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EDITORS

Hollis L. Hyans
hhyans@mofo.com

Irwin M. Slomka
islomka@mofo.com

NEW YORK STATE + LOCAL TAX GROUP

Craig B. Fields
cfields@mofo.com

Hollis L. Hyans
hhyans@mofo.com

R. Gregory Roberts
rroberts@mofo.com

Open Weaver Banks
obanks@mofo.com

Amy F. Nogid
anogid@mofo.com

Richard C. Call
rcall@mofo.com

Nicole L. Johnson
njohnson@mofo.com

William T. Pardue
wpardue@mofo.com

Paul H. Frankel
pfrankel@mofo.com

Mitchell A. Newmark
mnewmark@mofo.com

Irwin M. Slomka
islomka@mofo.com

Roberta Moseley Nero
rnero@mofo.com

Michael A. Pearl
mpearl@mofo.com

Ted W. Friedman
tfriedman@mofo.com

Kara M. Kraman
kkraman@mofo.com

Rebecca M. Ulich
rulich@mofo.com

COURT OF APPEALS HEARS ORAL ARGUMENT IN AMAZON SALES TAX APPEAL

By Irwin M. Slomka

On February 6, 2013, the New York Court of Appeals heard oral argument in the appeal by Amazon.com and Overstock.com challenging the constitutionality of the New York "Amazon tax." *Overstock.com, Inc. v. N.Y.S. Dep't of Taxation and Fin.* (Case No. 33); *Amazon.com LLC v. N.Y.S. Dep't of Taxation and Fin.* (Case No. 34).

Background

The so-called "Amazon tax," enacted in 2008, is actually a statutory presumption of nexus under the New York sales tax law. It provides that an out-of-state seller of goods is presumed to be engaged in in-State solicitation through others and must collect sales tax on its New York sales, when under a contract with a New York resident the retailer pays a commission or other consideration to the resident for referring potential customers, whether by link on an Internet website or otherwise. The law also provides that the presumption can be rebutted by proof that the in-State resident did not engage in solicitation on behalf of the seller that would satisfy constitutional nexus requirements.

Shortly after the law was enacted in 2008, Amazon and Overstock, both Internet retailers that operate "affiliate" marketing programs, brought declaratory judgment actions challenging the constitutionality of the law. They argued that the presumption was facially unconstitutional under the Commerce, Due Process, and Equal Protection Clauses of the U.S. Constitution and that it was also unconstitutional "as applied." In 2009, a New York County Supreme Court judge dismissed the complaints in their entirety. On appeal, the Appellate Division, First Department, upheld the dismissal of the companies' facial challenge, rejecting both the Commerce Clause and Due Process Clause challenges. *Amazon.com LLC v. N.Y.S. Dep't of*

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Taxation & Fin., et al., 81 A.D.3d 183 (1st Dep't, Nov. 4, 2010). The Appellate Division remanded the case to the lower court on the "as applied" challenge, but Amazon and Overstock eventually dropped that argument. Thus, the question before the Court of Appeals was whether the rebuttable presumption was unconstitutional on its face.

Oral Argument

At the February 6, 2013 oral argument in Albany, Amazon and Overstock, each represented by their own counsel, faced a "hot" bench that had clearly read the briefs and was cognizant of the significance of the decision (not just in New York, but in the many states that have enacted "Amazon tax" laws modeled after New York's law). The thrust of the companies' Commerce Clause challenge was that the presumption reached out-of-state vendors who were merely "advertising" in New York on the Internet, and did not satisfy the "substantial nexus" requirement. They also argued that the law violated the Due Process Clause because the presumption was irrational and effectively irrebuttable by large retailers like Amazon and Overstock.

Chief Judge Lippman asked why the provision in the law allowing sellers to rebut the presumption doesn't cure any potential facial unconstitutionality. Counsel for Overstock responded that it was still a burden on interstate commerce, with thousands of state and local taxing jurisdictions potentially able to impose their own nexus presumptions. Overstock analogized the commissions paid to its affiliates to an advertiser paying the *New York Times* to run an advertisement, which would not result in nexus.

Counsel for Amazon focused on the Due Process challenge, arguing that the test for the constitutionality of the rebuttable presumption is whether there is a high degree of likelihood that the factors that trigger the presumption will lead to the fact presumed — that is, that in-State solicitation is conducted by the affiliate. Chief Judge Lippman asked whether there is any activity short of "knocking on doors" that would result in nexus. Counsel responded that the line the presumption draws is based on "mere advertising," with the manner of paying for that advertising merely reflecting modern age technology. Judge Pigott asked whether nexus can result through solicitation via computer. Amazon's counsel responded that while it was "theoretically possible," it was no different than Quill sending thousands of catalogs into North Dakota, which the U.S. Supreme Court held did not result in nexus.

Counsel for the Department argued that the presumption in the law was not triggered by "advertising," but was based on the reasonable inference that an in-State affiliate that is paid a commission for referring business is engaged in some form of solicitation, that the seller has the ability to rebut the presumption, and whether that is unconstitutionally burdensome is a factual question, not a legal one. Counsel claimed that it is acceptable to place the burden of rebutting the presumption on the retailer, calling the presumption an

The thrust of the companies' Commerce Clause challenge was that the presumption reached out-of-state vendors who were merely "advertising" in New York on the Internet, and did not satisfy the "substantial nexus" requirement.

"evidentiary rule" that the legislature may reasonably set. Judge Pigott suggested that if every state imposed a presumption like New York's, there could be a detrimental impact on interstate commerce. The Department's counsel responded that there is no risk of multiple taxation and that Amazon deliberately entered into these business relationships.

Chief Judge Lippman asked the Department's counsel why a presumption is needed. Counsel responded that without the presumption, retailers could claim that they had no burden to come forward with evidence regarding their business arrangements, information they are in the best position to produce. Counsel for the Department said that based on "common experience," commissions have always been associated with an incentive for solicitation. Judge Smith, who appeared to be skeptical of the Department's position, said he had trouble getting common experience to tell him that the placement of an advertisement on a website converts the website owner into a sales agent.

The oral argument lasted nearly an hour. There is no fixed timetable for the Court of Appeals to issue its decision, although the Court will likely render a decision this Spring.

TRIBUNAL AFFIRMS THERE IS NO RIGHT TO A HEARING WITHOUT A NOTICE OF DEFICIENCY OR REFUND DENIAL

By Hollis L. Hyans

In *Matter of Mark A. Rothberg*, DTA No. 823318 (N.Y.S. Tax App. Trib., Jan. 17, 2013), the New York State Tax Appeals Tribunal affirmed the decision of an Administrative Law Judge that a taxpayer is not entitled to a hearing when he had received neither a notification of a tax deficiency nor denial of a refund application.

In *Rothberg*, the petitioner was a New York resident employed in New Jersey. He filed resident income tax returns for the years 1994 through 2010, but according to the Department did not make full payment of the amounts shown as due in certain

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years, or any payment in other years. The Department did receive portions of federal income tax refunds owed to Rothberg by the Internal Revenue Service, and applied those payments as offsets to Rothberg's outstanding New York self-assessments.

Rothberg claimed that, in 2003, in connection with refinancing his apartment, he had been required to and did satisfy all outstanding tax obligations, and that this satisfaction was confirmed in a telephone conversation with a Department official, although no documentation was provided.

Rothberg had commenced a proceeding in Supreme Court, the State's trial court, seeking to vacate the levy and warrants. That proceeding was dismissed for failure to exhaust administrative remedies. Rothberg then requested a conciliation conference, which was rejected on jurisdictional grounds, leading to a petition filed with the Division of Tax Appeals seeking a hearing.

As reported in the May 2012 issue of *New York Tax Insights*, the ALJ had held that Rothberg had no right to a hearing. The Tribunal has now affirmed the ALJ's decision, finding that the only notices issued by the Department were notices and demand for the tax shown due (or determined to be due based on math errors), which are not the same as the assertion of a "deficiency." Under Tax Law § 173-a(2), a notice and demand "shall not be construed as a notice which gives a person the right to a hearing…." The Tribunal also rejected Rothberg's argument that the Department waived jurisdiction, holding that jurisdictional issues cannot be waived and may be raised at any time.

Additional Insights

After a 2004 statutory amendment, it is clear that the Tax Law provides no right to a hearing before the Division of Tax Appeals when the taxpayer is challenging a notice and demand for unpaid tax, interest, and penalties resulting from a mathematical or clerical error, or from the failure to pay the tax shown due on a return.

However, the Tribunal decision does not deal at all with the issue that was also left unresolved by the ALJ—the fact that Rothberg first tried to bring his action in the state court, where it was dismissed, presumably on the Department's motion, for failure to exhaust administrative remedies. Although the decision does not specify the waiver argument raised by Mr. Rothberg, perhaps that argument was based on the allegation that, having argued to the court that the action should be dismissed based on failure to exhaust administrative remedies, the Department should be deemed to have waived a jurisdictional objection. Since the Tribunal has now confirmed that Rothberg has no administrative remedies, it seems the only alternative available to Rothberg would be paying all amounts claimed to be due and filing a claim for refund, an option not discussed in the decision.

DEPARTMENT RULES THAT REAL ESTATE-RELATED EMPLOYEE COMPENSATION IS NOT SUBJECT TO SALES TAX

By Irwin M. Slomka

A recent Advisory Opinion holds that compensation paid by an employer to an employee for otherwise taxable building cleaning and maintenance services is not subject to New York State and local sales tax. *Advisory Opinion*, TSB-A-13(2)S (N.Y.S. Dep't of Taxation & Fin., Jan. 8, 2013). The ruling reaffirms the Department's policy of not imposing sales tax when building owners properly structure agency relationships with managing agents.

New York State and local sales tax is imposed on receipts from the sale of building cleaning and maintenance services. Tax Law § 1105(c)(5). However, wages, salaries, and other compensation paid by an employer to an employee for performing those services are excluded from sales tax. 20 NYCRR 527.7(c)(2) ("employee compensation exclusion"). Owners of office buildings in New York typically hire independent managing agents to perform building and maintenance services. The managing agents receive management fees, which in part cover the salaries of the maintenance workers hired by the managing agent.

For sales tax purposes, the critical issue for determining whether the employee compensation exclusion applies is whether the maintenance workers are employees of the building owner (in which case their compensation is not subject to tax) or employees of the managing agent (in which case the exclusion does not apply). The distinction between the provision of cleaning and maintenance services rendered by employees for their employers, and those same services rendered by third parties to their customers, is not always clear.

In light of this uncertainty, the Department previously ruled that the employee compensation exclusion applied when the building owner retains a managing agent to hire the employees, who work under the direction, supervision, and control of the property owner, even though they are nominally paid by the agent. In such cases, the employees are considered the employees of the building owner and no sales tax is due on the payments made to the managing agent for providing what is, in effect, a payroll-type service. See *Building Owners and Managers Association of Greater New York*, Advisory Opinion, TSB-A-93(52)S (N.Y.S. Dep't of Taxation & Fin., Oct. 4, 1993).

The recent Advisory Opinion involves managing agents that manage the performance of interior cleaning and janitorial services for owners of office buildings and, through a separate entity, also manage the performance of maintenance and engineering services for the owners. The managing agents and building owners enter into management agreements pursuant to which the managing agents hire and supervise workers on

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behalf of the owners. Workers are subject to the building owner's "ultimate direction and control" and must perform the services under work rules and practices prescribed by the owners.

Separate control agreements and payroll services agreements provide that the managing agent "shall act for and in the name of the owner, as owner's Agent" and that "[a]ll persons providing the [cleaning and maintenance] services shall perform such services on behalf of owner and under owner's ultimate direction and control, subject to the supervision of [the managing agent] as the representative of the owner." Also under these agreements, the building owner indemnifies the managing agent for claims related to the workers and must carry adequate liability insurance and workers' compensation coverage. However, the managing agent is permitted to obtain insurance policies in its own name as agent and for the benefit of the building owner, can issue W-2s to the workers, and can establish a bank account in the building owner's name with the agent as signatory solely for payroll processing purposes.

The Department reviewed the agreements and concluded they are consistent with the existence of an agency relationship between the managing agent and the building owner, and do not make the managing agents independent contractors for this purpose. Thus, the maintenance workers are considered the employees of the building owners, and the owners' payments to the managing agents for the wages and salaries paid to those maintenance employees to perform cleaning and maintenance services are not subject to sales tax.

Additional Insights

The Advisory Opinion reaffirms the Department's long-standing (and prudent) policy in this area of disregarding formal labels and considering the substance of the employer-employee relationship. This is particularly welcome news with respect to the sales tax, where the taxability of a transaction is often driven by its form rather than its substance. If management agreements between building owners and agents adhere to the guidelines set out in TSB-A-93(52)S —as they did here — the Department will treat the managing agent as the building owner's agent, and the maintenance workers will be considered employees of the owner for purposes of the employee compensation exclusion. It is noteworthy that the Department looks to the "ultimate" direction and control exercised by the building owner, and not to the day-to-day supervision carried out by the managing agent, in reaching its conclusion.

INSIGHTS IN BRIEF

Peter Madoff Petition Dismissed Again

On remand from a reversal by the Tax Appeals Tribunal, a New York State Administrative Law Judge has again dismissed as untimely Peter Madoff's petition challenging a Notice of Determination arising out of a sales and use tax audit of Bernard L. Madoff Investment Securities, LLC. *Matter of Peter Madoff*, DTA No. 823411 (N.Y.S. Div. of Tax App., Jan. 31, 2013). The Department argued that the petition had not been filed within the required 90-day period from mailing of the notice, but the Tribunal had rejected the affidavits originally relied upon by the Department to establish timely mailing, finding that one affiant was not knowledgeable about the procedures in the Mail Processing Center, and the other affiant had not been employed by the Department on May 4, 2009, the date the notice was claimed to have been mailed. On remand, the ALJ found that the Department had now presented additional proof that the notice was indeed mailed as claimed on May 4, 2009, including revised affidavits that established the basis for personal knowledge by individuals with direct participation in the processing of statutory notices, and the petition was therefore again dismissed as untimely.

Leasing Agreements Treated as Outright Sales for Sales Tax Purposes

The New York State Department of Taxation and Finance has determined that agreements for the transfer of non-vehicle equipment to customers were security agreements, and therefore resulted in outright sales of the equipment, rather than true leases, so that the full amount of sales tax should be collected at the outset of the lease. *Advisory Opinion*, TSB-A-13(5)S N.Y.S. Dep't of Taxation & Fin., Jan. 24, 2013). Although one agreement provided that the lessee has the option of returning the equipment or purchasing it for $1, and in the second the lessee is required to purchase the equipment for $1, both agreements were found to be security agreements under the definitions contained in U.C.C. section 1-201(37), because the lessees were either required to become the owners of the equipment or had the option to become the owners for nominal consideration.

ABB v. Missouri
Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
AE Outfitters Retail v. Indiana
American Power Conversion Corp. v. Rhode Island
Citicorp v. California
Citicorp v. Maryland
Clorox v. New Jersey
Colgate Palmolive Co. v. California
Consolidated Freightways v. California
Container Corp. v. California
Crestron v. New Jersey
Current, Inc. v. California
Deluxe Corp. v. California
DIRECTV, Inc. v. Indiana
DIRECTV, Inc. v. New Jersey
Dow Chemical Company v. Illinois
Dupont v. Michigan
EchoStar v. New York
Express, Inc. v. New York
Farmer Bros. v. California
General Motors v. Denver
GMRI, Inc. (Red Lobster, Olive Garden) v. California
GTE v. Kentucky
Hair Club of America v. New York
Hallmark v. New York
Hercules Inc. v. Illinois
Hercules Inc. v. Kansas
Hercules Inc. v. Maryland
Hercules Inc. v. Minnesota
Hoechst Celanese v. California
Home Depot v. California
Hunt-Wesson Inc. v. California
IGT v. New Jersey
Intel Corp. v. New Mexico
Kohl's v. Indiana
Kroger v. Colorado
Lanco, Inc. v. New Jersey
McGraw-Hill, Inc. v. New York
MCI Airsignal, Inc. v. California
McLane v. Colorado
Mead v. Illinois
Meredith v. New York
Nabisco v. Oregon
National Med, Inc. v. Modesto
Nerac, Inc. v. New York
NewChannels Corp. v. New York
OfficeMax v. New York
Osram v. Pennsylvania
Panhandle Eastern Pipeline Co. v. Kansas
Pier 39 v. San Francisco
Powerex Corp. v. Oregon
Reynolds Metals Company v. Michigan
Reynolds Metals Company v. New York
R.J. Reynolds Tobacco Co. v. New York
San Francisco Giants v. San Francisco
Science Applications International Corporation v. Maryland
Scioto Insurance Company v. Oklahoma
Sears, Roebuck and Co. v. New York
Shell Oil Company v. California
Sherwin-Williams v. Massachusetts
Sparks Nuggett v. Nevada
Sprint/Boost v. Los Angeles
Tate & Lyle v. Alabama
Toys "R" Us-NYTEX, Inc. v. New York City
Union Carbide Corp. v. North Carolina
United States Tobacco v. California
USV Pharmaceutical Corp. v. New York
USX Corp. v. Kentucky
Verizon Yellow Pages v. New York
Wendy's International v. Virginia
Whirlpool Properties v. New Jersey
W.R. Grace & Co.—Conn. v. Massachusetts
W.R. Grace & Co. v. Michigan
W.R. Grace & Co. v. New York
W.R. Grace & Co. v. Wisconsin

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