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Updates and Practice Notes on Recent New York Developments

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Last week a client called wondering if I had seen a new sales tax case involving a business similar to his. I pride myself on being on top of new developments, not only because of my gig as a monthly columnist, but also to keep on with issues that could affect my clients. But this client caught me unawares. He was referring to an administrative law judge case that had been posted to the Division of Tax Appeals' Web site just two days earlier!

So that got me thinking: A New York tax practitioner better be on his or her toes. Although I can cite no empirical evidence for this point, I would bet that there are more rulings, cases, publications, and so forth coming out of New York than in just about any other state. And I'm not just referring to a backlog of tax protester cases or late-filed appeals. Instead, several substantive developments now seem to emerge every week, many of them addressing New York tax practice issues. The real meaning or importance to everyday tax practitioners is not always apparent. So this month I'll comment on some of the developments in the past few months that could be particularly relevant to New York tax practitioners. I'll focus on a few published rulings as well as cases decided by the Division of Tax Appeals.

Rulings

Most rulings coming out of the New York State Department of Taxation and Finance are advisory opinions. Advisory opinions are provided for by statute and are written responses to questions posed by taxpayers.[1] Recently, however, the tax department also began issuing guidance memoranda, which are basically advisory opinions in which the requester decided, for one reason or another, to pull a request for advisory opinion. But in most cases, because the work has already been put in by the department on developing those pulled advisory opinions, the department now issues them as guidance memos, with no attribution to a particular requester or taxpayer.[2] Of course, the tax department also regularly issues technical services bureau memorandums (TSB-Ms) to proclaim official policy or interpretation of specific issues, provide updates on developments, and so on.[3]

The department (and taxpayers) make great use of those procedures. For instance, in 2008 the department has already issued 22 advisory opinions in the sales tax area alone, and over the past few years has issued more than 150 sales tax advisory opinions. Opinions on income and franchise taxes are not as frequent but still are common. The development of those advisory opinions over the past 20 years gives a practitioner a wealth of knowledge on how the tax department will respond in specific situations.

In any event, over the past few months there have been a number of notable rulings.

Gimme Credit Publications, Inc., TSB-A-08(14)S. The department ruled on the application of the "periodical" exemption for financial and investment newsletters. For practitioners involved in sales tax issues for companies in the financial services industry, that is an issue that comes up often, given the prevalence of investment research in recent years. The opinion's analysis of the periodical exemption is consistent with the previous cases and rulings, but it nonetheless serves as an important reminder for practitioners, particularly those involved in sales tax audits of companies in the financial services industry, to pay attention to the application of the periodical exemption applicable to investment research. Also, the advisory opinion contains an important reminder about the use of e-mail for distribution of publications. To qualify for the periodical exemption, the publication must be available in hard-copy format and the electronic version cannot be substantially different from the hard-copy version.[4]

Richard Leavy, TSB-A-08(18)S. In *Leavy*, the issue was the taxability of personalized consultation services provided in both oral and written formats. Again, that is an issue that arises often in the investment research area, especially as the department continues its focus in that area. This advisory opinion reiterates the general rule and policy that personalized information provided in written or oral form is not subject to tax so long as the information provided is not culled from or contained in a common database of information. When the provider of information obtains and gathers data in response to

a unique question posed by a client, and the information provided neither comes from a common database nor is shared with other clients, sales tax will not apply.

Google, Inc., TSB-A-08(22)S. This advisory opinion reinforces the position that the electronic delivery of otherwise taxable products or services remains a nontaxable transaction for sales tax purposes. At issue were Google's charges for video delivered to customers over the Internet. Normally, of course, the sale of a video in tangible format would be subject to sales tax. But when that same video is delivered in an electronic format, no sales tax is due. The opinion also addresses two arguments that could be made by tax department auditors concerning the taxability of the video. First, the opinion dismisses the notion that the customer viewing a video is buying or using Google software. That software argument has been raised by other tax department auditors in audits of e-commerce transactions, in which auditors basically take the position that anything involving the Internet involves the use of software. The department dismisses that notion in this advisory opinion, which is consistent with the department's general disapproval of the expansion of the software argument to other nontaxable services or categories. Also, any contention that providing the video was an entertainment service was also dismissed as incorrect.

NYT-G-07(3)C; NYT-G-07(2)S. Both of these guidance memos dealt with the taxation of voice over Internet protocol for sales and telecommunications-excise tax purposes. And in both rulings, the department held that the tax would be applicable in a fashion similar to the way regular telephone and other telecommunications transactions are handled. That the voice or data communications are taking place over the Internet instead of the telephone lines was not viewed as a distinguishing factor.

Cases

Kellwood Co., ALJ ruling, Mar. 27, 2008. This case dealt with combination rules as applied to a supplier of fashion apparel products. The taxpayer had set up a factoring company in an apparent effort to reduce state income tax liability as well as for other alleged business purposes. Although documentation was prepared at the time of the transaction detailing different business purposes for the move, the ALJ found that those business purposes could have been accomplished by other means and that the taxpayer failed to show it could have anticipated any economic benefit other than the tax savings through that transaction. Interestingly, the ALJ also pointed to the fee arrangement between the accountants and the taxpayers -- whereby the firm received a 40 percent fee based on tax savings -- as proof that the primary goal was tax savings.

Lake Grove Entertainment LLC, ALJ ruling, Mar. 27, 2008. This case centered on two interesting issues. First, a procedural issue arose involving waivers, or consents given by taxpayers to extend the statute of limitations in audits. Issues involving waivers often emerge in sales and personal income tax cases because those waivers are so commonly used. In *Lake Grove*, however, a more unusual set of circumstances applied. The taxpayer made two arguments regarding some waivers. First, it argued one waiver was not signed by a person authorized to execute the waiver (not an officer, shareholder, and so on). The ALJ never reached that issue, however, because a corresponding waiver was also in the audit file and was signed by a person who had sufficient power to execute the document. But the taxpayer had argued that that waiver was also invalid because it was dated sometime late in 2007 -- at a date *after* the hearing in the matter occurred! The ALJ ruled that the taxpayer's arguments led to nonsensical results and, even worse, said there was a "contrived effort to circumvent the tax examination and assessment process." Unsurprisingly, the ALJ rejected the taxpayer's arguments that the waivers were invalid.

The substantive issue in *Lake Grove* involved sales of party packages. The taxpayer sold party packages including food, rock climbing, and ice skating, and charged one price for the event. The taxpayer argued that it could remit tax on only the taxable items while charging a bundled price to the customer. Under New York's rules, however, when taxable and nontaxable items are sold for one bundled price, the entire charge is taxable. That rule is commonly known as the cheeseboard rule, based on the example provided in the regulations at 20 NYCRR section 527.1(b).[5] Applying the cheeseboard rule, the ALJ held that when a single invoice charge includes taxable and nontaxable components, the entire charge is subject to tax. The cheeseboard rule commonly arises in sales tax audits, and the result reached by the ALJ appears to be an appropriate application of that test. However, in actual audits, when a taxpayer sells nontaxable products that may have a taxable component included, the taxpayer can often work with tax department auditors to alleviate potential cheeseboard problems. However, that is an issue that should be worked out at the district office level during the audit stage.

Harry Schein, Inc., ALJ ruling, Feb. 21, 2008. *Schein* dealt with a procedural issue involving the issuance of bills of particulars, allowed for under 20 NYCRR section 3000.6. While those procedural devices are used often in regular litigation, they are less common in New York tax practice. I have used that mechanism on a few occasions, and the department has issued demands for bills of particulars from my firm in a few others. But given the relative informality of

the Division of Tax Appeals' process and the general willingness of the parties to exchange documents, the use of that device is not common. In *Schein*, however, the taxpayer issued over 100 requests for information, and the ALJ determined the requests were excessively detailed and sought evidential material. Thus, the demand was vacated in its entirety, even though the ALJ noted that there may have been proper demands commingled with all the improper ones. That ruling confirms that the Division of Tax Appeals will not permit the use of bills of particulars as a means of causing undue hardship, burden, or delay. That said, bills of particulars can be effective when properly used and applied. In the recent case involving the New York Yankees' shortstop Derek Jeter,[6] the taxpayer issued a demand for a bill of particulars and requested that the division specify the date when it claimed the taxpayer changed his domicile to New York. Because that was a matter on which the division bore the burden of proof, the ALJ held that the division was required to answer that question. The use of the bill of particulars mechanism in situations like that is appropriate and can help specify and limit problems or weaknesses in a party's case.

Richard T. and Carol J. Bourns, ALJ ruling, Feb. 21, 2008. Although the relative dollars per taxpayer on this issue might be minimal, *Bourns* is a relatively important personal income tax case. The issue here deals with the pension or annuity income exclusion contained in Tax Law section 612(c)(3-a). Under that provision, distributions from a nonqualified retirement plan are eligible for up to a $20,000 subtraction modification for personal income tax purposes. In *Bourns*, as in many other cases, the tax department had argued that pension plan distributions that were reported on W-2 forms qualified as wages and not pension payments because of federal wage-withholding rules. The ALJ, however, held that the special withholding rules regarding qualified pension plan distributions did not apply to New York's rules and that the inclusion of the pension payments on a W-2 was not at all dispositive. That determination rejects a position that the division apparently has been taking for years, so there may be a substantial refund opportunity for many taxpayers who have that issue.

Rochester Amphibian Airways, Inc., ALJ ruling, Apr. 17, 2008. *Rochester Amphibian* highlights an important use tax issue. Generally, the use tax applies to the use of taxable products or services within New York's borders. However, the use tax does not apply to nonresidents, which includes companies that do not do business in New York. In *Rochester Amphibian*, the taxpayer was a Delaware corporation that owned an aircraft that happened to be stored in New York for a significant period of time and used in New York by the corporation's owner. All the corporation did was buy and hold title to the aircraft; it had no other business purposes for the plane. Also, the aircraft was used only for the benefit of the corporation's sole owner. The tax department offered several theories as to why the sales or use tax should be imposed on the taxpayer corporation, most of which focused on the fact that the aircraft was used by the corporation's owner for his own purposes in New York. But the ALJ, relying on a similar court of appeals case issued several years ago, *Morris v. State Department of Taxation and Finance*,[7] rejected the division's attempt to do that. First, the ALJ refused to pierce the corporate veil because there was no indication of a fraudulent act on the part of the corporation or that the corporation had been formed for the purpose of tax avoidance. Also, consistent with the argument made by the court of appeals in the *Morris/Sunshine Developers* case, piercing the corporate veil in this type of situation makes sense only when it is presupposed that the corporation itself is liable for the tax. If a corporation could not be liable for the use tax because it was a nonresident, no additional tax issues arise through the piercing of the corporate veil. The division also tried to argue that the corporation was a sham or that the ALJ should apply substance over form to impose tax on the corporation, but the ALJ rejected those claims as well. Finally, the ALJ also dismissed the division's contention that this was a de facto lease between the owner and the corporation.

Is there a planning opportunity here? Possibly. Often individuals and companies take steps to have aircraft, vehicles, and vessels owned in separate corporations primarily for liability or tax purposes. *Rochester Amphibian* makes it clear that kind of arrangement may be respected if the circumstances are right.

DZ Bank, ALJ ruling, May 1, 2008. Here we have another case involving products or services purchased in the financial services industry. The products purchased in *DZ Bank* generally appeared to be software-based products that allowed the taxpayer to perform market and credit-risk measurements and models. *DZ Bank*, however, provides an important distinction between taxable and nontaxable services. Some of the products purchased by the taxpayer were allegedly software products that allowed the taxpayer to measure credit risks, run analytical models, and so forth. Three of those services, at least according to the agreements that were in the record, were accomplished through the provision of software and databases that were installed on the taxpayer's computers. The software was used by the taxpayer to perform those analytical functions. The ALJ held that these were taxable software sales, although there was an issue as to whether software was actually provided to the taxpayer under the services agreement.

Importantly, however, another product similar to the three software products was held to be nontaxable. In contrast to the other products, that product was entirely Web based, updated daily, and accessed online by the petitioner. Thus, instead of the taxpayer having access to the software and running the report itself, the taxpayer had access only to the online portal, and the actual reports were run by the vendor with the vendor using its own software to do so. The ALJ viewed that as a nontaxable electronic financial consulting service, not the sale of software. Arguably that also was an information

service, but it nonetheless would have been nontaxable since the information provided to the taxpayer was personal and based on the portfolio data it had provided to the vendor. For practitioners involved in e-commerce-type audits, the distinction made by the ALJ in the *DZ Bank* case is important. There is a difference between having access to software or using the software to generate reports, and simply having online access to reporting functions that are provided by the vendor. The latter is a nontaxable service.

Conclusion

Obviously, because of the many cases and rulings coming out of New York weekly, this summary provides only a snapshot of some of the more recent cases and rulings. And sometimes, with so many rulings, cases, and publications, it is difficult to identify a trend or a focus in any one particular area addressed by the department. However, when one steps back and looks at a sampling of the cases and rulings in the recent past, there does appear to be an increasing focus -- in these cases and rulings, and even in audits -- on software, information services, and e-commerce issues. Practitioners should keep their eyes out for that trend to continue.

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FOOTNOTES

[1] *See* 20 NYCRR section 2376.1.

[2] *See* TSB-M-06(14).

[3] *See* 20 NYCRR section 2375.6.

[4] *Citing* CCH Inc., TSB-A-03(13)S.

[5] The example provides: "A vendor sells a package containing assorted cheeses [exempt], a cheeseboard and a knife [taxable] for $15. He is required to collect tax on $15." Because the amounts are not separately stated by the vendor, the entire charge is subject to tax even though the cheese is exempt.

[6] *Matter of Derek S. Jeter*, ALJ ruling, Nov. 8, 2007.

[7] 82 N.Y.2d 135 (N.Y. 1993) (the case stemmed from the ruling in *Sunshine Developers, Inc. v. Tax Commission*, 132 AD2d 752 (3rd Dept. 1987)).

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