 13, 2011). The Department has advised that candy is subject to sales tax; also taxable are certain beverages, such as fruit drinks, heated coffee, water, and carbonated drinks, but not milk, fruit juice, vegetable juice, or unheated coffee. And, in Bulletin No. TB-ST-835, the Department addresses "What is considered a sandwich" and subject to tax: BLTs, club sandwiches, croissant sandwiches, and yes, bagel sandwiches, "served buttered or with spreads, or otherwise as a sandwich."

### ALJ Treats Letter as a Timely Petition

In *Matter of William H. Dourlain*, DTA No. 823892 (N.Y.S. Div. of Tax App., Mar. 24, 2011), the Department sought to dismiss a petition as untimely, arguing that it had not been filed within the 90-day time period set by Tax Law § 170.3-a(e). The ALJ found that the Department had introduced adequate proof that it had mailed the Conciliation Order on June 10, 2010, and therefore that the petition filed on September 30, 2010, was untimely. However, the petition had been preceded by a letter sent on September 7 and received by the DTA on September 8, which, in making it clear that the petitioner disagreed with the notices of deficiency, was deemed sufficient to satisfy the requirements of being a "pleading" under New York law. While the letter failed to meet many of the specific requirements under the law, the petitioner was given 30 days to correct those deficiencies.

### New Procedure to Request Discretionary Adjustments to Allocation Methods

On March 28, 2011, the Department of Taxation and Finance amended the procedures to be followed by a taxpayer in requesting a discretionary adjustment to its allocation method, for both the business corporation franchise tax and the franchise tax on banking corporations. As before, a taxpayer that has not previously received consent to use an alternative method is supposed to file in accordance with the statutory method, and submit a request to vary from the formula. Under the new rules, the request must be submitted separately from the tax return (rather than attached to it, as was previously required), and must set forth full information on which the request is based. 20 N.Y.C.R.R. §§ 4-6.1, 19-8.4 (effective March 28, 2011).

### Amounts Received from Sale of Inventory Pursuant to an Asset Sale Agreement Not "Business Receipts"

The Department of Taxation and Finance has ruled that amounts received by a corporation from the sale of all of its assets, including its inventory, pursuant to an asset sale agreement did not qualify as "business receipts" and were therefore not includible in the denominator of its receipts factor. *Advisory Opinion*, TSB-A-11(6)C (N.Y.S. Dept. of Taxation & Fin., Mar. 11, 2011). The Department reasoned that the sale of the entire inventory was not in the regular course of the corporation's business, noting that after the sale, the corporation wound down its business affairs and ceased operation.

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ABB v. Missouri
Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
American Power Conversion Corp. v. Rhode Island
Citicorp v. California
Citicorp v. Maryland
Clorox v. New Jersey
Colgate Palmolive Co. v. California
Consolidated Freightways v. California
Container Corp. v. California
Crestron v. NJ
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
General Mills v. California
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Union Carbide Corp. v. North Carolina
United States Tobacco v. California
USV Pharmaceutical Corp. v. New York
USX Corp. v. Kentucky
Verizon Yellow Pages v. New York
W.R. Grace & Co.—Conn. v. Massachusetts
W.R. Grace & Co. v. Michigan
W.R. Grace & Co. v. New York
W.R. Grace & Co. v. Wisconsin

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