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Appellate Division Denies Deduction for Interest Income Received from Lower Tier Subsidiaries

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By Hollis L. Hyans

Affirming a decision by the New York City Tax Appeals Tribunal, the Appellate Division, First Department, held that a taxpayer was not entitled to a 17% deduction for interest income it received from its third- and fourth-tier subsidiaries under the City bank tax. *Bankers Trust Corp. v. Tax Appeals Tribunal*, No. 7057-36, 2012 NY Slip Op. 01761 (1st Dep't, Mar. 13, 2012).

Bankers Trust Corporation and several affiliated corporations filed combined City Bank Tax returns for the years 1986, 1987, and 1993 (the "years in issue"). They reported interest income that Bankers Trust Company ("BT") had received from affiliated corporations not included in those returns, including non–U.S., lower-tier companies (called the "Indirect Subsidiaries" in

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the Tribunal decision), owned through several "Intermediate Subsidiaries." The corporate structure was made necessary by the laws and regulations of the various jurisdictions in which these corporations did business, as well as by the Edge Act, 12 U.S.C. ch. 6, subch. II, and served to insulate and protect BT's assets.

Deductions were claimed for 17% of the interest income paid by all subsidiaries as interest income from subsidiary capital. On audit, the Department of Finance allowed the 17% deduction to the extent the interest was paid by first-tier subsidiaries, but disallowed a deduction for the rest.

The City Tribunal Decision. Administrative Code § 11-641(e)(11)(i) allows a deduction under the City bank tax for 17% of interest income from subsidiary capital. "Subsidiary capital" is defined as "investments in the stock of subsidiaries and any indebtedness from subsidiaries. . . ." A "subsidiary," in turn, is "a corporation or association of which over fifty percent of the number of shares of stock entitling the holders thereof to vote for the election of directors or trustees is owned by the taxpayer."

These provisions were enacted by the State Legislature in 1985 as part of a major overhaul of the taxation of banks. The City Tribunal found that, while the relevant definition of "subsidiary" refers to voting stock "owned by the taxpayer," elsewhere in the same legislation the State Legislature used different language in establishing stock ownership requirements for other purposes. For example, the definition of a banking corporation includes "any corporation sixty-five percent or more of whose voting stock is owned or controlled, *directly or indirectly*," by certain other types of banking entities, Code § 11-640(a)(9), Tax Law § 1452(a)(9); and the statute requires the filing of combined returns if a banking corporation "owns or controls, *directly or indirectly*" the stock of another corporation. Code § 11-646(f)(2); Tax Law § 1462(f)(2).

The Tribunal noted that where different language was used, the Court of Appeals has held that "'courts may reasonably infer that different concepts are intended,'" and therefore that the State Legislature intended the word "owned" in the definition of subsidiary for purposes of the 17% deduction to mean something different from "owned or controlled . . . directly or indirectly." Instead, the City Tribunal determined that the test for "ownership" for purposes of the 17% deduction was "actual beneficial ownership," as set forth in the City's regulation, 19 RCNY § 11-46(b).

BT argued that it had demonstrated actual beneficial ownership, primarily relying on *Matter of The Racal Corp. and Decca Elec. Inc.*, DTA No. 807361 (N.Y.S. Tax App. Trib., May 13, 1993); and *Matter of Bankers Trust NY Corp.*, DTA No. 811316 (N.Y.S. Tax App. Trib. March 14, 1996) ("*Bankers Trust I*"). In *Racal*, the New York State Tax Appeals Tribunal addressed 20 NYCRR §3-6.2, relating to the definition of a subsidiary under the State corporation franchise tax, and applied it to stipulated facts, including the fact that intermediate corporations in the chain were inactive shell corporations, and that the party claiming the deduction "had absolute control over" the election and removal of the subsidiaries' operations and their officers and directors. The City Tribunal held that the decision in *Racal* merely stood for the proposition that, where a corporation controls all aspects of a remote subsidiary's operations and management, beneficial ownership is established, and that those facts were stipulated in *Racal*. It also held that *Bankers Trust I* confirmed that, in order to establish beneficial ownership, an indirect shareholder "must prove a degree of control over that subsidiary beyond…power to control the voting of the shares, board membership and personnel of the lower-tier subsidiary through a chain of ownership."

THE CITY TRIBUNAL HELD THAT THE DECISION IN *RACAL* MERELY STOOD FOR THE PROPOSITION THAT, WHERE A CORPORATION CONTROLS ALL ASPECTS OF A REMOTE SUBSIDIARY'S OPERATIONS AND MANAGEMENT, BENEFICIAL OWNERSHIP IS ESTABLISHED.

The City Tribunal found that BT had failed to submit sufficient proof that it so controlled the Indirect Subsidiaries to come within the rule of *Racal* or *Bankers Trust I*. While BT introduced evidence concerning four specific transactions, the Tribunal found that each transaction was initiated by local personnel, the manner of the transactions was often dictated by local regulatory requirements, and that there was not sufficient testimony based on actual personal knowledge to demonstrate complete beneficial control of those transactions or the Indirect Subsidiaries in general. Therefore, the City Tribunal found that BT did not prove that it "possessed or exercised sufficient control over the Indirect Subsidiaries to be considered the actual beneficial owner of those entities."

The First Department Decision. The Appellate Division, in a brief opinion, affirmed the City Tribunal's decision, which it found was based on "a rational interpretation" of the statutes. It also held that the two State cases cited by BT did not require a different result, since in *Racal* the parties had stipulated that the direct parent of the indirect subsidiary was a "'paper' entity

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that performed no business," so there was no real issue that beneficial ownership existed, and in *Bankers Trust I*¸ the taxpayer had failed to introduce enough evidence to allow the criteria to be applied. The appellate court found that BT's control of the Remote Subsidiaries was through the Intermediate Corporations, which were fully functioning entities, and therefore the Tribunal's decision that BT was not the beneficial owner was rational.

Additional Insights. At the time of the decision in 1993, *Racal* was seen as potentially having a significant effect on the treatment of second-tier and more remote subsidiaries. In fact, there seem to be few decided cases in which relief was actually granted. In addition to the fact that both the State and City regulations were quickly amended, so that they now both provide that "[a]ctual beneficial ownership of stock does not mean indirect ownership or control of a corporation through a corporate structure consisting of several tiers and/or chains of corporations," 20 NYCRR §§ 3-6.2(b), 16-2.22; 19 RCNY § 11-46(b), the burden of proving actual beneficial ownership of remote subsidiaries can be substantial. In *Racal* itself, that issue was stipulated, but on the facts of the instant case, the City Tribunal found that the taxpayer had not met its burden of showing complete control, and the appellate court let the decision stand.

Tribunal Upholds Denial of Investment Tax Credit Claimed by Utility

By Irwin M. Slomka

The New York State Tax Appeals Tribunal has upheld the denial of a New York State investment tax credit claimed by a public utility on the grounds that the property in question — the utility's system of pipes, mains, and equipment — was principally used for the distribution and delivery of natural gas, and not for gas production or processing as required for claiming the credit. *Matter of Brooklyn Union Gas Co. and Keyspan Gas East Corp.*, DTA Nos. 822692 & 822693 (N.Y.S. Tax App. Trib., March 8, 2012). The decision illustrates the potential uncertainty in determining when property is considered to be used in "production" for purposes of the credit.

The taxpayers, Brooklyn Union Gas and Keyspan, were both public utilities engaged in the distribution and sale of natural gas to customers in New York State, principally in New York City and Long Island. Until 2000, they were subject to Article 9, which does not permit a investment tax credit ("ITC"). Beginning in 2000, however, they became subject to Article 9-A, which does permit an ITC.

A taxpayer is entitled to claim an ITC against its Article 9-A tax liability, generally at the rate of five percent of the first $350 million of its cost or other basis in "qualified property." Qualified property consists of tangible personal property that is (i) depreciable under IRC § 167, (ii) has a useful life of at least four years, (iii) is acquired by "purchase" as defined in IRC § 179(d), (iv) is sitused in New York State, and (v) among other things, is principally used in the production of "goods" by manufacturing or processing. Tax Law § 210.12(b)(i). The first four requirements were met, and it was agreed that natural gas constitutes "goods" for ITC purposes. The only issue was whether the claimed property was principally used to produce natural gas by manufacturing or processing within the meaning of the Tax Law.

The property in issue was the utilities' pipes and mains, and machinery and equipment, through which the natural gas flowed to their customers. The Tribunal decision goes into some detail, not repeated here, regarding the manner in which the ITC was claimed, including a discussion of the assets, supporting asset schedules, and the taxpayers' sampling methodology for the ITC claims. The majority of assets on which ITC was claimed, whether measured by cost or size, was the installed cost of underground gas piping (*i.e.*, pipes and mains). Out of the total ITC base of $904 million of costs, the portion attributable to these mains was approximately $750 million. The remainder related to equipment, such as gas purification equipment and gas odorizing equipment.

The taxpayers argued that theirs was an "integrated system" for the production or processing of natural gas, and the fact that they also transported the gas did not disqualify the assets from ITC. The Department's position was that the utilities' gas distribution system was not principally used in the production or processing of natural gas, and the Department denied the ITC claims. Following a hearing, an Administrative Law Judge held that ITC was properly denied because, in his view, what the utilities were operating was an integrated gas "delivery" system, and not a gas "production" system.

The Tribunal has now affirmed the denial of the ITC. The Tribunal found that the evidence indicated that the utilities operated "distribution and delivery channels," and that the pipes and mains did not materially change the gas, but merely served as conduits for the gas to be delivered to customers.

The utilities argued that even though the pipes and mains were not themselves "production equipment," they were "a necessary

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part of an integrated system consisting of certain production components," such as gas purifiers and equipment that added odor to the gas as required by law. The Tribunal found that, whether in terms of size or cost, the portion of the ITC claims attributable to such equipment was relatively small.

The taxpayers also argued that the Tribunal's analysis in *Matter of B.R. DeWitt*, *et al*., DTA Nos. 806601, *et al*., (N.Y.S. Tax App. Trib., Sept. 19, 1991) supported their position that it was necessary to evaluate the relationship of the pipes and mains to their gas processing process. *DeWitt*, a sales tax case that did not involve the ITC, dealt with whether a concrete manufacturer's purchases of concrete mixer trucks were exempt from sales tax as production machinery and equipment under Tax Law § 1115(a)(12). In *DeWitt*, the Tribunal held that the fact that the trucks were used to transport concrete did not necessarily disqualify them from the production activity exemption under the sales tax, stating that "the correct analysis requires an evaluation of the equipment *in the context in which it is used* " (emphasis added). The Tribunal ultimately concluded in *DeWitt* that the trucks were "intimately and directly connected with the process of producing concrete," and thus qualified for the production equipment exemption.

THE TRIBUNAL . . . [NOTED] THAT ALL OF THE UTILITIES' EQUIPMENT WAS "PRIMARILY AND HARMONIOUSLY INVOLVED IN THE TRANSPORTATION OF GAS," AND NOT THE PRODUCTION OR PROCESSING OF GAS.

In the instant case, the utilities similarly argued that the pipes and mains were being indirectly used in processing natural gas. The Tribunal rejected this argument, noting that all of the utilities' equipment was "primarily and harmoniously involved in the transportation of gas," and not the production or processing of gas. While the Tribunal acknowledged that certain equipment did alter the natural gas in essential ways for consumer use, most of these alterations were to counteract changes resulting from the storage and transportation of the gas, and not to significantly change it from how it was originally received. This, the Tribunal held, was not "processing," which required that the essence of the underlying product be changed.

Additional Insights. While the Tribunal is correct that the utilities were distributing natural gas to their customers, they were also engaged in the necessary processing of the gas through purification, odor additions, and pressure adjustment. The pipes and mains were undoubtedly a necessary element for carrying out those activities, seemingly no less so than the cement mixer trucks which the Tribunal in *DeWitt* found to be a necessary element of the production of concrete. Yet even if the pipes and mains did not qualify for ITC, it would appear that ITC should have been allowed at least for the portion of the costs relating to the equipment actually used for such processes as gas purification and adding odor to the gas.

One interesting side note was the Tribunal's conclusion — which had no impact on the denial of the ITC claims — that had the pipes, mains and equipment constituted qualifying property, the taxpayers would have been entitled to claim ITC even for property acquired and placed in service in an earlier year, when the utilities were subject not to Article 9-A, but to Article 9, which does not permit an ITC. According to the Tribunal, the fact that property may not be eligible when placed in service does not preclude it from becoming eligible in a later year. However, since the Tribunal held that the property was not qualifying property, this conclusion did not affect the outcome of the decision.

Tribunal Holds That Executive Officer Is Liable for Unpaid Taxes

By Hollis L. Hyans

In *Matter of David Steinberg*, DTA No. 822971 (N.Y.S. Tax App. Trib., Feb. 23, 2012), the State Tax Appeals Tribunal affirmed the decision of an Administrative Law Judge (covered in the November 2010 issue of *New York Tax Insights*) that the founder and Chief Executive Officer of a publicly traded company was personally liable for the company's outstanding sales and use tax. The Tribunal has thus confirmed that, even in a large company with many employees and outside professional advisors, senior executives should not lose sight of the risk of responsible person liability.

In *Steinberg*, the petitioner was the founder of InPhonic, Inc., an online phone and service provider that sold devices and accessories, and managed branded portals on behalf of the major telephone carriers. Before 2004, InPhonic 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

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approximately 15% and later to approximately 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 with respect to the operations of InPhonic, and 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 as 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.

While conceding his ultimate authority over the company's operations, Steinberg argued 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 functions were handled by different outside firms, and that his direct interaction with the operating finance employees was "discouraged if not prohibited."

THE TRIBUNAL DECISION IN *STEINBERG* IS AN IMPORTANT REMINDER THAT SENIOR CORPORATE EXECUTIVES, EVEN THOSE WITH LARGE STAFFS AND PROFESSIONAL OUTSIDE ADVISORS UPON WHOM THEY RELY, CAN END UP WITH PERSONAL LIABILITY FOR UNPAID SALES TAXES.

The Tribunal held that the ALJ had properly found Steinberg a responsible person, and rejected Steinberg's argument that he was not a responsible person because he relied upon those who reported to him, including the CFO and outside auditors. The Tribunal found that Steinberg had not introduced any evidence of restrictions or limitations on his corporate powers, or shown any specific instances in which he was hindered in carrying out his corporate powers. The Tribunal found that he "still had complete authority to review the books and records, as well as to monitor the actions of the persons to whom he delegated responsibility, if he chose to do so."

Additional Insights. New York law provides that personal liability for unpaid sales or use tax may be imposed on responsible parties, including "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). Simply holding the title of corporate officer does not necessarily result in liability, and 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, and 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 well-established that someone who had sufficient authority to be considered a responsible person cannot delegate that responsibility.

The Tribunal decision in *Steinberg* is an important reminder that senior corporate executives, even those with large staffs and professional outside advisors upon whom they rely, can end up with personal liability for unpaid sales taxes. While neither the ALJ nor the Tribunal decision provides 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. 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 act but *could not* have ensured that the taxes were collected and remitted. In fact, even where a petitioner convinced an ALJ 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, the Tribunal reversed the ALJ and held that the petitioner had "sufficient authority to compel compliance with sales tax obligations." *Matter of Frank A. Marchello*, DTA No. 821443 (N.Y.S. Tax App. Trib. Apr. 14, 2011).

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Real Estate Consulting Services Not Subject to Sales Tax

By Kara M. Kraman

The Department of Taxation and Finance has ruled that a real estate consultant's services are not subject to New York State or local sales or use tax. *Advisory Opinion*, TSB-A-12(4)S (N.Y.S. Dep't of Taxation & Fin., Mar. 2, 2012). In reaching its conclusion, the Department specifically considered the possible applicability of the tax on information services and the tax on the maintenance, repair, or servicing of real property.

The consultant planned to provide various services to landlords, developers, and purchasers of commercial properties. Among the anticipated services were locating properties for sale; assisting clients in obtaining financing; developing opportunities to increase revenue and decrease expenses; reviewing, hiring and firing of employees at building sites; dealing directly with the client's on-site property manager; and developing custom analyses including cash flow spreadsheets of historical performance and financial projections.

In general, consulting services are not one of the enumerated services subject to sales or use tax. Therefore, in determining whether the consultant should collect sales tax from its clients, the Department analyzed whether the services fell into one of two taxable categories, information services taxable under Tax Law § 1105(c)(1), or real property maintenance and repair services taxable under Tax Law § 1105(c)(5).

The Department concluded that although the consultant would compile and analyze information and provide reports to clients, such information services were non-taxable under Tax Law § 1105(c)(1) because the information will be individual in nature and not included in written reports furnished to any person other than the client.

The Department also ruled that none of the consultant's anticipated services would be from servicing, maintaining, or repairing real property, and therefore would not be subject to sales tax under Tax Law § 1105(c)(5). Although the consultant would deal with the on-site property managers who *do* provide taxable repair and maintain services with respect to the client's real property, the consultant would neither perform those services nor contract with any service provider to perform those services. Accordingly, the Department found that none of the real estate consultant's services will be subject to sales or use tax.

Additional Insights. The Advisory Opinion illustrates that although consulting services generally are not subject to sales tax, specific services rendered in the course of providing consulting services may be subject to the sales tax. While in this instance none of the components of those consulting services were found to be taxable, it is always prudent to examine the specific services that constitute "consulting services" to make sure they do not trigger a sales tax obligation.

Department to Propose Amendments to Article 9-A Combined Return Regulations

By Irwin M. Slomka

Officials at the Department of Taxation and Finance have confirmed that they expect to propose in the coming weeks amendments to the Article 9-A combined return regulations. The amendments will contain guidance with respect to legislation enacted in 2007 that significantly changed the circumstances under which combined returns with related entities are required under Article 9-A. For tax years beginning on or after January 1, 2007, the Tax Law requires that combined returns include related corporations for any taxable year where there are substantial intercorporate transactions between the entities, regardless of the transfer price of those transactions.

It is expected that the proposed regulation amendments will be substantially similar to draft amendments that the Department circulated to professional organizations for preliminary comment in October 2008. That draft addressed the definitions of the terms "related corporation" and "substantial intercorporate transactions," which are expected to be the main focus of the upcoming proposed amendments.

The regulation amendments are long overdue. The current regulations still reflect the pre-2007 law, and there has been no guidance issued on the 2007 legislation since the Department's release of *Combined Reporting for General Business Corporations (including Real Estate Investment Trusts and Regulated Investment Companies) and Insurance Corporations*, TSB-M-08(2)C (N.Y.S. Dep't of Taxation & Fin., Mar. 3, 2008). Once the amendments are proposed, there will be a period for public comment.

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New York Continues to Find Access Charges for Businesses Operating via the Internet Subject to Sales Tax

By Open Weaver Banks

In an *Advisory Opinion*, TSB-A-12(3)S (N.Y.S. Dep't of Taxation & Fin., Feb. 27, 2012), the Department of Taxation and Finance ruled that annual subscription fees for accessing a global network of data pools are subject to sales tax as the sale of prewritten software.

The Petitioner in the *Advisory Opinion* operates a data pool, which is certified as compliant with the Global Data Synchronization Network ("GDSN"). Petitioner's certified data pool ("CDP"), which is essentially an electronic catalogue of standardized item data, captures information in a hosted, online application about products in the supply chain for suppliers, distributors, and retailers (all referred to in the *Advisory Opinion* as "trading partners"). Petitioner's CDP serves as both a source and a recipient of master data and is one of many CDPs around the world.

Petitioner charges the trading partners a standard annual subscription fee for accessing the GDSN, a network that connects participating data pools around the world to the "GS1 Global Registry" for the purpose of enabling trading partners to exchange accurate and standards-compliant data. Subscription fees are based on the number of products registered within the CDP.

Petitioner's software runs the CDP and resides on a server located outside of New York. Trading partners have access to the CDP anywhere there is an Internet connection. Petitioner's contract with its trading partners grants the trading partners a limited license to access Petitioner's system and proprietary information required for the trading partner's use of Petitioner's system and participation in the GDSN, which also includes a limited sublicense to all third-party software and applications employed or otherwise embedded in the Petitioner's system or service.

In order to use the Petitioner's system, a trading partner must first obtain an annual subscription from Petitioner. Supply-side trading partners then use the system by entering their product information into the CDP. One method of entering this information is by uploading a Microsoft Excel spreadsheet that can be downloaded from the Petitioner's website to facilitate a batch upload from the supplier. The CDP then registers this information with the Global Registry.

Sell-side/retail trading partners access the information contained within a CDP to make purchasing, inventory, logistics, and other supply chain decisions. A sell-side/retail trading partner will send a subscription request to a CDP and request to receive product information.

Once the sell-side/retail trading partner submits the request to a CDP, that CDP will forward the request to the Global Registry. The Global Registry will identify the data pool to which the vendor subscribes and forward the subscription request to the vendor's CDP. The supply-side trading partner will confirm the request and identify that retail trading partner as approved to share product information. A sell-side/retail trading partner may only access information related to products or vendors which have been requested and approved. Both supply-side trading partners and retail trading partners can also generate online reports pertaining to their information uploaded to the CDP and the status of responses.

In New York, prewritten computer software is considered tangible personal property, the sale of which is subject to sales tax regardless of the medium by which the software is conveyed to a purchaser. Tax Law § 1101(b)(6). For purposes of determining whether a taxable transfer of the software has occurred, the Department's regulations provide that actual or constructive custody or possession of property, as well as the right to use, or control, or direct the use of, tangible personal property, constitutes a transfer of possession that is subject to sales tax. 20 NYCRR § 526.7(e)(4).

THE DEPARTMENT HAS RULED THAT . . . ANNUAL SUBSCRIPTION FEES FOR ACCESSING A GLOBAL NETWORK OF DATA POOLS ARE SUBJECT TO SALES TAX AS THE SALE OF PREWRITTEN SOFTWARE.

Relying on this regulation, the Department concluded in the *Advisory Opinion* that because the trading partners have the right to use Petitioner's software to upload information to the data pool and to view information on the data pool, and because trading partners can use the software to send a subscription request and to run reports, the subscription charge represents a sale of prewritten software that is taxable. Additionally, the situs of the sale for purposes of determining the local tax rate and jurisdiction is the location of the trading partner or its agents or employees who use the software.

Additional Insights. The *Advisory Opinion* is the latest in a series of opinions dating back to November 24, 2008, when the Department advised Adobe Systems, Inc. that charges for access to its ASP software were subject to sales tax as prewritten software that is accessed remotely. *See Adobe Systems, Inc.*, TSB-A-08(62)S

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Charges for Businesses Operating via the Internet

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(N.Y.S. Dep't of Taxation & Fin., Nov. 24, 2008). Perhaps because the Department's position is so difficult to reconcile with traditional notions of what it means to transfer tangible personal property, businesses continue to ask the Department to consider the same or similar issues and the Department continues to give similar answers. For example, in *Homecare Software Solutions LLC*, TSB-A-09(25)S (N.Y.S. Dep't of Taxation & Fin., June 18, 2009), the Department advised that charges for a homecare agency's use of an online service for finding subcontractors and exchanging information with subcontractors are taxable receipts from sales of prewritten software. Similarly, the Department found fees for online payroll processing services to be subject to sales tax as sales of prewritten software in *National Football League*, TSB-A-09(37)S (N.Y.S. Dep't of Taxation & Fin., Aug. 25, 2009). In all of its rulings the Department stresses that the location of the code embodying the software is irrelevant, because the software can be used just as effectively by the customer even though the customer never receives the code on a tangible medium or by download.

IN ORDER TO PROVIDE THE SERVICE FOR WHICH A CUSTOMER IS PAYING, IS THE *SUPPLIER* "USING" THE PETITIONER'S SOFTWARE, OR IS THE PETITIONER USING ITS OWN SOFTWARE TO PROVIDE THE SERVICE?

To date, there are no published decisions either upholding or overruling the Department's interpretation, although its position is subject to attack on multiple grounds. The most commonly voiced objection is that remote access to software should not be equated to a transfer of the software to the customer. Businesses can also challenge what it means to "use" or "possess" software. When a supplier referenced in this *Advisory Opinion* uploads a Microsoft Excel spreadsheet to the Petitioner's data pool, the supplier is clearly using Microsoft Excel, as well as its own computer hardware and software, to complete the upload. In order to provide the service for which a customer is paying, is the *supplier* "using" the Petitioner's software, or is the Petitioner using its own software to provide the service? The better answer is that the Petitioner is using its own software and the Internet to provide its service to the supplier.

While the Department relies heavily on its regulations to support the notion of the customer's "constructive possession" of the software, those regulations have not been amended since 1994 and were not written with remote access software or cloud computing in mind. However, the regulations include an example that suggests that remote access to software should not be considered a transfer of possession that gives rise to sales tax:

> A corporation contracts with a computer center for access time on the computer center's equipment through the use of a terminal located in the corporation's office. The terminal is connected to the computer by telephone. The corporation's access to the computer through the terminal is not deemed to be a transfer of possession of the computer subject to tax. However, the transaction may be taxable based on the information provided to the customer.

20 NYCRR § 526.7, Example 14.

In this example, mere access to a remote computer (and presumably the software necessary to make the computer useful) is *not* deemed to be a transfer of possession that is subject to sales tax. The tax consequences should not be any different when the supplier in the *Advisory Opinion* remotely accesses the Petitioner's software to upload data.

State Tribunal Announces Policy Changes to Expedite Hearings

By Irwin M. Slomka

The New York State Tax Appeals Tribunal has recently begun notifying taxpayers of certain policy changes to help reduce a backlog of cases at the Division of Tax Appeals. The new procedures are as follows:

- In every instance, the first pre-hearing conference (usually by telephone) will now be scheduled two weeks after the case has been assigned to an Administrative Law Judge ("ALJ"), which takes place after the Department files its Answer in response to a Petition.
- During the initial pre-hearing conference with the ALJ, the parties will be advised that they have 30 days to narrow issues and "exchange pertinent documents." The parties will also be advised that a second conference will take place in 30 days, at which time the parties will be expected to set a hearing date.
- At the second conference, the parties will be expected to pick a "firm" hearing date, allowing sufficient time for witness gathering,

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hearing preparation, and any settlement discussions. Once a hearing date is set, adjournments will not be permitted in the absence of a compelling reason. Adjournments to pursue settlement discussions will not be permitted, "unless it is for only a few days to get stipulations signed" (presumably, referring to stipulations of discontinuance).

- Where parties wish to place a case on hold pending the outcome of another case at the Tribunal or Article 78 level, the case will only be placed on hold if the parties "agree in writing to be bound by the outcome of that prior case."

Additional Insights. The Tribunal points out that this policy change is being made in order to reduce a backlog of cases in recent years. The setting of "firm" hearing dates is an attempt to address what the Tribunal describes as "a development in recent years whereby the setting of a hearing date has been viewed as only tentative in nature." Any initiative that allows cases to proceed expeditiously to hearing is welcome, and is consistent with the Division's stated purpose to provide a "clear, uniform, rapid, inexpensive and just system of resolving controversies." 20 NYCRR § 3000.0(a). Nonetheless, we are hopeful that the ALJs will retain some flexibility to deviate from these new procedures in extraordinary circumstances.

Insights in Brief

Elimination of One-Week Stay Requirement for Bungalow Rentals

In TSB-M-12(4)S (N.Y.S. Dep't of Taxation & Fin., Mar. 16, 2012), the Department of Taxation and Finance announced the elimination of the requirement in the sales tax regulations, Section 527.9(e)(5), that, in order not to be subject to sales tax, rentals of furnished living units limited to single-family occupancy, for which no maid, food, or other common hotel services were provided, also had to be for at least one week As reported in the July 2011 issue of *New York Tax Insights*, an Administrative Law Judge held last year that the one-week stay requirement exceeded the statue and was invalid. *Matter of Old Forge Kampgrounds, LLC*, DTA No. 823254 (N.Y.S. Div. of Tax App., June 2, 2011). The Department has now decided to accept this conclusion and eliminate the one-week requirement.

Fluid Injected into Knees Exempt from Sales Tax

In an *Advisory Opinion* TSB-A-12(1)S (N.Y.S. Dep't of Taxation & Fin., Feb. 9, 2012), the Department of Taxation and Finance found that a substance called Synvisc is exempt from sales tax under Tax Law § 1115(a)(3) as a product consumed by humans for the preservation of health. Synvisc, produced from chicken combs, is used in the treatment of osteoarthritis; it is injected into patients' knees to supplement the knee fluid, relieve pain, and improve the knee's shock-absorbing abilities. Even though Synvisc is not recognized as a drug, and is classified by the Food and Drug Administration as a device, the Department found that Synvisc, when injected into the knee, "supplements the knee's synovial fluid…and thereby maintaining the patient's mobility," and thus qualified as an exempt product.

Clothing Exemption Returns to $110

Beginning April 1, 2012, clothing and footwear sold for less than $110 per item (or pair of footwear) is exempt from the State's 4% sales and use tax, and from ⅜% sales tax in those localities in the Metropolitan Commuter Transportation District that provide for the exemption. Countries and cities can elect whether to permit a similar exemption from their local sales tax. From April 1, 2011 through March 31, 2012, the exemption applied only to items sold for less than $55. Transitional rules are laid out in TSB-M-12(3)S (N.Y.S. Dep't of Taxation & Fin., Mar. 6, 2012), and a complete description of the clothing and footwear exemption, along with a list of exempt and taxable items, was included in TSB-M-06(6)(S) (N.Y.S. Dep't of Taxation & Fin., Mar. 29, 2006).

Individual's Gambling Activities Considered a Trade or Business for State Income Tax Purposes

The Department of Taxation and Finance has issued an Advisory Opinion ruling that an individual's full-time gambling activities in betting on thoroughbred horse racing, when undertaken in New York, would be considered a trade or business for New York State income tax purposes. *Advisory Opinion*, TSB-A-12(2)I (N.Y.S. Dep't of Taxation & Fin., Feb. 27, 2012). The Department applied the same factors that are used in making that determination for federal income tax purposes. However, the Department was unwilling to answer "with certainty" whether it would reach the same conclusion if the individual were to later secure additional full-time outside employment.