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NYC ALJ Holds That Consulting Firm May Source Receipts Based on Location of Independent Contractors

By Irwin M. Slomka

The nature of the services performed by a corporation, and how that corporation should source its receipts from those services for New York City general corporation tax purposes, are the subjects of an interesting recent decision of a New York City Administrative Law Judge. The ALJ held in favor of the taxpayer that it was engaged in the performance of consulting services, and could source receipts from those services based in part on the location of independent contractor consultants who performed the services. *Matter of Gerson Lehrman Group, Inc.*, TAT(H) 08-79(GC), *et al.* (N.Y.C. Tax App. Trib., Admin. Law Judge Div., Oct. 4, 2016).

Services Provided by the Taxpayer. Gerson Lehrman Group, Inc. ("GLG"), headquartered in New York City and with offices throughout the world, provides consulting services to clients. It engages expert "consultants"— typically, medical doctors, research scientists, engineers, and attorneys — as independent contractors who provide the expertise sought by GLG's clients. Those clients worked with GLG's employee "research managers" to identify the appropriate consultants, focus on research questions, and obtain expert views. GLG's employee "consultant managers" recruited and managed the independent consultants, who were selected from GLG's computer database of as many as 283,000 potential experts.

GLG entered into subscription agreements with clients, generally for periods of up to one year. Clients made non-refundable lump sum payments to GLG in exchange for access to its industry knowledge and expertise. GLG paid the independent contractor consultants. GLG obtained clients through the efforts of its salaried salespeople, the vast majority of whom worked in New York City. The agreements stated that GLG "helps clients find, engage, and manage experts . . . through [its] network of industry [consultants]." The agreements also provided that GLG was "not responsible for the content of Projects or the quality of [consultant] services." GLG's clients obtained expert information either through telephone conference calls, written research reports or seminars and expert round tables. In most cases, conference calls were made and written reports were prepared at the consultants' homes or offices.

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GCT Filings and Audit. The case spanned a seven-year period during which GLG changed the manner in which it sourced its lump sum business receipts. In its originally filed general corporation tax ("GCT") returns for 2003 and 2004, GLG sourced those receipts in its receipts factor based on the office locations of its salespeople. This resulted in New York City receipts factors of 96% (in 2003) and 77% (in 2004). GLG later filed amended GCT returns using a different methodology, this time based on a blend of (i) the locations of its independent contractor consultants and (ii) the locations of its employee research and consultant managers, but not its salespeople. This reduced its reported receipts factor to approximately 40% in each year, resulting in refund claims.

[I]t was appropriate to source the receipts in question based on the locations of both the independent consultants and the employee research managers . . . .

For the years 2005 through 2010, GLG filed its GCT returns using the same receipts factor methodology as it did in its amended GCT returns for 2003 and 2004. Following an audit, the Department issued Notices of Determination asserting additional tax by applying GLG's original sourcing methodology, sourcing receipts based on the location of its salespeoples' offices, and not based on where the work was performed.

The Department maintained that under GCT Regulation § 11-65(b)(1), the efforts of independent contractors may only be considered where they generate receipts for the taxpayer. According to the Department, GLG generated receipts not from the independent contractors, but rather from the efforts of its salaried salespeople who sold subscriptions to clients.

Under the GCT, receipts from the performance of services are generally sourced based on where the service is performed. Admin. Code § 11-604(3)(a)(2). The parties disagreed about what service GLG was actually providing to its clients. GLG contended that it was providing a consulting service through its employee research managers and the independent expert consultants. The Department argued that GLG's service was simply to locate the appropriate expert, and that it was GLG's salespeople who were responsible for generating GLG's business receipts.

Refund Claims. GLG also raised alternative refund claims for the years 2005 through 2010, based on a receipts factor that considered either (i) the location of its employee research managers and independent consultants, or (ii) only its independent consultants. No formal refund claims were actually filed, only refund claim summary schedules.

Holding. The ALJ held that GLG was engaged in the service of providing "expert knowledge, analysis and views," which it rendered through independent consultants with the assistance of its employee research managers. Under GCT Regulation § 11-65(b)(3)(i), lump sum payments for services are sourced based on "the relative values of, or amounts of time spent in the performance of, such services . . . ." Thus, it was appropriate to source the receipts in question based on the locations of both the independent consultants and the employee research managers, the individuals who performed the services.

The ALJ rejected the Department's reliance on several Article 9-A Advisory Opinions, finding that they were either irrelevant or were based on a "generation of income" analysis that the ALJ found unsupported by the statute or regulations. The ALJ also found unpersuasive the Department's claim that since GLG received a lump sum payment from clients at the outset of the subscription period, the receipts were generated without regard to the amount of expert services actually used. The ALJ reasoned that since the regulations provide that the location of payment of receipts is immaterial with regard to sourcing, the timing of the payment is also irrelevant. The ALJ also held that there was no authority to source receipts based on the location of GLG's salespeople, noting that under the GCT regulations only the activities of *commissioned* sales agents are relevant, and here GLG's salespeople were salaried employees. Thus, the ALJ held that the Notices of Determination should be cancelled.

However, the ALJ rejected the taxpayer's alternative refund claims. One such refund claim (totaling $2 million) was held to be incorrect since it only took into account the location of the independent consultants, without considering the location of the GLG's employee research managers who also provided the services. As for the alternative refund claims that were purportedly based on the location of both, the ALJ concluded that the taxpayer failed to substantiate the claims, despite being given the opportunity to do so after both the hearing and briefing were completed.

Additional Insights

It is somewhat surprising that there is little New York City precedent on the sourcing of receipts from services that are performed in part by a taxpayer's

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independent contractors. The decision reaches a reasonable result since it was clear that GLG was performing services for its clients, in part by utilizing the services of its independent consultants, and was not merely acting as a "middleman" to procure expert consultants for clients as the Department had argued. Interestingly, the decision rejects the approach taken by the New York State Department of Taxation and Finance in certain Advisory Opinions (*see, e.g., Petition of Alan Langer*, TSB-A-92(9)C (N.Y.S. Dep't of Taxation & Fin., May 20, 1992), which in sourcing receipts considered only those activities by the taxpayer that actually "generated" the receipts in question. The decision does not discuss how GLG actually sourced the receipts in its Article 9-A returns in light of those Advisory Opinions, possibly because it was not in the evidentiary record. An exception has been filed with the New York City Tax Appeals Tribunal seeking review of the decision.

The sourcing issue in *Matter of Gerson Lehrman* is no longer a continuing issue for most corporations in New York City. For tax years beginning after 2014, under New York City corporate tax reform — applicable except with respect to S corporations, which remain subject to the GCT— receipts of the type in question are sourced based on customer location and not where the services are performed.

Appellate Court Upholds Denial of QEZE Exemption from Sales Tax

By Hollis L. Hyans

Affirming the decision of the New York State Tax Appeals Tribunal, the Appellate Division, Third Department, held that vending equipment stored and stocked at a facility within an Empire Zone did not qualify for a sales tax exemption because it was not used primarily within the Empire Zone. *American Food & Vending Corp. v. New York State Tax Appeals Tribunal*, No. 522043 (App. Div. 3d Dep't, Nov. 3, 2016).

Facts. American Food & Vending Corporation ("AFVC") is a New York corporation that provides food and refreshment services to educational institutions, sports arenas, hospitals and other businesses. Its principal place of business was in Onondaga County within an established Empire Zone. In 2003, the corporation was certified as a qualified Empire Zone enterprise ("QEZE") and received a QEZE sales tax certification entitling it to sales and use tax exemptions on purchases of certain property to be used or consumed within Empire Zones. AFVC ordered vending machines from out-of-state suppliers, and had them delivered to its facility located in the Empire Zone. Generally, new machines were held in inventory for 30 to 45 days. When machines were needed for delivery to customer locations, they were unpacked, inspected, tested and programmed, loaded with food products, and placed on trucks for delivery to and installation at customer locations by AFVC employees. The preparation process took about two and a half hours. The products sold in the vending machines were warehoused at AFVC's facility and were delivered to the customer locations by AFVC drivers, who collected the cash from the machines and returned it to the accounting department at the facility. Once installed at customer locations, machines usually remained there for the remainder of their useful life, about 10 to 15 years.

The Third Department [found] that the activities conducted by AFVC at its facility . . . added little or no value and that the majority of the machines' usefulness to AFVC occurs outside the facility . . . .

Issues and Decisions Below. After an audit for the years 2007 through 2009, the Department sent AFVC a Notice of Determination, imposing sales tax on the vending machines that had been purchased by AFVC without payment of the tax. The applicable statute, former Tax Law § 1115(z)(1), provided for an exemption from tax for "tangible personal property . . . directly and predominantly . . . used or consumed . . . in an area designated as an empire zone . . . ." The Department claimed that the equipment did not qualify for the exemption because its predominant use was not in AFVC's facility, but instead was at the customer locations outside the Empire Zone. AFVC argued that the predominant use of the vending equipment occurred within its facility and that, in addition, its use of the equipment through its employees at customer locations in restocking and retrieving cash should be deemed a use within the Empire Zone, since the use was inextricably tied to its facility and, other than the restocking and cash retrieval, it was not using the machines at its customers' locations, but the customers themselves were using them.

An Administrative Law Judge sustained the sales tax assessment, and the Tax Appeals Tribunal agreed,

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defining the term "use" broadly and finding that AFVC's predominant use of the vending equipment occurred while it was deployed at customer locations outside the Empire Zone, and rejecting AFVC's assertion that the use of the equipment at customer locations was a use by its customers and not by AFVC. Noting that the Department has defined "predominantly" for purposes of the QEZE sales tax exemption as "50% or more," *see* TSB-M-02(5)S (N.Y.S. Dep't of Taxation & Fin., July 24, 2002), and that the definition was in accord with the common meaning of the term, the Tribunal found that AFVC's predominant use of the vending equipment occurred while such equipment was deployed at the customer locations and not while the equipment was being prepared in AFVC's facility.

Appellate Division Decision. The Appellate Division, Third Department, affirmed the decision of the Tribunal. Given the limited standard of review, which requires a Tribunal decision to be affirmed if it is "'rationally based upon and supported by substantial evidence . . . even if a different conclusion is reasonable,'" the Third Department found that the Tribunal properly concluded that AFVC had failed to meet its burden of demonstrating that it was entitled to an exemption. The court agreed with the Tribunal's broad definition of the word "use," and found that the Tribunal had properly concluded that AFVC's predominant use occurred outside the QEZE facility.

The Third Department also went on to consider AFVC's argument that the sale of foods at customer locations from vending machines that had been stocked with items once stored at the facility should be regarded as being a "direct" use at the facility as if AFVC had sold the food items directly to a customer from the facility. The Third Department rejected this argument, finding that the activities conducted by AFVC at its facility, while necessary for the machines to function, added little or no value and that the majority of the machines' usefulness to AFVC occurs outside the facility when used by customers. The court found AFVC's argument to be "too attenuated and wholly inconsistent with the entire purpose of the empire zone initiative."

Because AFVC was arguing for entitlement to an exemption, the Third Department concluded that AFVC had to prove not only that its construction of the statute was plausible, but that its interpretation was "the only reasonable construction," and that it had failed to do so. Since the court found that the Tribunal's determination was rational and supported by substantial evidence, the determination was upheld and the exemption was denied.

Additional Insights.

The standard applied to review of a Tax Appeals Tribunal decision by the Appellate Division requires the taxpayer to demonstrate that the Tribunal decision was either not supported by substantial evidence or that it was irrational and a clearly erroneous interpretation of the law or the facts. In addition, and as the Third Department noted, here AFVC was also arguing for application of an exemption from sales tax, and New York cases have repeatedly held that a taxpayer bears the burden of proving entitlement to an exemption. These are difficult standards to meet, and it appears that the Third Department accepted the Tribunal's rejection of AFVC's arguments trying to bring vending machine sales at remote locations around the state within the statutory definition of activities conducted "directly" and "primarily" at the facility where the machines were stored and the food items were loaded.

ALJ Rules That Sole Shareholder Is Not a Responsible Person for Sales and Use Tax Purposes

By Michael J. Hilkin

Facing a fairly unusual set of facts, a New York State Administrative Law Judge held that a "very young man with no business background or education" who was the sole owner and shareholder of a company was not a responsible person liable for sales and use tax owed by such company. *Matter of P.S.R.N., Inc., et al.*, DTA Nos. 826140 & 826413 (N.Y.S. Div. of Tax App., Nov. 3, 2016).

Facts. Ryan W. Nessing was an employee of H. Parkin Saunders, an interior design business. Mr. Nessing was also the president and sole shareholder of P.S.R.N., Inc. ("PSRN"), a purchasing company operated by H. Parkin Saunders.

Mr. Nessing "was under the direction and control of Mr. Saunders in all his dealings with PSRN." At the time that Mr. Nessing first became involved with PSRN, he was only 19 years old, had no business background or education, and was primarily working for H. Parkin Saunders by running errands, answering the telephone, and folding sample products. Mr. Nessing never received a salary or any remuneration or capital distribution from PSRN.

Testimony from another H. Parkin Saunders employee, supported by several documents in the

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record, established that both H. Parkin Saunders and PSRN were actually under the "complete control" of Mr. Parkin Saunders, and Mr. Saunders did not delegate duties to any of his employees (including Mr. Saunders' personal assistant and bookkeeper, who purportedly handled the business operations of PSRN). While Mr. Nessing signed checks, tax returns, and corporate documents for PSRN, he did so at the direction of Mr. Saunders. Further, Mr. Saunders directed Mr. Nessing to sign a shareholder resolution that elected Mr. Saunders as a director and chief executive officer of PSRN with responsibility over the corporate bank account, and Mr. Saunders transferred and withdrew money from the PSRN account.

The ALJ concluded that Mr. Nessing lacked such authority and control over PSRN, based on . . . evidence showing that Mr. Nessing was "under the direction and control" of Mr. Saunders in all of his dealings with PSRN.

PSRN filed various sales and use tax returns (many of which were signed by Mr. Nessing) without remitting tax. The Department subsequently issued PSRN several notice and demands related to such returns in 2010 and 2011 (the "PSRN Notices"), and also issued notices of determination to Mr. Nessing as a responsible person of PSRN on November 29, 2011 (the "Responsible Person Notices").

Thereafter, PSRN and Mr. Nessing apparently made partial payments related to the PSRN Notices and Responsible Person Notices and, on or about August 24, 2012, PSRN and Mr. Nessing filed an application for credit or refund of approximately $27,000 in sales and use tax (the "Refund Application"). The Refund Application provided no supporting documentation substantiating that the amount requested to be refunded was actually paid, but PSRN and Mr. Nessing nonetheless asserted that "moneys had been paid and that it was the [Department's] responsibility to know how much was paid."

The Refund Application included an explanation that Mr. Nessing "was young and naive when [PSRN] was put in his name" and "was being used without knowing or understanding what was being done in his name." The Department ultimately notified PSRN and Mr. Nessing that substantive consideration of the Refund Application would be deferred until the full amounts identified in the PSRN Notices and Responsible Person Notices were paid.

Separately, on or about February 14, 2014, PSRN and Mr. Nessing filed a petition seeking a redetermination or refund of the taxes set forth in the PSRN Notices; such petition was subsequently amended to also protest the Responsible Person Notices. Mr. Nessing contended that he was not a responsible person, and that despite his status as the sole shareholder of PSRN, he had no meaningful control over the business's affairs. Thereafter, through the research of a Department employee, it was determined that liabilities related to only one of the Responsible Person Notices issued to Mr. Nessing had been paid in full.

Tax Law. Tax Law § 1133(a) imposes upon any "person required to collect" sales and use tax personal liability for the tax imposed, collected, or required to be collected by a corporation. Persons "required to collect" sales and use tax are commonly referred to as "responsible persons," and are defined to include corporate officers and employees who are under a duty to act for such corporation in complying with the sales and use tax laws. The determination of whether a person is a responsible person for a corporation depends "on the particular facts involved." 20 NYCRR § 526.11(b)(2). This regulation specifically identifies factors to be considered when determining whether a person is a responsible person for a corporation, including whether such person was authorized to sign the corporate tax return, was responsible for managing or maintaining the corporate books, or was permitted to generally manage the corporation.

The Decision. The ALJ first determined that he lacked jurisdiction over the PSRN Notices and all but one of the Responsible Person Notices because: (1) no hearing rights attached to the PSRN Notices because such notices related to sales and use tax that was self-assessed on returns filed by PSRN; (2) the period during which the Responsible Person Notices could be challenged without paying such notices had closed; and (3) only a refund claim related to a Responsible Person Notice that was paid in full may be considered by the Division of Tax Appeals, and only one Responsible Person Notice had been paid in full.

With respect to the one Responsible Person Notice found to be under the ALJ's jurisdiction, however, the ALJ determined that Mr. Nessing was not liable as a responsible person for PSRN's sales and use tax. Applying the Department regulation and applicable case law, the ALJ framed the issue under consideration as whether Mr. Nessing "had or could have had sufficient

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authority and control over the affairs of" PSRN to be considered a responsible person. The ALJ concluded that Mr. Nessing lacked such authority and control over PSRN, based on the "very detailed description of the business operations" of PSRN provided by documentary and testimonial evidence showing that Mr. Nessing was "under the direction and control" of Mr. Saunders in all of his dealings with PSRN.

Additional Insights

On initial consideration, it would seem unlikely that the president and sole shareholder of a corporation could be found not to be a responsible person of such corporation. However, based on the evidence presented in this case, the ALJ appears to have reached a fair conclusion in determining that Mr. Nessing was not a responsible person for PSRN. Through individual testimony and supporting documentary evidence, Mr. Nessing was able to show that the only meaningful connection he had to the business of PSRN was to sign legal documents at the direction of his boss (who actually controlled the activities of PSRN). While this case presents a unique set of facts, and still may be appealed by the Department, it illustrates that a responsible person assessment may be overcome with sufficient testimonial and documentary evidence.

INSIGHTS IN BRIEF

Provider of Taxable Protective Services Cannot "Absorb" Sales Tax in its Hourly Rate for Those Services

A provider of security guard services to a construction contractor at construction sites, required to collect New York State and local sales tax on those protective services, cannot "absorb" the sales tax into its hourly rate charged to the customer, but must separately state the sales tax on its invoice to the customer. *Advisory Opinion*, TSB-A-16(28)S (N.Y.S. Dep't of Taxation & Fin., Oct. 12, 2016) (released Nov. 1, 2016). According to the Department, such a vendor cannot agree to a contract clause that prohibits it from stating the sales tax due on an invoice, and the willful failure to separately state sales tax on an invoice given to a customer, or to properly collect and remit sales tax, may subject the vendor to criminal penalties. The Department also separately confirmed that a vendor who accepts in good faith a timely, properly completed sales tax exemption certificate from a contractor is under no duty to investigate the customer's representations on that certificate.

Maximum Penalties for Failure to File Alcoholic Beverage Tax Information Return Rejected

A New York State ALJ has set aside the maximum penalties imposed by the Department of Taxation and Finance on an alcoholic beverage wholesaler for failing to file information returns, and reduced the penalties to the statutory minimum. *Matter of Carousel Beverage Corp.*, DTA No. 826388 (N.Y.S. Div. of Tax App., Oct. 20, 2016). The ALJ found that, based on a legitimate concern about transmitting valuable client information over the Internet, the vendor had tried to present all of the records and information for review in person, but the Department would only permit submission of the information electronically. Since the Department had not only failed to make a proper request for records, but had actually affirmatively refused to review records, the ALJ found that the maximum penalties of $50,000 lacked a rational basis and must be cancelled, and instead imposed the minimum penalties of $500 per return. This is the second decision within two months in which an ALJ has set aside as improper the imposition of maximum penalties for failure to file information tax returns due from alcoholic beverage wholesalers.

Sales Tax Audit Based on Estimate Upheld by the Tax Appeals Tribunal

The New York State Tax Appeals Tribunal has affirmed the decision of an ALJ upholding an assessment of sales tax and penalties, finding that the petitioner's records were inadequate and that the Department's reliance on an estimation method was reasonable. *Matter of Zohir Laham*, DTA No. 825802 (N.Y.S. Tax App. Trib., Oct. 27, 2016). Although some register tapes and other records were eventually provided at a courtesy conference afforded to the petitioner after the assessments had been issued and become final, these were also deemed inadequate, and the petitioner admitted at the conference that the business kept no formal books or records and could not explain how sales had been reported. The Tribunal upheld the assessments, finding that, in the absence of auditable books and records, the Department's estimate, based on the auditor's observation of items displayed for sale and her experience with similar establishments, was reasonable and that, in light of the "clear failure to maintain records" as required, the petitioner had failed to demonstrate any basis to set aside the penalties based on reasonable cause and good faith.

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