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MoFo
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Court of Appeals Reverses Appellate Division, Holds that EchoStar's Equipment Purchases Qualified as Sales for Resale

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By Paul H. Frankel and Irwin M. Slomka

The New York Court of Appeals, reversing the Third Department, unanimously ruled that a provider of satellite television services was not subject to sales or use tax on its purchases of equipment that was leased to customers for a separately stated fee. *Matter of EchoStar Satellite Corp. v. Tax Appeals Trib.*, 2012 NY Slip Op. 08672 (N.Y. Dec. 18, 2012). The Third Department had upheld the Tax Appeals Tribunal's denial of a sale for resale exclusion for those equipment purchases, even though EchoStar had collected and remitted from its customers more than $2 million in sales tax on the equipment leases.

A taxable "retail sale" includes "[a] sale of tangible personal property . . . other than . . . *for resale as such.*" Tax Law § 1101(b)(4)(i)(A) (emphasis added). This "sale for resale" exclusion reflects the fundamental principle – applicable in sales tax laws throughout the United States – that sales tax should be imposed on the end-user, not on an interim purchaser of property. A "sale" includes a "lease" of tangible personal property. Tax Law § 1101(b)(5).

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Court of Appeals Finds EchoStar Entitled to Resale Treatment

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EchoStar provided satellite television service under the name "DISH Network." It purchased equipment, principally TV remote controls and receiver boxes, from manufacturers, and then leased the equipment to its DISH Network customers for a separately stated $5.00 per unit monthly "equipment fee," pursuant to customer lease agreements. The equipment was used by customers to receive DISH Network programming.

EchoStar did not pay sales or use tax on its equipment purchases. Instead, it collected and remitted approximately $2 million in New York sales tax from customers based on the separately stated equipment lease fees. On audit, the Department of Taxation and Finance took the position that EchoStar had erroneously collected and remitted sales tax on the equipment lease fees. The Department claimed that EchoStar instead should have paid approximately $1.8 million in use tax on its purchases of the equipment. The Department would not credit the sales tax already remitted by EchoStar against the use tax allegedly due on the equipment purchases.

[T]HE COURT WAS TROUBLED BY THE OBVIOUS INEQUITY OF THE DEPARTMENT SEEKING TO COLLECT AN ADDITIONAL $1.8 MILLION IN USE TAX ON ECHOSTAR'S EQUIPMENT PURCHASES, AFTER THE DEPARTMENT HAD ALREADY RECEIVED $2 MILLION IN SALES TAX ON THE LEASING OF THE SAME EQUIPMENT.

EchoStar challenged the assessment of use tax on its purchases, arguing that the purchases of equipment were nontaxable sales for resale. It argued that, since the equipment was being leased to its customers for a separately stated charge on which sales tax had been collected, the case presented facts different from those in various court decisions in which resale treatment was denied. EchoStar pointed out that the Department would receive an undeserved tax windfall if permitted to collect both sales tax *and* use tax on the same equipment. An administrative law judge, the Tax Appeals Tribunal and the Appellate Division all upheld the Department's use tax assessment, concluding that the equipment was "purely incidental" to EchoStar's primary business of providing satellite television programming, and therefore was not being "resold" to customers. EchoStar requested leave to appeal to the Court of Appeals, which the Court granted. Oral argument was held in November 2012.

The Court of Appeals agreed with EchoStar, holding that its purchases of equipment were nontaxable sales for resale because the equipment was being leased to customers. The Court cited to its decision in *Matter of Burger King v. State Tax Comm'n*, 51 N.Y.2d 614 (1980), which involved the applicability of the resale exclusion for Burger King's purchases of hamburger wrappers, french fries sleeves and soda cups, for the proposition that sales tax should be imposed only upon the ultimate consumer. The Court also rejected the Department's claim that EchoStar's provision of the equipment was merely "incidental" to the furnishing of its satellite television programming.

The Court devoted considerable attention to the Department's contrary position in *Matter of Galileo Int'l Partnership v. Tax Appeals Trib.*, 31 A.D.3d 1072 (3d Dep't 2006). *Galileo* involved a successful attempt by the Department to impose sales tax against the operator of a proprietary computer travel reservations system on computers that it leased to its clients (principally travel agencies) for use in accessing its reservations system. The Third Department upheld the imposition of sales tax on Galileo's fixed monthly charges for the computers. The Court of Appeals in *EchoStar* could not reconcile the imposition of sales tax on the monthly computer lease charges in *Galileo* with the Department's contention that EchoStar was not truly leasing the equipment to its customers.

Notably, the Court was troubled by the obvious inequity of the Department seeking to collect an additional $1.8 million in use tax on EchoStar's equipment purchases, after the Department had already received $2 million in sales tax on the leasing of the same equipment. According to the Court, this "would amount to an unwarranted windfall to the State."

Paul H. Frankel, Irwin M. Slomka, and Kara M. Kraman of Morrison & Foerster LLP represented the taxpayer at the Court of Appeals in the *EchoStar* case.

Appellate Court Holds Electronic Messaging Services Subject to Sales Tax

By Irwin M. Slomka

The Appellate Division, Third Department, upholding a Tax Appeals Tribunal decision, has held that electronic messaging services are subject to sales tax as the furnishing of taxable "telegraphy" services. *Matter of Easylink Services International, Inc. v. N.Y.S. Tax Appeals Trib.,* Case No. 512864 (3d Dep't, Dec. 6, 2012). The decision adopts a broad definition of the term "telegraphy" – a term of antiquated origin – which some may find surprising.

New York State and local sales tax is imposed on "[t]he receipts from every [intrastate] sale . . . of . . . telegraphy and . . . telegraph service of whatever nature." Tax Law § 1105(b)(1)(B). The Department's sales tax regulations have long defined "telephony and telegraphy" together, generally as including the "use or operation of any apparatus for the transmission of sound, sound reproduction or coded or other signals." The regulations identify "message switching services" over leased communications lines and fax services as taxable "telegraph services." 20 NYCRR 527.2(d)(2). Sales tax does not apply where telephony or telegraphy is "incidental" to the provision of another service, although it is not always easy to determine when that limitation applies.

Facts. Easylink is a global provider of electronic messaging services. It furnishes customized electronic fax and telex services, closed network e-mail services and electronic data interchange (EDI) services (the latter principally involving the electronic exchange of customer purchase orders and invoices). Those customized services include converting text or data from one format to another, as well as providing tracking and authentication services. Easylink routes data over the Internet and over its own network.

Prior to the tax periods in issue, Easylink was a division of AT&T, and collected sales tax on its messaging charges. It stopped collecting sales tax on those charges shortly after it was sold to a new owner in February 2001, believing that the services were not taxable. The Department's auditors initially concluded that Easylink's messaging services were subject to sales tax as "telephony" services, although the Department later took the position that they constituted "telephony or telegraphy" services. Easylink argued that the tax law imposes sales tax not on "telecommunications services," a broader category, but on "telephone or telegraph services." Easylink claimed that its enhanced messaging services only incidentally involved the furnishing of telegraphy.

After a hearing, an administrative law judge concluded that the services did not constitute "telephony or telegraphy" as those terms are commonly understood, and thus were not subject to sales tax. The Tax Appeals Tribunal reversed. It applied a broad interpretation of the terms "telephony and telegraphy," reasoning that the reference in the law to "telephony or telegraphy *of whatever nature*" (emphasis added) "indicate[s] that a broad construction is to be given [to] the terms," citing 20 NYCRR 527.2(d)(2). The Tribunal held that Easylink's enhanced fax, telex, e-mail and EDI services were in the nature of message conduit services, similar to the services performed by "a traditional telephone or telegraph company," and therefore were taxable telephony or telegraphy services.

Decision. The Third Department has now affirmed, holding that Easylink was furnishing taxable "telegraphy" services. The Court began by stating that it was appropriate to apply a deferential standard of review to the Tribunal's decision, so that if the taxing agency's interpretation was found to be rational, it should be confirmed. The court went on to conclude that, whether applying a broad or narrow construction of the statutory term "telephony or telegraphy," the services in question were taxable "telegraphy" services. The court viewed Easylink's routing of messages and data over the Internet and over its own network as being comparable to the taxable "message switching services" and taxable "facsimile" services referenced in the sales tax regulations. 20 NYCRR 527.2(d)(2). The court also held that even if the examples in the regulations were not applicable to Easylink's messaging services, the "ordinary meaning of [the term] telegraphy" supported the Tribunal's conclusion.

Additional Insights. In reaching its decision, the Third Department appears to have applied an overly deferential standard of review. The terms "telephony and telegraphy" are not defined in the tax law. The proper legal standard in interpreting a tax imposition statute such as Tax Law § 1105(b)(1)(B) is that any ambiguities in the law regarding the scope of the tax should be construed against the taxing authority and in favor of the taxpayer. The court's conclusion that its interpretation is consistent with the "ordinary meaning of telegraphy" also seems far from clear. While the court held that Easylink's services constituted the furnishing of "telegraphy," it did not adopt the Tribunal's broader holding that the services were taxable as "*telephony* or telegraphy." (emphasis added).

Interestingly, the Department's position in this case appears inconsistent with the position it took in an earlier Advisory Opinion involving similar services furnished by a competitor of Easylink (*Petition of Diginet, Inc*., Advisory Opinion, TSB-A-99(18)S (N.Y.S. Dep't of Taxation & Fin., Apr. 8, 1999). Neither the Third Department nor the Tribunal addressed that inconsistency. It is reasonable to ask whether this was another instance of the Department retroactively applying a new policy to a taxpayer that had reason to believe that its services were not taxable, and therefore that it did not have to collect sales tax on those services.

ALJ Finds Husband and Wife Were No Longer NYC Domiciliaries

By Hollis L. Hyans

In *Matter of Gordon R. and Jennifer L. Cooke*, DTA No. 823591 (N.Y.S. Div. of Tax App., Nov. 15, 2012), a New York State Administrative Law Judge held that a husband and wife could not be taxed as New York City residents, since they established that they had changed their historic domicile from a New York City apartment to their home in the Hamptons.

Facts. The Cookes had maintained an apartment in New York City since 1975, and the ALJ found that, during the period 1975 through 1984, their life centered around their New York City apartment. However, in 1984, they completed construction on a house in the Hamptons, and began to shift their possessions there, to spend an increasing amount of time there, and to become involved in church activities there. Between late 1984 and 1995, the Cookes generally spent Monday through Friday in New York City, where Mr. Cooke worked and their children attended school. They spent the majority of their weekends and other free time in the Hamptons home.

In 1995, Mr. Cooke accepted a job in Massachusetts, where he rented an apartment, and spent his workweeks. Mr. Cooke continued to spend his weekend and family time in the Hamptons, and spent almost no family time in New York City, although he did use the apartment for business travel. The New York City apartment continued to be maintained, largely for Mrs. Cooke to pursue weekday interests. The Cookes' two daughters went to college outside of New York, starting in 1996 and 2001, respectively, and after those years no longer had their own bedrooms in the New York City apartment, but did have bedrooms in the Hamptons home, where they continued to keep personal memorabilia. In 2002, the Cookes purchased a larger home in the Hamptons, where they moved all of their valuable artwork, family heirlooms and memorabilia. They kept a vehicle at the Hamptons residence, joined clubs in the Hamptons, hosted social gatherings there, and celebrated holidays there.

For the years in issue, 2002 through 2004, Mr. Cooke filed Massachusetts resident personal income tax returns, since he spent more than 183 days there during each year, and also filed New York State resident income tax returns. He was present in New York City for fewer than 183 days in each year, and therefore could not be subject to tax as a "statutory resident," which requires both maintaining a permanent place of abode in New York City and presence in the City for more than 183 days.

Mr. Cooke retired from his Massachusetts employment in May 2006, and testified that thereafter he spent more time than ever in the Hamptons, where one of his daughters was married in 2006. Both the Cookes and one of their daughters testified at the hearing that they considered the Hamptons their home during and after the years in issue, and did not think of the New York City apartment as home.

REGARDLESS OF WHETHER MR. COOKE WAS WORKING IN NEW YORK CITY OR BOSTON, THE HAMPTONS "WAS THE PLACE TO WHICH PETITIONER INTENDED TO RETURN WHENEVER HE WAS ABSENT," UNDER THE STANDARD OF 20 NYCRR 105.20[D][1].

The ALJ Decision. The ALJ concluded that the Cookes had met the burden of establishing a change in domicile, and that an examination of the Cookes' "'general habit of life'" during the years prior to and including the years in issue substantiated the claimed domicile change. He reviewed all of the connections formed by the Cookes to their Hamptons homes, and concluded that they were much more than the weekend visitors claimed by the Department. He found that, regardless of whether Mr. Cooke was working in New York City or Boston, the Hamptons "was the place to which petitioner intended to return whenever he was absent," under the standard of 20 NYCRR 105.20[d][1]. In particular, the ALJ relied on what he described as the "candid, credible testimony" of the Cookes and their adult daughter about the feelings and sentiment they associated with their home in the Hamptons, which, together with documentary evidence, established the Cookes' intention to make the Hamptons their home "throughout their lives."

Additional Insights. Proving a change in domicile can be difficult, since it is well established that, under the statute, regulations and case law, an existing domicile continues until a new one is acquired, and that a party seeking to demonstrate a change has the burden to prove any change by clear and convincing evidence. While there were several factors relied upon by the Department that allegedly showed connections to New York City, the ALJ did not find those persuasive. Even though the amount of time spent in New York City and the Hamptons by Mr. Cooke was roughly equal during the years in issue (he spent most of his weekdays in Massachusetts), his presence in New York City was found to be largely related to business travel and therefore not determinative of his domicile. The use of New York City doctors was also found not determinative, both because Mr. Cooke also used doctors in Massachusetts, where he spent his workweek but never considered his home, and because Mr. Cooke was "hardly the only nonresident" to see specialists in New York City.

Stipulation To Be Bound By Result In Another Case Held Binding on Parties

By Kara M. Kraman

A New York State Administrative Law Judge has held that taxpayers that stipulate to be bound by a final decision rendered in another matter dealing with a similar issue are bound by that stipulation, and may not subsequently raise new issues. *Matter of Island Recycling Corp.*, DTA Nos. 822193, 81294, *et al.* (N.Y.S. Div. of Tax App., Dec. 6, 2012).

Island Recycling Corp., Omni Recycling of Babylon, Inc. and their respective responsible officers (collectively, the "Recyclers") received Notices of Determination from the Department of Taxation and Finance for sales tax due on charges they paid for the transfer of solid waste materials from a transfer station in New York to approved disposal facilities. In early 2008, the Recyclers filed petitions protesting the Notices, claiming that the transportation of waste from a waste transfer station to an approved disposal facility was an exempt transportation service, and not a taxable service.

In May 2008, in an unrelated matter, an Administrative Law Judge ("ALJ") held that similar payments for the removal of solid waste materials from a licensed transfer station to an approved disposal facility were not subject to sales tax. *Matter of Island Waste Services*, *Ltd*., DTA Nos. 820978, 820979, *et al*. (N.Y.S. Div. of Tax App., May 8, 2008). In August 2008, the Recyclers and the Department entered into stipulations agreeing "to be bound by the final decision rendered in *Matter of Island Waste Services, Ltd*.," and that such final decision "shall . . . control the disposition of the instant matter." In *Matter of Island Waste Services, Ltd.*, DTA Nos. 820978, 820979, *et al.* (N.Y.S. Tax App. Trib., Apr. 16, 2009), the Tax Appeals Tribunal reversed the ALJ's decision and found that the removal of solid waste *was* a real property maintenance service subject to sales tax, and the Appellate Division affirmed. *Matter of Island Waste Services, Ltd. v. Tax Appeals Tribunal*, 77 A.D.3d 1080 (3d Dep't 2010), *lv. denied,* 16 N.Y.3d 712 (2011).

In light of the final outcome in *Matter of Island Waste Services*, the Department filed a motion to dismiss the Recyclers' petitions. The Recyclers refused the Department's request that they withdraw their petitions, claiming that there were still unresolved issues aside from the characterization of the waste hauling services as a taxable service, such as the proper computation of the amounts subject to tax as maintenance services rather than waste disposal services, and filed a cross-motion to amend their petitions to raise additional issues.

The ALJ dismissed the Recyclers' petitions and denied their cross-motion to amend the petitions as moot. In reaching his decision, the ALJ first looked at the plain language of the stipulations, noting that the language of a stipulation should be interpreted according to the rules governing the interpretation of contracts. The ALJ stated, "[a]s with a contract, courts should not disturb a valid stipulation absent a showing of good cause such as fraud, collusion, mistake or duress." (Citation omitted). The ALJ held that the plain and ordinary meaning of the language in the stipulations that "such final decision [in *Matter of Island Waste Services, Inc.*] shall be binding on and control the disposition of the instant matter" permitted only one conclusion, that the petitions must be dismissed.

While the ALJ found that the Recyclers positions lacked merit, it rejected the Department's request that a $500 per petitioner "frivolous petition" penalty be imposed on the Recyclers for maintaining a proceeding primarily for delay. The ALJ found that the Recyclers position was not similar enough to the examples of frivolous positions set forth in Section 3000.21 of the Tribunal's Rules of Practice and Procedure – for example, claiming that Federal Reserve Notes are not "legal tender," or arguing that the income tax system is based on voluntary compliance.

> **"[A]S WITH A CONTRACT, COURTS SHOULD NOT DISTURB A VALID STIPULATION ABSENT A SHOWING OF GOOD CAUSE SUCH AS FRAUD, COLLUSION, MISTAKE OR DURESS."**

Additional Insights. In finding that the stipulations were binding, the ALJ noted that the Recyclers did not raise any recognized grounds for disregarding a stipulation, as set forth in *McCoy v. Feinman*, 99 N.Y.2d 295 (2002). In that case, the Court of Appeals opined that stipulations should be upheld unless a party can show collusion, mistake, duress, that the stipulation goes against public policy, that the stipulation is unconscionable, or that the stipulation is so ambiguous as to not accurately represent the parties intentions. Ambiguity, for instance, may sometimes be found where the parties to the agreement believed the language they used would address all possibilities, but did not contemplate the situation which ultimately occurred. Since the Recyclers did not appear to raise ambiguity or any of the established grounds for disregarding the stipulations, they were bound by them.

ALJ Agrees Restructured Company Is Entitled to QEZE Benefits

By Hollis L. Hyans

In another decision interpreting the rules for Qualified Empire Zone Enterprise ("QEZE") benefits, a New York State Administrative Law Judge has found that a newly formed corporation was sufficiently different from its predecessor entity to qualify for benefits as a "new" business. *Matter of James V. and Catherine C. Breuer and John Andrew Breuer*, *Matter of Douglas and Margaret Mooney*, DTA Nos. 823665, 8223663 and 823664 (N.Y.S. Tax App. Trib., Nov. 15, 2012).

The petitioners were all shareholders of a family business, originally named Hueber-Breuer Construction Co., Inc. (the "predecessor corporation") and later, after a re-structuring, named Hueber-Breuer Construction Services, Inc. ("Hueber-Breuer"). The business had operated in New York in various forms since the 19th century, and was incorporated in 1958. Petitioner James Breuer began working for the predecessor corporation in 1964, and by the time of the hearing was president and chief executive officer of Hueber-Breuer. The predecessor corporation had operated as a "hard-bid" general contractor, hiring tradespeople as employees to provide general contracting services by submitting the lowest bid.

James Breuer wanted to change and expand his company's operations, to be able to take a more active role in planning and completing a client's construction project. In the 1990s, he began considering options for providing additional and different construction services, rather than simply building what others had designed. He was also concerned about successor planning, in order to transition the company to the next generation of the family, and had significant concerns regarding liabilities both for employees, under the state's labor laws, and for personal injuries resulting from construction accidents, including a major crane accident at a construction site. He was advised that the use of a Delaware corporation would simplify the process of successor planning. He also became aware of the benefits available under the QEZE program for businesses that started new ventures and hired new employees. He spent many years, from the 1990s until the early 2000s, deciding how to best proceed, and noted that the opportunity to participate in the program offering QEZE benefits "may have been" the catalyst that finally made him move forward.

The new business, Hueber-Breuer, had very different relationships with its clients than had the predecessor corporation: it acted as a construction manager, providing oversight of all construction activities, and participated in the preconstruction process, including such areas as site selection, resolution of environmental issues, obtaining necessary permits and approvals, and overall project design. This was quite different from the work performed by the predecessor corporation, which was required to construct a building in strict compliance with instructions prepared by others. Hueber-Breuer had a different client base from that of the predecessor corporation, and hired many new employees, included mechanical and electrical engineers, a software expert, computer-aided design operators, and an expanded marketing department. It changed from having one-man leadership to a management team of eight, and its average annual payroll increased from $4.8 million in 1999 to 2002 to $8.3 million in 2003 to 2010. It redesigned and significantly expanded its location in a high poverty area in Syracuse, increased its office space by approximately 50%, upgraded its facilities, and tripled its public spaces.

Hueber-Breuer claimed QEZE credits on its New York corporation franchise tax returns, for 2006 and 2007, and, after an audit, the Department denied those credits, concluding that Hueber-Breuer had not demonstrated a valid business purpose for its corporate restructuring, as required under Tax Law § 14.

Availability of QEZE Benefits. Under the QEZE program, qualified businesses receive certain tax credits and exemptions directly linked to job creation. As discussed in several recent issues of *New York Tax Insights*, including the September 2012 article on the decision in *Matter of Ward Lumber*, and the August 2012 article on *Dunk & Bright Furniture Co. Inc.*, 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).

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.

ALJ Decision. On the facts before her, the ALJ seemed to have no difficulty in concluding that Hueber-Breuer qualified as a new business under the language of Tax Law § 14(j)(1), since the new operations were not "substantially similar" to those of

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ALJ Agrees Restructured Company Is Entitled to QEZE Benefits

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the predecessor corporation. She focused on the different and expanded services available, the change in its procedures for obtaining new work so that Mr. Breuer could have earlier and more complete involvement in new projects, as well as its leasing of additional space and substantial redesign and renovation of its existing premises.

EVEN IF THE CORPORATE CHANGE WAS NOT AN ABSOLUTE NECESSITY, IT APPEARED TO BE A PRUDENT BUSINESS DECISION, WAS NOT A SHAM, AND RESULTED IN THE CREATION OF A SUBSTANTIALLY DIFFERENT COMPANY.

Also, while noting she was "not in complete disagreement" with the Department's argument that there was no need for the creation of a new entity to effectuate the change in business activity, the ALJ found that "whether the same goals could be accomplished employing a different path is not the issue." Even if the corporate change was not an absolute necessity, it appeared to be a prudent business decision, was not a sham, and resulted in the creation of a substantially different company.

Additional Insights. Once again, this decision in a QEZE case involving whether or not a company could demonstrate it was "substantially similar" to a predecessor entity turns on the factual record. Hueber-Breuer produced a credible record of substantial changes to and expansion of its business activities. The fact that the availability of QEZE benefits was considered, and may have actually precipitated a re-structuring that had long been considered, did not mean that the new business was so similar to the old one that it was disqualified, or that the re-structuring has occurred *solely* to obtain such benefits, in light of the many other benefits that were considered and eventually obtained. The decision also recognizes that nothing in the statute requires a company to establish that restructuring was the only way it could have achieved those benefits. Instead, the law requires only that a company demonstrate the new entity was not substantially similar to the old one and that the restructuring was not undertaken solely to achieve QEZE benefits.

Here, based on the facts as stated in the decision, it appears that, even if the restructuring were undertaken in part because of the availability of benefits, the result was just what was intended by the QEZE program – which offers benefits to employers so that employment opportunities increase for state workers in economically disadvantaged areas.

Innocent Spouse Relief Rejected

By Amy F. Nogid

A New York State Administrative Law Judge rejected a wife's request for innocent spouse relief for years in which returns were filed as well as the year for which no return was filed, finding the statutory criteria were not met. *In re Carnesi*, DTA No. 823507 (N.Y.S. Div. of Tax App. Dec. 6, 2012).

Carnesi involved a joint return filed by a wife, who was college-educated and who earned a paralegal certificate, and her husband, an attorney in private practice who also owned a consulting firm operated as a subchapter S corporation. The Department of Taxation and Finance sought to perform an audit of the years 1992 through 1995, but calls to the husband and correspondence sent to the jointly owned residence did not generate a response. A deficiency notice was issued based on the disallowance of all Schedule C deductions claimed for the husband's business expenses and all of the couple's itemized deductions. The notice was not protested, so it became a final assessment and eventually resulted in a docketed lien on the couple's home. The home was later sold as a result of a mortgage foreclosure and over $300,000 was paid to the Department. The wife's wages were also garnished and the couple's son's custodial bank account was seized in the Department's attempts to satisfy outstanding tax liabilities.

The wife sought innocent spouse relief and a refund of the amounts taken by the Department. The Department agreed to refund the money seized from the son's account. At the hearing, both spouses testified that the claimed deductions were proper and that, at the time the returns in question were filed, documentation substantiating the deductions taken on the joint returns existed. Ms. Carnesi did not review or sign the return; her husband signed her name with her consent. She claimed not to know an audit was begun.

Tax Law § 651(b), in effect during the years at issue, provided that a spouse is relieved of income tax liability (1) if a joint return was filed, (2) the return reflects a substantial understatement of tax attributable to "grossly erroneous" items of one spouse, (3) the other spouse in signing the return did not know or have reason to know about such items, and (4) it would be inequitable to hold that spouse liable for the taxes attributable to such substantial understatement.

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Innocent Spouse Relief Rejected

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In *Carnesi*, since the issue was one of proof, *i.e.*, whether the claimed deductions could be substantiated, and both the husband and wife testified that the deductions were proper, the "grossly erroneous" condition for innocent spouse relief was found to be absent. The ALJ also concluded that the wife did not meet the no "reason to know" requirement because the husband did not conceal income and the deductions taken were evident from the return. The ALJ observed that "[a] spouse's role as a homemaker, giving complete deference to the other spouse's judgment concerning the couple's finances, standing alone, is insufficient to establish that a spouse has no 'reason to know.'"

Additional Insights: The ALJ pointed to the wife's level of education and stressed her failure to review the returns for accuracy, and the lack of any mitigating circumstances, such as spousal abuse or deceit, that are often present in innocent spouse applications. While expanded spousal tax relief provisions were enacted for 1999 and future years, which now include the possibility for relief based on separation of liability (proportionate relief to a divorced, legally separated spouse, or a spouse not living in the same residence as the other spouse for a year prior to filing for relief) and on equitable grounds, it is unclear whether Ms. Carnesi would have fared better under the newer provisions. Even though Ms. Carnesi had no knowledge of the tax issues until the tax deficiencies were deducted from the proceeds of the mortgage foreclosure, she continued to maintain that the deductions taken on the joint return were correct. If, however, Ms. Carnesi could have established that she was denied access to information or knowledge to determine whether or not the deductions taken on the joint return with respect to her husband's practice and consulting business were correct, or had testified that she had not given her consent for her husband to sign on her behalf, the result might have been different.

This case serves as an important reminder that filing a joint return can have serious implications for both spouses, since each spouse assumes joint and several liability for the entire amount of tax due with respect to the return. Signing a joint return (or authorizing the other spouse to sign on her behalf, as Ms. Carnesi did) without reviewing the return can be deleterious to the trusting spouse. Where one spouse has reasons to believe that the other spouse may not have accurately prepared the joint return, serious consideration should be given to filing a separate return if the spouse wants to avoid being jointly liable for the tax.

Governor Cuomo Appoints Members to Tax Reform Commission

By Irwin M. Slomka

Early in 2012, New York Governor Andrew Cuomo announced the creation of a New York State Tax Reform and Fairness Commission to address possible long-term changes to the State tax system and to help economic growth in the State. Nearly a year later, the Governor has finally appointed ten members to the Commission. The co-chairs are H. Carl McCall (formerly the New York State Comptroller and now chair of the State University Board of Trustees) and Peter J. Solomon (founder and chair of the investment advisory firm that bears his name). Other appointed members include current State Tax Commissioner Thomas H. Mattox, James W. Wetzler (formerly State Tax Commissioner in the administration of the Governor's father), and Dall W. Forsythe (formerly State Budget Director).

The Governor has authorized the Commission to conduct a comprehensive review of the State's tax policies and make "revenue-neutral" recommendations to improve the current State tax system. With that mandate, the Commission will undoubtedly be given broad authority to examine the entire New York tax system, but is unlikely to recommend overall tax reductions, despite the fact that New York is widely recognized as one of the most heavily taxed states in the country. The Commission's timetable and specific agenda, and the extent to which its deliberations and written conclusions will be open and available to the public, have not been announced.

Insights in Brief

Commercial Printer's Purchases of Envelopes Not Subject to Sales Tax

The Department of Taxation and Finance has ruled that a commercial printer's purchase of envelopes that are included with statements that it prints for its customers' clients are purchases for resale and are not subject to sales tax. *Advisory Opinion*, TSB-A-12(31)S (N.Y.S. Dep't of Taxation & Fin., Dec. 5, 2012). The commercial printer prints various account statements related to clients of its customers (such as credit unions and insurance companies), inserts the statements into mailing envelopes (outer envelopes) and mails the statements directly to its customers' clients, including a reply envelope (inner envelopes). The Department ruled that the envelopes qualify as nontaxable purchases for resale.

Exemption Permitted for Property Purchased by Operator of Internet Data Center

The developer and operator of an Internet data center facility is entitled to claim an exemption from sales tax for its purchases of machinery, equipment and other tangible personal property to be installed in the facility. *Advisory Opinion*, TSB-A-12(30)S (N.Y.S. Dep't of Taxation & Fin., Dec. 3, 2012). Under the Tax Law, a qualifying Internet data center is a data center designed and constructed to provide a high security environment for servers and similar equipment and to provide uninterrupted Internet access. The Department ruled that developer's purchases qualified for exemption, even though under the facts presented the facility was not yet completed.