MOFO
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Tribunal Reverses ALJ and Holds that Department Impermissibly Discriminated Against Foreign Unauthorized Insurance Corporations

By Irwin M. Slomka and Kara M. Kraman

In an issue of first impression in New York, the New York State Tax Appeals Tribunal has issued two decisions, reversing two Administrative Law Judge decisions, holding that the Tax Department's use of an alternative apportionment formula for insurance franchise tax purposes impermissibly discriminated against a foreign insurer not engaged in an insurance business in the State in violation of both a treaty and the Foreign Commerce Clause. *Matter of Bayerische Beamtenkrankenkasse AG*, DTA No. 824762 (N.Y.S. Tax App. Trib., Sept. 11, 2017); *Matter of Landschaftliche Brandkasse Hanover*, DTA No. 825517 (N.Y.S. Tax App. Trib., Sept. 11, 2017).

Facts. The facts in both cases are straightforward and substantially the same. Both cases involved German non-life insurance companies that did not conduct an insurance business in the United States. As such, they were not authorized by the Superintendent of Financial Services (formerly known as the New York Superintendent of Insurance) to transact an insurance business in New York and were considered "unauthorized insurance corporations" under the Tax Law. The insurance companies' activities in the United States and New York were limited to holding interests in two partnerships that owned and managed real property, including real property located in New York. Neither insurance company wrote insurance premiums in the United States, and for federal income tax purposes their income consisted principally of their distributive shares of partnership income.

Both insurance companies filed New York State non-life insurance corporation tax returns and paid the minimum tax. Following an examination of the New York State partnership tax returns of the two partnerships, the Department assessed additional tax against the insurance companies, first by subjecting them to tax under

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Tax Law § 1501 (which is imposed on the higher of four alternative bases, in this case the highest being on allocated net income). Then, in the absence of any New York premiums, the Department exercised its discretionary authority to disregard the prescribed allocation formula (90% of which is based on premiums) and instead applied a non-premiums based formula (based on Article 9-A allocation factors) to the insurance companies' distributive share of partnership income.

In determining whether the nondiscrimination provision of the U.S.-Germany tax treaty should apply, the Tribunal noted that when a tax treaty and the Tax Law are in conflict, the tax treaty must prevail.

ALJ decision. Ruling for the Department, the ALJ had held that the insurance companies were properly subject to tax on their allocated net income under Tax Law § 1501, and not subject to the tax on premiums under Tax Law § 1502-a, which by its terms only applied to *authorized* non-life insurers and which is "in lieu of" the § 1501 tax. On the issue of allocation, the ALJ held that the statutory formula was inappropriate under the taxpayers' facts and that the Department's application of an alternative non-premiums based apportionment formula was reasonable. The ALJ thus upheld the deficiencies in their entirety. The taxpayers appealed to the Tribunal.

Tribunal decision. The Tribunal first rejected the taxpayers' claim that they were subject to tax under Tax Law § 1502-a, concluding that the statute clearly and unambiguously applied only to *authorized* non-life insurance corporations. Thus, the Tribunal concluded that, as *unauthorized* non-life insurers, the taxpayers were not subject to the premiums tax under § 1502-a, but rather were taxable under § 1501 on their allocated entire net income base, as the ALJ had found.

The Tribunal next addressed whether the Department properly exercised its discretionary authority in applying an alternative apportionment formula. Like the ALJ, the Tribunal found that the taxpayers had zero New York premiums and zero total premiums, and thus had a premiums factor of "0/0, [which] cannot be computed." In their appeal to the Tribunal, the taxpayers claimed that the Department should have taken into account their worldwide premiums – which were not includable in their federal "effectively connected income" – giving them a zero premiums factor. Citing the Court of Appeals decision in *British Land v. Tax Appeals Tribunal*, 85 N.Y.2d 139 (1995), the Tribunal held that, in the absence of a premiums factor, application of a "truncated statutory formula" (based solely on the taxpayers' payroll) would result in an allocation "out of all appropriate proportion" to the taxpayers' business in New York. Therefore, consistent with the ALJ's decision, the Tribunal also held that it was proper for the Department to have applied an alternative allocation method.

The third issue addressed by the Tribunal, raised for the first time by the taxpayers on appeal, was whether the Department's alternative apportionment impermissibly discriminated against it based on its status as an alien corporation, in violation of the United States-Germany tax treaty. The Tribunal noted that the issue could properly be newly raised on exception as it was a legal issue and not factual in nature. The Tribunal rejected the Department's claim that the Tribunal was without jurisdiction to review a claim under a tax treaty, finding that the language of the treaty itself did not preclude an aggrieved taxpayer from pursuing redress through the Tribunal.

In determining whether the nondiscrimination provision of the U.S.-Germany tax treaty should apply, the Tribunal noted that, when a tax treaty and the Tax Law are in conflict, the tax treaty must prevail. The Tribunal then considered the comparison of a German insurance company (the taxpayers) to a hypothetical U.S. insurance company that similarly had no New York premium income, and had no premium income anywhere in the United States, but that had worldwide premium income. The Tribunal concluded that the hypothetical corporation, unlike

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the taxpayers, would be able to compute a premiums factor because its total premium income – not subject to the federal "effectively connected income" limitations under IRC § 861 – would be greater than zero. The presence of a premiums factor would therefore permit that U.S. insurance company to use the statutory allocation formula, whereas the German insurance company could not do so. The Tribunal concluded that this different tax treatment contravened the U.S.-Germany tax treaty. The Tribunal therefore canceled the deficiencies, noting that for similar reasons application of the alternative apportionment formula also violated the Foreign Commerce Clause.

Additional Insights

These two decisions – which are not subject to appeal by the Department – are significant in several respects, in large part because it is unusual for state taxes to be covered by a tax treaty and for disputes arising under a treaty to be adjudicated by a state administrative body like the Tribunal. The decisions are also noteworthy in that the Tribunal agreed with the Department that its alternative allocation formula was proper under the facts and in all likelihood would have upheld that alternative allocation but for the treaty language, a legal argument first raised by the taxpayers' in their appeals to the Tribunal. The decisions also may provide support for the position that alternative apportionment should not be applied to a *domestic* non-authorized insurance corporation that does not have New York premiums, since the Tribunal suggests that such a domestic insurer *would* apply the statutory formula set forth in Tax Law § 1504(a).

A Third ALJ Rejects Department's Treatment of Service Revenue as "Other Business Receipts"

By Hollis L. Hyans

Once again, a New York State Administrative Law Judge has disagreed with the Department of Taxation & Finance's characterization of receipts earned by an online business as "other business receipts," holding that the receipts from provision of a litigation support service are receipts from services properly sourced to the location where those services were provided, entirely outside New York. *Matter of Catalyst Repository Systems, Inc.*, DTA No. 826545 (N.Y.S. Div. of Tax App., Aug. 24, 2017).

Facts. Catalyst Repository Systems, Inc. ("Catalyst") is a Colorado-based electronic data and document management company that provides litigation support services, including the use of proprietary software and technical personnel to acquire, store, sort, filter, and organize documents, generally useful to clients needing to respond to discovery requests in litigation or regulatory proceedings. Catalyst licenses the use of its system and services to clients, for a designated case, on a month-to-month basis. The clients provide data to be hosted by Catalyst, and then use the Internet to access Catalyst's system to search, review, and retrieve their own data. Catalyst organizes the data at its Colorado headquarters, where it maintains computer servers and storage facilities and where its employees develop, monitor, and maintain the necessary technology. Catalyst employs a large staff to keep the system operating and secure, assist clients in using the system, and build and maintain routers, servers, and other equipment. It charges its clients various forms of hosting fees, including monthly access fees, variable license fees, and base license fees.

Issue. Catalyst took the position that its receipts were "service receipts" under Tax Law former § 210(3)(a)(2)(B), and that they should be sourced to the location where the services were performed, outside of New York State. Alternatively, Catalyst argued that even if its receipts are classified as "other business receipts," under Tax Law former § 210(3)(a)(2)(D), they should still be sourced to Colorado because the activities and work that generated the receipts were performed there and not in New York.

The Department argued that Catalyst's receipts should be classified as other business receipts, as opposed to receipts derived from the performance of services, claiming there was no "human involvement" at the time of sale, and that the receipts were earned for access to software, and should be allocated based

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upon the location of the customer. Alternatively, the Department argued that, even if the receipts were from services, they should still be sourced to the location of the customers.

Decision. The ALJ rejected all of the Department's arguments. First, he found that there was no support for the Department's argument that a petitioner must prove its interpretation of the facts and law is the only reasonable interpretation, since the Division of Tax Appeals reviews cases involving statutory interpretation *de novo*. Then, similar to the decisions in *Matters of Expedia, Inc. and Expedia, Inc. (Delaware Company)*, DTA Nos. 825025 & 825026 (N.Y.S. Div. of Tax App., Feb. 5, 2015) and *Matter of CheckFree Services Corp.*, DTA Nos. 825971 & 825972 (N.Y.S. Div. of Tax App., Jan. 5, 2017), he rejected the Department's argument that the receipts did not arise from services because "no employees, agents, subcontractors or other persons . . . were involved in performing the transactions" at the moment of sale. The ALJ found that the regulation relied upon by the Department, 20 NYCRR § 4-4.3(a), did not define services, but merely requires receipts from services to be allocated whether performed by employees or independent contractors, and that, since the statute did not require human involvement at the moment of sale, the regulation could not be interpreted to add such a requirement. The ALJ found that the company was performing a litigation support service, through extensive personnel and facilities, and that the statute was drafted with "broad generalized language that fits squarely into today's digital world" and covered the services provided by Catalyst.

The ALJ also held that the determination of what the company's business activities are must be made from the perspective of its clients, rejecting the argument that the receipts resulted from the licensing of intangible assets, because the clients were paying not merely to have their documents hosted or to access petitioner's software but to use its entire litigation management system, including proprietary software and the activities of technical personnel. The ALJ then determined that the services were performed in Colorado where Catalyst's servers and computer infrastructure, as well as the majority of its employees, were located.

Finally, the ALJ in *Catalyst* noted, as did both ALJs who had reviewed the issue before, that New York has amended its law effective January 1, 2015, to adopt a customer-sourcing approach, which would have been unnecessary if the Department's interpretation of the previous statute were correct.

The ALJ found that the company was performing a litigation support service, through extensive personnel and facilities, and that the statute was drafted with "broad generalized language that fits squarely into today's digital world" and covered the services provided by Catalyst.

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While in some fields of endeavor, the rule is "three strikes and you're out," it is not clear that will be the rule in New York State tax administration. The decision in this case is very similar to the one reached in *Expedia* in February of 2015, and in *CheckFree* in January of this year. In all three cases, the Department was arguing that there was no "human involvement" at the final moment of the provision of services, and that such involvement was required under the Department's regulation, but that argument was soundly rejected. The Department did not file exceptions in either *Expedia* or *CheckFree*, but as of this writing the Department has requested an extension of its time to appeal in *Catalyst*. Meanwhile, it is apparent from the repeated decisions and from experience during audits that the Department, as well as the New York City Department of Finance, has been continuing to treat receipts from services rendered over the Internet as "other business receipts" and to source those receipts to the locations of customers or even the locations of customers' customers. After repeated defeats in litigation – which the Department thus far has chosen

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not to appeal but to simply ignore as nonprecedential – maybe this third decision will finally result in an appeal leading to a precedential decision that resolves the issue.

Tribunal Holds That Retailer Must File Combined Reports with Related Intellectual Property Licensing Company

By Michael J. Hilkin

The New York State Tax Appeals Tribunal has affirmed the decision of an Administrative Law Judge that a retailer must file combined corporate returns with a related company to which it paid royalties. *Matter of Whole Foods Market Group, Inc.*, DTA No. 826409 (N.Y.S. Tax App. Trib., Sept. 11, 2017). However, the Tribunal overturned the ALJ's decision sustaining substantial understatement of tax penalties against the retailer.

Facts. Petitioner, Whole Foods Market Group, Inc. ("Whole Foods"), operated retail stores selling natural and organic food products throughout the United States, including in New York. Whole Foods licensed certain trademarks and intellectual property from Whole Foods Market IP, LP ("WFMIP"), a limited partnership that elected to be treated as a corporation for income tax purposes. Whole Foods and WFMIP were brother-sister entities owned by a common parent corporation. Whole Foods had nexus in New York, but the Department stipulated that WFMIP did not have New York nexus.

Whole Foods paid royalties to WFMIP for the use of WFMIP's intellectual property. During the fiscal years 2008 through 2010 (the "Years in Issue"), these royalties constituted more than 50% of WFMIP's total receipts. Whole Foods deducted the royalties it paid to WFMIP on its federal income tax returns, but for New York corporate income tax purposes added back the royalties to its entire net income. On audit, the Department determined that, rather than adding back the royalties paid to WFMIP, Whole Foods instead should have filed combined reports with WFMIP. The Department assessed Whole Foods additional tax and assessed penalties for "substantial understatement of tax" under Tax Law § 1085(k).

Franchise Tax Law. During the Years in Issue, the corporate income tax was imposed on the highest of four bases, one of which was entire net income. In computing entire net income, a taxpayer started with its federal taxable income and made certain state-specific adjustments, including the addback of royalty payments made to a related member that were deductible in calculating federal taxable income. The royalty recipient was allowed a deduction from its federal taxable income in arriving at its entire net income. Tax Law former § 208(9)(o)(2) & (3). Effective for tax years beginning on or after January 1, 2007, and applicable to the Years in Issue, the royalty addback statute was amended to provide that the addback requirement would apply "[e]xcept where a taxpayer is included in a combined report with a related member . . . ." Tax Law former § 208(9)(o)(2).

The 2007 change to the addback statute was coordinated with a change to the combined reporting statutes. Prior to 2007, corporations were required to file combined reports when three requirements were met: (1) they were substantially related by ownership; (2) they engaged in a "unitary business"; and (3) the failure to file combined reports would cause distortion of the companies' income taxable by New York. Distortion was presumed to exist when there were "substantial intercorporate transactions" between the companies, but the presumption could be refuted by a showing that the intercorporate transactions were conducted in exchange for arm's length charges. After the 2007 change, the third combined reporting requirement would be irrefutably satisfied when substantial intercorporate transactions existed among related corporations "regardless of the transfer price for such intercorporate transactions." Tax Law former § 211(4)(a). Further, the 2007 change added language to Tax Law former § 211(4)(a), which required the Department to consider and evaluate "all activities and transactions" of a taxpayer and its related corporations in making the determination of whether a taxpayer and its related corporations were under a duty to make a combined report.

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Department guidance stated that substantial intercorporate transactions would be present when, during a taxable year, "50% or more of a corporation's receipts included in the computation of entire net income (excluding nonrecurring items) are from one or more related corporations." *Technical Memorandum*, "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). The guidance was subsequently incorporated into a Department regulation. *See* 20 NYCRR 6-2.3(b)(3)(i)(a)(1) (as amended in 2012).

[T]he Tribunal pointed out that ruling in Whole Foods' favor would render the amendment to the addback statute exempting companies that file combined reports meaningless where intellectual property is held by a related corporate member and payments for the use of that intellectual property make up greater than 50% of such member's gross receipts.

ALJ Decision. The ALJ had concluded that the Department properly required Whole Foods and WFMIP to file combined reports, rejecting Whole Foods' position that combined reports were unnecessary since Whole Foods added back the royalty payment deductions to its entire net income calculation. Further, the ALJ sustained the substantial understatement penalties imposed by the Department.

Tribunal Decision. The Tribunal affirmed the ALJ's conclusion that the Department could require Whole Foods and WFMIP to file combined reports. As there was no dispute that Whole Foods was related to, and engaged in a unitary business with, WFMIP, the only issue was whether the royalty payments from Whole Foods to WFMIP constituted substantial intercorporate transactions. Although WFMIP received over 50% of its receipts from Whole Foods each year, Whole Foods reasoned that "substantial intercorporate transactions" was statutorily defined based on "entire net income" (rather than receipts), and entire net income was calculated for franchise tax purposes only after applying the royalty addback requirement.

The Tribunal acknowledged that there was a "seeming conflict" between the Department's position that substantial intercorporate transactions were present between Whole Foods and WFMIP, and the actual statutory definition of "substantial intercorporate transactions," which Department guidance defined as relying on the definition of "entire net income." According to the Tribunal, the statutory definition of "entire net income[] seems to require backing out the intercorporate transactions that actually occurred."

The Tribunal resolved this potential conflict, however, by concluding that the effect of the royalty addback statutes is to include royalty payments in a corporation's entire net income "where such payments *would not otherwise* be included in that corporation's entire net income." (Emphasis added.) The Tribunal implied that filing combined reports would cause royalty payments to be included in entire net income, and explained that the royalty addback statutes would instead apply when combined reporting was "not required for some other reason," such as lack of substantial ownership of a would-be related member or lack of a unitary business.

The Tribunal found that Whole Foods' interpretation of the statutes was "inconsistent with both the language and intent of the overall statutory scheme," especially as the combined reporting statutes required the Department to "consider and evaluate all activities and transactions of the taxpayer and its related corporations." Further, the Tribunal pointed out that ruling in Whole Foods' favor would render the amendment to the addback statute exempting companies that file combined reports meaningless where intellectual property is held by a related corporate member and payments for the use of that intellectual property make up greater than 50% of such member's gross receipts.

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However, the Tribunal overturned the ALJ on the issue of penalties, concluding that the substantial understatement penalties should be abated because there was good cause for Whole Foods' reporting position and it had acted in good faith. In reaching this conclusion, the Tribunal pointed to the 2008 Department guidance interpreting the relevant 2007 changes in law, which the Tribunal concluded contained "circular references." The Tribunal held Whole Foods reasonably interpreted that guidance as requiring it to back out its intercorporate royalty transactions in arriving at WFMIP's entire net income for purposes of determining whether substantial intercorporate transactions were present.

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While subject to appeal by the taxpayer, the Tribunal's substantive analysis of combined reporting issues will be of limited continuing application, since, for years beginning on or after January 1, 2015, New York State has adopted unitary combined reporting, and the distortion test, including the substantial intercorporate transactions test, has been eliminated. Nonetheless, the issue of when substantial understatement penalties will be assessed is of continued significance. In circumstances where the Department issues unclear guidance for interpreting changes in the tax law, this decision supports the cancellation of penalties.

NYC Tribunal Upholds Department's Disregard of Corporation's Accounting Method for Installment Sale

by Kara M. Kraman

The New York City Tax Appeals Tribunal upheld the determination of an Administrative Law Judge that the Department of Finance properly invoked its authority to disregard the installment method of accounting employed by a corporate taxpayer, resulting in the inclusion of all of the taxpayer's gain from an installment sale of real property in its final General Corporation Tax ("GCT") return. *Matter of 1018 Morris Park Avenue Realty Inc.*, TAT(E) 14-4(GC) (N.Y.C. Tax App. Trib., Aug. 7, 2017).

Facts. In November 2009, 1018 Morris Park Avenue Realty Inc. ("Morris Park") sold two parcels of real property in the Bronx in an installment sale. Morris Park filed a final GCT return for the tax year December 1, 2008 through November 30, 2009, indicating that it had ceased operations. The final return reported Morris Park's net gain from the sale of the property under the installment method. In November 2012, the Department issued a Notice of Determination based on the inclusion of balance of the gain on the sale of the real property in Morris Park's entire net income on its final return, including amounts it had not yet received under the installment sale agreement.

The City Tribunal concluded that because Morris Park ceased to do business in New York City after November 2009, the Department was authorized to disregard Morris Park's use of the installment method . . . .

In August 2013, Morris Park filed an amended GCT return for the tax year ending November 30, 2009, which was *not* marked as a final return. At the hearing before the ALJ, the parties stipulated that Morris Park had not yet filed GCT returns for any periods subsequent to the tax year ending November 30, 2009, but indicated that it was in the process of preparing GCT returns for later tax years. Morris Park also introduced into evidence bank records from a Citbank account it maintained in the Bronx that showed activity in 2014 and 2015. The activity predominately consisted of recurrent monthly deposits of $53,624, which represented the installment payments it collected under its sales agreement. Morris Park was never formally dissolved.

Law. At issue was whether the Department properly exercised its discretion to disregard the installment method of accounting for Morris Park's sale of the property. Under the Internal Revenue Code, the entire amount of a gain on the sale of property must be recognized in the year of sale for federal income tax purposes, but in the case of an

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installment sale, only the portion of the installment payment representing gain is taxable in each year an installment payment is received. IRC § 1001(c), (d). While installment sales are not expressly addressed under the GCT statute or regulations, Administrative Code § 11 602.8(d) allows the Commissioner to disregard a taxpayer's method of accounting where it results in an understatement of income subject to the GCT. Although not precedential, letter rulings have been issued by the Department providing that the installment method of accounting should be disregarded when a corporation files a final return and ceases to do business. A regulation provides that a corporation is not deemed to be doing business in the City solely as a result of the "maintenance of cash balances with banks . . . in New York City." 19 RCNY § 11-04(c)(1)(i).

An Administrative Law Judge had held that the Department properly included the entire gain from the installment sale in Morris Park's final GCT return.

Tribunal Decision. The City Tribunal affirmed the ALJ's decision. The City Tribunal held that Morris Park failed to prove that it continued to do business in the City. Citing the regulations, the Tribunal found that Morris Park's maintenance of a bank account at a bank in the City did not establish that Morris Park continued to do business in the City. It further found that Morris Park's own admission that it had not yet filed GCT returns for any tax years ending after November 2009 further confirmed that it ceased doing business in the City at that time.

The City Tribunal concluded that because Morris Park ceased to do business in New York City after November 2009, the Department was authorized to disregard Morris Park's use of the installment method and include the entire gain from the sale of the real property in income on its final GCT return. In so holding, the Tribunal noted that if Morris Park were permitted to report the gain on the sale on its final return using the installment method, with the exception of the portion of the gain reflected in the first installment payment, it would avoid paying GCT on the entire gain on the sale of the property since it would no longer be subject to the GCT.

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While it is the Department's policy to prohibit the installment method of reporting gain from a sale where the taxpayer ceases to do business before all of the payments are made, it is not the Department's policy to prohibit the installment sale method of accounting in general. Had it continued to do business and continued to file GCT returns, the taxpayer would have very likely been permitted to recognize the gain from the sale as it received the installment payments, consistent with its federal income tax reporting. Businesses that are contemplating selling their assets in an installment sale and going out of business should be aware of the potential adverse consequences under the GCT – namely, that they will be required to pay tax on amounts they have not yet collected under the installment agreement.

New York State Issues Important Guidance on Taxation of Telephone Services

By Irwin M. Slomka

Two recent New York State pronouncements attempt to address problematic aspects of how certain telecommunications services are taxed in New York State, specifically the application of the sales tax and the § 186-e tax on: (i) sales of intrastate and interstate/international telephone service plans for a single charge; and (ii) sales of prepaid mobile calling minutes by a mobile services provider. The pronouncements reflect important guidance in those areas by the New York State Department of Taxation and Finance.

Sales tax on intrastate and interstate/international telephone services sold for a single charge. The New York State sales tax applies to *intrastate* telephone service, but not to interstate or international service. Other than for sales of mobile telephone services (which are taxed based solely on the customer's place of primary use), until now a provider of intrastate and interstate/international

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telephone services sold as a single package for a single charge was required to collect sales tax on the entire charge, unless the provider could show two things: first, that it actually sold a separate intrastate-only telephone package, and second, that it allocated the single charge for the package between taxable intrastate and nontaxable interstate/international telephone service consistent with how the provider's intrastate-only plan was priced.

In recognition that telephone service providers already maintain records identifying the portion of revenues from interstate/international revenues for purposes of their contributions to the Federal Universal Service Fund ("USF") – and perhaps also because there are few wholly intrastate calling plans – the Department has now significantly revised its sales tax policy. *Technical Memorandum*, "Sales Tax and Excise Tax on Intra- and Interstate/International Telephone Services Sold Together for a Single Charge or as Part of a Telecom Package," TSB-M-17(3)C, (6)S (N.Y.S. Dep't of Taxation & Fin., Sept. 5, 2017).

Under the new sales tax policy, made retroactive to March 1, 2017, the Department will now permit telephone service providers (but not mobile service providers) to allocate the single charge between intrastate and interstate/international telephone services, and collect sales tax only on the former, even if the provider does not sell a wholly intrastate service separately, so long as the allocation is "reasonable" and based on "objective and verifiable method[s]." Specifically, the Department will accept an allocation based on a "traffic study" of customer usage produced at least annually, if the study is consistent with the provider's filings for federal USF purposes.

In order to qualify for this sales tax treatment, the telephone service provider must make available to customers information clearly indicating the basis for the allocation. In addition, customer invoices must state the amount of sales tax due and that the tax is only being charged on the intrastate portion of the overall service. The new policy also applies to the furnishing of television, Internet, and telephone services sold as a package.

Sales tax and § 186-e tax on sales of prepaid calling minutes. The Department has also issued an Advisory Opinion regarding the applicability of sales tax and the Tax Law § 186-e excise tax on sales of prepaid telephone calling minute packages made by a mobile virtual network operator ("mobile operator"). *Advisory Opinion*, TSB-A-17(1)C, (18)S (N.Y.S. Dep't of Taxation & Fin., Aug. 3, 2017). Under the facts presented, the mobile operator buys telecommunications capacity from a "supplier" operator, and then sells packages of prepaid calling minutes, which include a cellphone bearing its trade name, to distributors, which in turn sell the packages to "brick and mortar" retailers. An end-user customer activates the service through the mobile operator. The mobile operator does not request the customer's address, and would be unable to verify the address even if it did request it.

Under the new sales tax policy . . . the Department will now permit telephone service providers (but not mobile service providers) to allocate the single charge between intrastate and interstate/international telephone services, and collect sales tax only on the former . . . .

Sales tax applies to prepaid telephone calling services which, when sold at a retail store, are taxable based on the retailer's location. If not sold at a retail store, then the sale is considered to take place at the customer's shipping address or, if nothing is shipped, at either the purchaser's billing address or the location associated with the purchaser's mobile telephone number. Tax Law § 1101(b)(22)(A). The § 186-e excise tax is imposed, in part, on a "home service provider['s]" gross receipts from sales of mobile telecommunications services, based on the customer's "place of primary use." Tax Law § 186-e(2)(a)(2). A customer's place of primary use is generally the street address where the customer's use occurs.

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With regard to the sales tax, the Department ruled that, when the prepaid mobile package is sold at a retail store, the retailer must collect the sales tax at the point of sale. The mobile operator's sale of the package to the distributor, and the sale by the distributor to the retailer, will qualify for the resale exclusion if properly completed resale certificates are furnished.

The Department's analysis of the application of the §186-e tax is significant. It concludes that neither the retailer nor the distributor is itself furnishing or selling a mobile telecommunications service to the customer, and therefore neither is liable for the § 186-e tax. Rather, the mobile operator is liable to the extent the end-user customer's place of primary use is in New York State. Under the Advisory Opinion, the provider must obtain the customer's residential street address or primary business street address when the customer activates the cell phone, which address can then be relied on by the mobile operator.

The Advisory Opinion goes on to provide that the "supplier" operator (which sells telecommunications capacity to the mobile operator) will not owe the § 186-e tax on its gross receipts from the mobile operator, provided the operator timely furnishes a properly completed § 186-e resale certificate. Since the Department does not consider either the distributor (or, for that matter, the retailer) as providing a telecommunications service, the mobile operator "may not, in good faith, accept a resale certificate from the distributor," and therefore its sales to the distributor do not qualify for the § 186-e resale exclusion.

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The *Technical Memorandum* reflects a reasonable relaxation of the Department's existing sales tax policy for sellers of intrastate and interstate/international telephone service packages for a single charge. The new policy makes it less onerous for those providers to limit the sales tax charged to customers only to the portion of the total charges attributable to the intrastate service.

In the *Advisory Opinion*, the Department, possibly for the first time, has provided guidance that a mobile operator's sales of prepaid packages to distributors or retailers will not qualify as excludable resales under § 186-e. One aspect of the *Advisory Opinion* that may be problematic is the Department's conclusion that a mobile operator must ascertain a customer's place of primary use (used to source gross receipts) by asking the customer for its street address. In many cases where prepaid services are sold through a retailer, the mobile operator does not have the ability to obtain a street address from that customer and will not have the customer's credit card information to ascertain a corresponding address. Thus, some mobile operators may need to develop a reasonable and verifiable methodology for determining the customer's place of primary use under § 186-e.

Tribunal Affirms Holding That Elevator Purchases Are Subject to Sales and Use Tax

By Hollis L. Hyans

The New York State Tax Appeals Tribunal has affirmed the decision of an Administrative Law Judge that an elevator installation company was liable for sales and use tax on the elevator products that it purchased for sale and installation, along with service and maintenance services related to the elevators. *Matter of Titan Elevator & Lift LLC, et al.*, DTA Nos. 825845, 825858, & 825859 (N.Y.S. Tax App. Trib., Sept. 11, 2017). The Tribunal agreed with the ALJ that the company had failed to demonstrate that all of the elevator products purchased and installed qualified for the statutory exemptions applicable to medical equipment and prosthetic devices.

Facts. Petitioner ("Titan") is a New York limited liability company engaged in the business of installing and servicing small elevators for use in homes and small business locations. It was not registered as a sales tax vendor in New York and had not paid sales tax on any of its purchases or collected tax from any of its customers. The Department audited Titan for the period December 1, 2003, through November 30, 2009, and repeatedly requested records for that entire period, but received records only for 2007. Despite recognizing that 2007 might not be a representative year, the Department treated that year as the "test period" to perform the

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audit because it was the only year for which Titan had purchase and sales invoice records.

The Department examined Titan's 2007 sales invoices and expense purchases, and extrapolated from those records to calculate tax due for the entire audit period on Titan's purchases of materials used in the installation of elevators. During the audit, the Department also reviewed letters, purportedly from Titan's customers, stating that the customers purchased and had installed the elevators "for medical purposes in order to create accessibility in the home." The Department disregarded these letters as unreliable, finding that in one instance a letter was changed after the individual had signed it, and in two other instances, the individuals whose names appeared on letters said that they had never seen the letters. The Department assessed tax on sales of service and maintenance of elevators and dumbwaiters, and on purchases of elevators and dumbwaiters from manufacturers, after calculating the percentage of sales that were for capital improvements and on which the Department asserted Titan should have paid sales tax when acquiring the elevators and other components, and imposed penalties.

[T]he Tribunal found that Titan failed to demonstrate that the elevators are "primarily and customarily *used* for medical purposes and [are] not" merely "generally *useful* in the absence of illness, injury or physical incapacity" . . . .

Tax Law and Decision Below. Sales of tangible personal property, and certain sales of tangible personal property installation and maintenance services, are generally subject to sales and use tax unless a statutory exemption applies. Tax Law §§ 1105(a) & (c)(3), 1110(a), 1115. Titan argued that its purchases and sales were exempt from sales and use tax either as "medical equipment" and "supplies" used "to correct or alleviate physical incapacity," or as "prosthetic aids." Tax Law § 1115(a)(3) & (4). Department regulations require that in order to qualify for the medical equipment exemption, the equipment in question "must be primarily and customarily used for medical purposes and not be generally useful in the absence of illness, injury or physical incapacity," 20 NYCRR 528.4(e)(2). Similar requirements also apply to the exemption for prosthetic devices. 20 NYCRR 528.5(b)(1).

The ALJ had concluded that the Department properly assessed tax on Titan's purchases of materials to install elevators and on its sales of installation and maintenance services related to such elevators, because Titan failed to meet its burden to demonstrate an exemption. In particular, the ALJ found there were no contracts or memoranda demonstrating that the elevators Titan installed were used solely for exempt purposes. The ALJ also upheld the penalties because Titan failed to maintain and provide proper records and underreported its sales and use tax liability.

Tribunal Decision. The Tribunal affirmed the ALJ determination in all respects. First, it found that the record contained no documentary or testimonial evidence to fully describe the products and their use and function, failing to distinguish, for example, between stair lifts and elevators and using the terms interchangeably. The Tribunal also found it "quite clear" that the Department had requested complete books and records for the entire period, in six separate requests, but never received complete records, justifying the Department's resort to an estimation method.

With regard to the claimed exemption for medical equipment, the Tribunal found that Titan failed to demonstrate that the elevators are "primarily and customarily *used* for medical purposes and [are] not" merely "generally *useful* in the absence of illness, injury or physical incapacity" as required by 20 NYCRR 528.4(e)(2). The evidence that Titan submitted, including statements that the elevators complied with international standards for elevators providing accessibility for persons with disabilities, and letters from manufacturers confirming that the elevators indeed met these standards, did not suffice to meet Titan's burden of proof and, the Tribunal

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found, did not amount to proof sufficient to show that the elevator products could not be used by persons without disabilities.

The Tribunal also found that Titan did not provide evidence that the elevators met the test under 20 NYCRR 528.5(b)(1) for prosthetic devices, despite inclusion in the Department's Publication 822 governing "Taxable Status of Medical Equipment and Supplies, Prosthetic Devices, and Related Items" of elevators and stair lifts providing access for persons with disabilities in residences. The Tribunal held that the law does not permit the exemption simply because the elevator was designed for use by a person with a disability, but requires evidence that the elevator is "primarily and customarily" used for such purposes.

The Tribunal also rejected Titan's argument that it purchased exempt products for resale, since Titan did not register as a sales tax vendor or provide its vendors with resale certificates, and because the elevators appeared to meet the definition of capital improvements, rather than products being sold for resale. Finally, the Tribunal upheld the imposition of penalties, noting the lack of adequate records, failure to register and file returns, and lack of any attempt to ascertain the Department's position.

Additional Insights

In the sales tax area, strict compliance with the statute and regulations is generally required. Here, Titan appears to have focused on the general nature of the elevators it installed, but not on the technical requirements of the statute and regulations, which mandate that the elevators must be used "primarily and customarily" by persons with disabilities to qualify as medical equipment or prosthetic aids. While one of Titan's principals testified at the hearing that Titan was not the "elevator police," tracking the use of every elevator it installed, the statute does impose a burden to demonstrate the "primary and customary use." This case highlights the necessity of gathering and maintaining detailed documentation contemporaneously with the purchases of materials and the sales to customers, and seeking expert advice on the exact requirements of technical statutes and regulations.

INSIGHTS IN BRIEF

Charges for Training at New York City Gym Found Subject to Sales Tax

The New York State Department of Taxation and Finance issued guidance stating that fees charged by personal trainers, under an agreement that gives the trainers the right to use a New York City gym's facilities and equipment, are subject to the New York City local sales tax on gym facilities imposed by Tax Law § 1212-A(a)(2), Administrative Code § 11-2002 (a). *Advisory Opinion*, TSB-A-17(16)S (N.Y.S. Dep't of Taxation & Fin., Aug. 2, 2017). The Department rejected the argument that the fees are for the rental of real property, finding that the agreements did not provide exclusive use of any part of the gym's space, and determined that they are fees for use of the facility.

ALJ Finds Notices Not Properly Directed to Taxpayer's Last Known Address

Agreeing with the Petitioner, a New York State Administrative Law Judge has held that notices of determination were not properly addressed, because the Department failed to use the address provided by the Petitioner on a responsible officer questionnaire submitted in 2010 in response to the auditors' specific request. *Matter of Gregorio Marin*, DTA No. 826378 (N.Y.S. Div. of Tax App., Aug. 31, 2017). The Department had relied on an address obtained from Mr. Marin's last income tax return filed in 2003, and argued that the responsible officer questionnaire is not a return or application that should be regarded as providing a "last known address" on which the Department must rely. Since the responsible officer questionnaire was an official form that Mr. Marin completed at the Department's explicit request, the ALJ held that ignoring the address on that form and using an address from eight years earlier "defies logic," and that the notices of determination should be cancelled.

ALJ Holds That Interest from Tobacco Settlement Revenue Bonds Must Be Added Back to Federal Income for Personal Income Tax Purposes

A New York State Administrative Law Judge has upheld an assessment of personal income tax against

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an individual on the basis that she was required to add back to her federal adjusted gross income ("AGI") interest income from District of Columbia Tobacco Settlement Revenue Bonds ("DC Bonds"), which were issued in accordance with a Tobacco Master Settlement Agreement entered into by the four largest tobacco companies to resolve lawsuits alleging states had increased health costs due to the harmful effects of tobacco products. *Matter of Carmen M. Quinones*, DTA Nos. 826795, 826804 & 827510 (N.Y.S. Div. of Tax. App., Aug. 17, 2017). The ALJ found that the interest income resulted from the sales of bonds by the District of Columbia that were secured by the stream of settlement payments to be received from tobacco companies, and that the interest they generated, like interest on other obligations of states and the District of Columbia, must be added back to federal AGI to determine New York State AGI. The ALJ held that the District of Columbia is properly treated as a "state" for this purpose, and that the interest was not an amount for damages in settlement for physical injuries and sickness but was instead interest on bonds purchased as an investment.

Management and Consulting Fees for Arranging for the Provision of HVAC Services Are Subject to Sales Tax

According to a recent Advisory Opinion, all of the amounts a company collects from its retail-chain customers to arrange for the provision of on-site HVAC services by a third party, including the company's management and consulting fees, are subject to sales tax. *Advisory Opinion*, TSB-A-17(20)S (N.Y.S. Dep't of Taxation & Fin., Aug. 4, 2017, released Sept. 5, 2017). The Department concluded that the company was not acting as an agent for its customers in arranging for the HVAC services—which would have meant that the management fees were not taxable—but was instead reselling HVAC services to its customers. The Department also ruled that the company had nexus with New York State by providing the HVAC services to customers through in-State independent contractors, citing the U.S. Supreme Court decision in *Scripto, Inc. v. Carson*.

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