Volume 2, Issue 6 June 2011

MoFo New York Tax Insights

Editors

Hollis L. Hyans	hhyans@mofo.com
Irwin M. Slomka	islomka@mofo.com

IN THIS ISSUE

1 Interview with Nonie Manion
4 Tribunal Upholds Forced Combination of Bank's Investment Subsidiary
6 Update: Cigarette Sales on Reservations
8 ALJ Accepts Vendor's Proof of Resales
9 Telecom Equipment "Shelters" Held to Be Exempt from Sales Tax
10 Sole Shareholder of Corporation Personally Liable for Sales Tax
11 Insights in Brief

New York State & Local Tax Group

Craig B. Fields	212.468.8193 cfields@mofo.com
Paul H. Frankel	212.468.8034 pfrankel@mofo.com
Hollis L. Hyans	212.468.8050 hhyans@mofo.com
Mitchell A. Newmark	212.468.8103 mnewmark@mofo.com
R. Gregory Roberts	212.336.8486 rroberts@mofo.com
Irwin M. Slomka	212.468.8048 islomka@mofo.com
Marjorie S. Elkin	212.468.8133 melkin@mofo.com
Roberta Moseley Nero	212.506.7214 rnero@mofo.com
Amy F. Nogid	212.468.8226 anogid@mofo.com
Michael A. Pearl	212.468.8135 mpearl@mofo.com
Richard C. Call	212.336.4364 rcall@mofo.com
Nicole L. Johnson	212.336.4305 njohnson@mofo.com
Bee-Seon Keum	212.336.4342 bkeum@mofo.com
Rebecca M. Ulich	212.336.4308 rulich@mofo.com
Kara M. Kraman	212.336.4139 kkraman@mofo.com

Interview with Nonie Manion

Director of Tax Audits, NYS Department of Taxation & Finance, Audit Division

Many issues that arise during the course of a New York State tax audit have long troubled both taxpayers and the Audit Division: from the taxpayer side, lengthy and delayed audits, voluminous or duplicative Information Document Requests ("IDRs"), last-minute requests for extensions of the statute of limitations, and threats of subpoenas; and, from the Audit side, non-responsive taxpayers, delays in getting information, and lack of efficiency in audits. In recent months, the Audit Division has been engaged in an internal initiative designed to resolve many of these issues. To provide our readers with an explanation of this new initiative, we spoke with Nonie Manion, Director of Tax Audits of the New York State Department of Taxation and Finance, Audit Division, who developed the initiative.

(Continued on page 2)

Interview with Nonie Manion

(Continued from Page 1)

NYTI: Let's start by talking about the Audit Division in general. How many audits are going on at the same time, and what is the size of your staff?

Ms. Manion: We have about 28,000 field audit cases open at any one time, and to handle that caseload we have about 1,000 field auditors. We also have about 600 tax technicians who perform about 450,000 desk audits a year. The composition of the staff has changed. Five years ago, we had a lot of people with many years of experience, who were able to work independently and did not need a lot of on-the-job training. Over the past few years, a substantial number of those experienced folks have retired. While we have been able to hire new replacements, many of them are new auditors and we are working to train them and get them up to speed.

NYTI: Often at the beginning of an audit, a taxpayer will receive a set of IDRs asking for information. The taxpayer will do its best to timely respond, send in the information, and then may hear nothing for months. What has been happening during the interim, and how can problems like this be avoided?

Ms. Manion: We believe a critical place to begin is in improving communication and planning, so both sides know what has happened, what should happen next, and when it should happen. We have created several new documents that will be implemented in every audit, and we hope these will lead to clearer understanding on both sides. We are focusing on all stages in the audit, starting with the opening conference. We want the auditors to be able to understand the business and explain what they will need in order to audit this particular business.

NYTI: What have you been working on internally, and what changes should taxpayers expect to see?

Ms. Manion: Over the past year I have worked with several taxpayers and practitioners as well as our staff in developing some new tools to address delays and communications issues during the course of an audit. Since January of this year, I have been visiting all of our district offices to introduce our new documents to our staff and demonstrate their use. These include a new form IDR, an IDR Log, and an Audit Case Work Plan Template. We hope these will help to achieve better accountability and timely follow-up, and will help the auditor to keep the taxpayer informed. The IDR will be accompanied by an IDR cover letter, which can either be part of an initial contact letter, a letter setting an appointment for a field audit, or a stand-alone request for information, if there will be no field appointment but only a desk audit. Also, at the beginning of every audit, a new "Contact Sheet" will be presented at an opening conference, or included with the initial letter in a desk audit.

NYTI: What will be included in the cover letter that accompanies the IDR?

Ms. Manion: All cover letters will contain the due date for the information that is requested, an explanation of the IDR that is attached, and instructions to return the completed IDR with the requested information. There will be a place for the taxpayer to initial and return a copy of the letter to indicate receipt.

NYTI: Tell us about the new IDR, and how it differs from what taxpayers have been accustomed to seeing.

Ms. Manion: The IDR will list all information requested, and include a "Date Provided" column for the taxpayer or its representative to complete, filling in the date when each line item is provided. There's a place for that person to provide his or her name, to indicate who is responding on behalf of the taxpayer. All IDRs must indicate the due date for the information requested, and each new IDR must be sequentially numbered. If there is no field visit, the taxpayer can sign the IDR and send in a copy along with the information being provided. If the information is provided during the course of a field audit, when the auditors are done with their field visit, they should review the IDR and the date provided column with the taxpayer or representative, and then have the taxpayer or representative sign the IDR.

NYTI: How will taxpayers know if the auditor is satisfied with the information provided?

Ms. Manion: Auditors should always discuss with the taxpayer the adequacy of the information received, either by telephone, by letter, or in person during the field visit. Auditors are all being instructed to involve the taxpayer in the IDR process and in the determination of a suitable response time. They should discuss the contents of the IDR, either prior to its issuance or at the time of issuance, to seek clarification and see if there might be alternative methods of meeting the IDR objective in a more efficient matter. If there are additional open questions, or if some information requested initially has not been provided, follow-up IDRs may be issued, and if new information is requested, it should be done on a new IDR. Our new IDR Log will be used to track the IDRs when multiple IDRs are issued to the same taxpayer. Follow-up cover letters should acknowledge the information that was received, explain any deficiencies in prior submissions, and list the information the taxpayer has indicated is simply not available, so there are no disputes later on.

NYTI: Taxpayers often believe that IDRs ask for much more information

(Continued on page 3)

Interview with Nonie Manion

(Continued from Page 2)

than is reasonably needed for the issues actually being audited. Can we expect any changes?

Ms. Manion: We are instructing all auditors to refrain from issuing overly broad IDRs, and to focus their IDRs on specific information needed to examine identified areas. They should discuss with the taxpayer the reasons for requesting the particular documents being sought.

NYTI: What can be done about the situation where a taxpayer submits information, has not heard anything back for a long time, and then suddenly receives many new questions right before the expiration of the statute of limitations, when of course the auditor also wants an extension. How can taxpayers work with auditors to avoid such problems?

Ms. Manion: We have developed the Audit Case Work Plan Template to address these potential problems. It will list all open issues under review, along with an estimated tax effect for each issue. That will help identify issues that are worth the time of both sides to explore further. The Work Plan includes a place to list the status and a plan of action for each issue. The auditor must enter an estimated completion date for each issue. A date should be entered when an issue is listed; then, an allowance should be given for additional time needed by the auditor to review the information received, maybe in the range of two to four weeks, and an estimated completion date should also be provided. Subsequent updates to the estimated completion date should be separately listed, and auditors should not simply overwrite the original date, so the entire history can be traced. The date the issue is closed should be listed as an update in the status/plan of action section. When the issue is complete, it should be so noted, along with the date. If an auditor decides to reopen an issue after it is closed, the auditor should list the reason, along with a plan of action and a follow-up date. The follow-up date is the next date of anticipated action, which could include submission of responses to outstanding IDRs, review of the responses, an expected IRS Determination, or review by Office of Counsel, Field Audit Management, or the Office of Tax Policy Analysis.

WE ARE INSTRUCTING ALL AUDITORS TO REFRAIN FROM ISSUING OVERLY BROAD IDRS, AND TO FOCUS THEIR IDRS ON SPECIFIC INFORMATION NEEDED TO EXAMINE IDENTIFIED AREAS.

NYTI*:* On what time frame should taxpayers expect to see their audits completed?

Ms. Manion: In an ordinary, "on-time" audit, we have generally reached completion in 24 months for complex audits, and 18 months for more standard audits. In the future, under our new systems and with good cooperation, we are hoping it can be shorter.

NYTI: Do you have an expedited audit program?

Ms. Manion: Yes. It requires an agreement between the Department and the taxpayer at the beginning. Both sides need to commit resources: we will have a team of auditors to make requests, review the information and present results; and the taxpayer needs to have resources available to provide information, commit to response dates, be available to clarify information in response to questions and review the information we provide. Taxpayers who are interested in participating in such an audit should make the request through their auditor or one of the District Office managers identified on the Contact Sheet. The request will be reviewed by management followed by discussion to determine if the request can be accommodated. Even an expedited audit requires that the audit be complete, so it is not a limited scope audit. It could be described as a tightly managed audit. Both sides will have to devote a lot of resources, and we need to make sure that they are efficient and productive.

NYTI: Sometimes, auditors have threatened or actually issued subpoenas, often including exactly the same questions that were previously asked in an IDR, and the subpoenas may be sent to third parties without any notice to the taxpayer. Can you please explain your policy on subpoenas?

Ms. Manion: Subpoenas should not be used unless a less intrusive method to gather facts has not been successful. Through the use of the tools mentioned above, if a subpoena to the taxpayer for records or interview is required it will not be a surprise to the taxpayer and therefore it is not a threat. Subpoenas must be addressed to the taxpayer and served on the taxpayer, not the representative, in order to be enforceable, but copies should be delivered to the representative as well. Before a subpoena is issued, the auditor must first ask the taxpayer or its representative, preferably in writing, to voluntarily provide the information or documents being sought. If the information is not provided, at least one supervisor or manager must personally attempt to obtain the information from the taxpayer or representative before approving the use of the subpoena, and

(Continued on page 4)

Interview with Nonie Manion

(Continued from Page 3)

any exception to this process must be approved by me.

The use of any third-party subpoena requires direct supervisor approval to determine that there is little likelihood that the subpoena will result in adverse consequences for the taxpayer, which could occur if, for example, the subpoena is going to a bank or other financial institution, a utility, an airline, or other large third-party entities. Most of this information would not have to be subpoenaed if the taxpayer kept adequate books and records. While we do not believe we are required to notify taxpayers of third-party subpoenas, in many instances it is appropriate and sensible for us to do so.

NYTI: When will taxpayers start to see these new documents in their audits?

Ms. Manion: These documents are coming into use right now, and taxpayers should expect to see them in any new audits beginning after this time. You also may see them for cases that have been in progress for some time serving as a plan to bring them to completion.

NYTI: What should taxpayers do if they feel the process you have outlined is not being followed?

Ms. Manion: This is where the Contact Sheet will prove useful. At the beginning of each audit, we will give the taxpayer a Contact Sheet, which will provide the names, titles, and telephone numbers for contacts within the district office and also Albany's Field Audit Management. If a taxpayer or representative is unable to obtain information from the auditor, or feels the audit is not progressing in a timely manner, they can get in touch with a Team Leader, a Section Head, a Program Manager, or a District Audit Manager. At the same time, taxpayers will be asked for contact information for their managers as well, and for the name of someone outside the Tax Department. Sometimes, the Tax Department employee charged with responding to our questions is unable to gather the information we need, either because he or she does not have access to it, or it must come from another division or location, or it cannot be readily located. We need to be able to reach a senior person who can speak for the entire company if we feel the individual handling the audit just cannot obtain the information.

NYTI: Are these new processes you have described also going to be used by New York City auditors?

Ms. Manion: The City sales tax and personal income tax are administered by New York State, so these same procedures will be used for those audits.

NYTI: Thank you very much for taking the time to explain all these new procedures, and we look forward to smoother, more efficient audits.

NOTE TO READERS:

If you would like to see a sample IDR, IDR Log, Audit Case Work Plan Template, or Contact Sheet referenced in the interview, please click on either hhyans@mofo.com or islomka@mofo.com to send one of the editors a message and we'll be happy to send you sample documents.

Tribunal Upholds Forced Combination of Bank's Investment Subsidiary

By Irwin M. Slomka

Upholding an earlier ALJ determination, the Tax Appeals Tribunal has held that the Department could forcibly combine a bank's wholly-owned Delaware investment subsidiary with the bank because of what the Tribunal concluded was a distortive arrangement. *Matter of Interaudi Bank f/k/a Bank Audi (USA)*, DTA No. 821659 (N.Y.S. Tax Appeals Trib., Apr. 14, 2011).

Interaudi Bank is a commercial bank that conducts a banking business in New York, with its principal office in New York City. In 1997, it formed an investment subsidiary ("BA Investments") in Delaware to hold the bank's investment portfolio. At formation, Interaudi Bank contributed to BA Investments approximately $98 million in investment securities in exchange for 100% of the new entity's stock. This transaction qualified as nontaxable under I.R.C. § 351. Thereafter, BA Investments leased office space and conducted its investment activities in Wilmington, Delaware, using the services of a Delaware-based corporate management support services firm.

Interaudi Bank and BA Investments, along with other substantially owned affiliates, filed their federal income tax returns on a consolidated basis. Interaudi Bank filed a combined Article 32 (bank tax) return with all of its subsidiaries except BA Investments. BA Investments did not itself file separate New York returns under either Article 32 or Article 9-A since it did not have taxable nexus with New York.

Under Article 32, a banking corporation (or bank holding company) doing business in New York State which owns or controls, directly or indirectly, at least 80% of another banking corporation or bank holding company (or whose voting stock is similarly owned by such an entity) must file a combined Article 32 return with the 80% or more owned entity. However, a nontaxpayer corporation cannot be combined unless necessary to properly reflect the taxpayer's tax liability. Tax Law § 1462(f)(2)(i).

On audit, the Audit Division concluded

(Continued on page 5)

Bank Combination Upheld

(Continued from Page 4)

that BA Investments should be combined with Interaudi Bank for several reasons: (i) the bank was actually managing the investments; (ii) BA Investments' portfolio was an integral part of the bank's capital requirements; and (iii) the bank, rather than BA Investments, was incurring the costs of the investment portfolio. The Audit Division determined that this resulted in a distortion of Interaudi Bank's income that could be cured by combining BA Investments.

Administrative Hearing. At the administrative hearing, an expert witness for the Department testified that the only economic explanation for the creation of BA Investments was to circumvent Article 32. Among the reasons given by the Department's expert was that Interaudi Bank incurred between $22 million and $27 million annually in interest expenses during the years in issue, but that BA Investments did not incur any interest expenses. It is not clear from the Tribunal decision (or from the ALJ's earlier determination) whether, or the extent to which, the ALJ relied upon the expert's testimony.

The evidentiary record included a letter from the bank's accounting firm sent to the bank's senior vice president, advising him of the state tax minimization benefits of forming BA Investments as a Delaware passive investment company. The letter advised the bank of the risks of challenge by the New York State tax authorities, but noted that "based on our experience . . . we are often able to secure favorable settlements under which all tax benefits of a [Delaware investment subsidiary] are not lost."

The ALJ held that while there was no presumption of distortion, the deduction by Interaudi Bank of interest expenses that "were attributable to assets held by [BA Investments]" resulted in a distortion which was properly corrected by requiring that BA Investments be included in the bank's combined Article 32 return. The Department had also argued that tax minimization was the sole reason for the transfer of the bank's investment portfolio to BA Investments, although the ALJ did not directly address this argument.

On exception, Interaudi Bank contended that the Department had not met its burden of proving a distortive arrangement in the absence of a presumption, and also claimed that the Department had raised new allegations of distortion at the hearing that were not identified during or at the conclusion of the audit. Interaudi Bank also cited to the Tribunal's decision in *Matter of Premier National Bancorp, Inc.*, DTA No. 819746 (N.Y.S. Tax App. Trib., Aug. 2, 2007) for the proposition that no distortion exists by virtue of a parent's capital contributions to its investment subsidiary.

Tribunal Decision. The Tribunal upheld the ALJ determination, and sanctioned the Department's forced combination of the bank's Delaware investment subsidiary. The Tribunal first acknowledged that in attempting to combine a nontaxpayer (such as BA Investments), a presumption of distortion does not arise under Tax Law § 1462(g) in the absence of substantial intercorporate transactions between the entities. Thus, in order to require the combination of a nontaxpayer, the Department must show that the taxpayer's activity, business, income, or assets are improperly or inaccurately reflected.

The Tribunal concluded, however, that the factual record evidenced a distortive arrangement justifying the combination of BA Investments. The Tribunal agreed with the ALJ's analysis that upon the formation of BA Investments, Interaudi contributed approximately $100 million of investment securities at a time when the bank's total stockholder equity was only $38 million. The Tribunal reasoned that this meant that about $62 million of the securities contributed by the bank must have been attributable to bank deposits or other borrowings by Interaudi that generated interest expenses. The Tribunal found that the nature of this capital contribution to the investment subsidiary was a distortive arrangement whereby Interaudi was presumably claiming interest expenses attributable to investment assets held by a subsidiary, the income from which was not otherwise subject to New York tax.

The Tribunal acknowledged that an I.R.C. § 351 transaction is not itself a distortive transaction. However, the Tribunal concluded that here the Department had "identified the particular arrangement" resulting in distortion, facts that went beyond the Section 351 transaction. The Tribunal also distinguished the case from its decision in *Matter of U.S. Trust Corp.*, DTA No. 810461 (N.Y.S. Tax Appeals Trib., Apr. 11, 1996), in which it rejected the Department's attempt to forcibly combine a Delaware investment subsidiary because of insufficient evidence in the record to support a finding of distortion. The Tribunal noted that, "[u]nlike the circumstances in *U.S. Trust*, here the [Department] has pointed out specifically both the subject arrangement and the distortion created by the arrangement, which is supported by the evidence in the record."

Interaudi Bank also argued that the Department's action violated the Commerce Clause and Due Process Clause of the U.S. Constitution, noting that (i) non-U.S. investment subsidiaries could, under Tax Law § 1452(g), engage in the same investment activities in New York without incurring a tax liability and

(Continued on page 6)

Bank Combination Upheld

(Continued from Page 5)

that (ii) corporations "grandfathered" as Article 9-A corporations under Tax Law § 1452(d) were not subject to forced combination under Article 32. Viewing this as a challenge to the facial constitutionality of the bank tax law, the Tribunal concluded that it was without authority to rule on the issue.

In addition, the Tribunal upheld the imposition of penalties, referring to the letter from the bank's CPA firm as proof that the bank was aware that its course of action was likely to be challenged by the Department.

Additional Insights. Under the particular facts of the case—the undercapitalization of the bank when it contributed the investment securities to its subsidiary, the testimony of the Department's expert witness, and the CPA firm letter that raised questions regarding the tax minimization purpose for BA Investments—the Tribunal's decision is not entirely unexpected. Indeed, the bank tax regulations set out several factors in determining whether a distortive arrangement exists, including whether there is a reasonable business purpose and whether the arrangement was motivated principally for a tax avoidance purpose.

Left unsaid is that one possible—and undoubtedly unintended—consequence of the decision is that distortion may always be found to exist when a parent corporation contributes assets to a subsidiary, since arguably there is always the possibility that the parent incurred some expenses to acquire or maintain the contributed assets. Such a harsh result would certainly be a departure from longstanding Article 32 precedent involving combination.

Regarding Interaudi's constitutional challenge, it should be noted that had its Delaware investment subsidiary been in existence in 1985, the "grandfather" election that would have avoided combination would likely have been unavailable because the subsidiary was not actually subject to New York tax. This would have raised another constitutional question: whether it is discriminatory to allow a taxpayer corporation, but not an out-of-state corporation, to make the "grandfather" election.

Sale of Cigarettes on Reservations to the Public: Federal Court Lifts One Injunction, State Court Enters Another

By Hollis L. Hyans

In the latest developments in the continuing saga of New York State's attempts to collect taxes on reservation sales of cigarettes to non-Indians, a Federal appeals court lifted an injunction that had kept the State from enforcing its regulations for collecting the tax, and the next day a State court entered another injunction. *Oneida Nation of New York et al. v. Cuomo*, Docket No. 10-4265(L) *et al.*, (2d Cir. May 9, 2011); *Seneca Nation of Indians v. State of New York*, Index. No. 2011-000714 (Sup. Ct. Erie Cnty. May 10, 2011).

The Seneca Nation of Indians, Unkechauge Indian Nation, St. Regis Mohawk Tribe, Cayuga Indian Nation of New York, and Oneida Nation of New York (referred to by the court collectively as the "tribes") filed three separate actions in federal court seeking to enjoin the State from enforcing the collection of tax on sales to non-tribal-member purchasers, claiming that the law interferes with tribal sovereignty and fails to ensure their access to tax-free cigarettes for personal use. In two cases, the Western District denied the preliminary injunctions but stayed enforcement pending appeal, while in the third action the Northern District granted a preliminary injunction. The cases were consolidated for an expedited appeal.

The tax at issue is imposed at $4.35 per pack on all non-exempt cigarettes sold in the state. While the tax ultimately falls on the consumer, it is "precollected" from a limited number of license stamping agents, and these agents are the only legal entry point for cigarettes into New York. The agents incorporate the tax into the price charged to distributors and affix stamps to the packs allowing the cigarettes to be legally sold.

While federal law prohibits New York from taxing cigarettes sold to enrolled tribal members on their own reservations for personal use, the State's right to tax sales on reservations to non-tribal members has been upheld by the United States Supreme Court. *Dep't of Taxation & Fin. v. Milhelm Attea & Bros.*, 512 U.S. 61 (1994). The Department had previously issued regulations attempting to collect tax on the non-exempt portion of sales, but these had been repealed in 1998, and for many years, according to the Second Circuit, the Department had followed a policy of "forbearance" allowing the sale of untaxed cigarettes to continue, in an atmosphere of "litigation, civil unrest, and failed negotiations." Meanwhile, statistics regarding the numbers of cigarettes sold indicated to the State that significant amounts of tax on non-member sales, estimated at $110 million per year, were not being collected.

(Continued on page 7)

Sale of Cigarettes

(Continued from Page 6)

For example, if only Unkechauge members had purchased the entire volume of untaxed cigarettes bought by Unkechauge retailers from licensed agents, every man, woman, and child on the reservation would have smoked 364 packs of cigarettes per day in 2009. Similar figures were presented for the other tribes, and the court accepted the fact that large amounts of cigarette tax were not being paid.

In June 2010, the Department revoked its former "forbearance" policy, the Legislature amended the statute, and the Department adopted new implementing regulations. The new provisions require state-licensed stamping agents to prepay the tax on all cigarettes packs, including those intended for sale to exempt tribal members. Tribes may purchase a limited quantity of untaxed cigarettes, determined to mirror each tribe's "probable demand," calculated by analyzing tribal population and per capita smoking statistics. Tribes may also submit evidence of prior consumption, and the tribes did not challenge the Department's probable demand figures. Two mechanisms were set forth for tribes to obtain tax-free cigarettes: a "coupon system," under which the Department provides each tribe with a quantity of tax exemption coupons corresponding to probable demand, which allow the tribe to purchase tax-free cigarettes; or the "prior approval" system, which requires wholesalers to obtain the Department's approval before selling tax-free cigarettes to a tribal government.

The tribes contended that the precollection mechanism either imposes an impermissible direct tax on tribal retailers or, alternatively, imposes on them an undue and unnecessary economic burden. They also contended that the coupon and prior approval systems interfere with their right of self-government, unduly burden tribal retailers, and fail to adequately ensure members' access to tax-free cigarettes.

The Second Circuit Court of Appeals has now rejected all of these arguments, finding that the tribes could not demonstrate a likelihood of success on the merits, which is necessary for a preliminary injunction. It noted that the United States Supreme Court has held that states may "impose 'on reservation retailers minimal burdens reasonably tailored to the collection of valid taxes from non-Indians,'" citing *Milhelm Attea*, and that the Supreme Court had upheld several times the use of collection mechanisms similar to those put in place by New York. The appeals court stated that, while the precollection mechanism would indeed impose an increased economic cost on tribal retailers who continue to market taxable cigarettes to non-member purchasers, those costs result from the retailer's decision to make such sales, and the court found that the tribes possessed no "vested right" to make a certain volume of sales, or even to make any such sales at all. The court also rejected the tribes' argument that the substantial difference in tax rates between this case and earlier cases in which states' collection methods were upheld—which had been in the range of $1.20 to $1.60 per carton, instead of the $43.50 per carton currently imposed by New York — meant the burden was greater and mandated a different result, noting that, to the contrary, the higher the tax rate, the greater the economic incentive to avoid the tax. The court also rejected arguments that implementation issues and problems are sure to arise, stating that such hypothetical worries cannot support a pre-enforcement injunction of the entire collection mechanism.

However, no sooner was the federal injunction lifted than a State court issued a new one. On May 10, a New York State Supreme Court justice issued a temporary restraining order preventing immediate enforcement of the taxes, in response to a claim by the Seneca Nation that the regulations implementing the 2010 amended statute were adopted without proper public input. The temporary restraining order was put in place for three weeks, and the State court is scheduled to hear argument on the validity of the regulations on June 1.

Additional Insights. Disputes over the imposition of cigarette taxes on reservation sales to non-members have been going on for many years in New York, and appear to have only grown in recent years as the tax rate has increased dramatically. Although the Supreme Court held unambiguously in *Milhelm Attea* that the State had the right to collect such taxes, political and practical issues had never been sufficiently resolved to allow such collections to proceed. For instance, in 1997, portions of the New York State Thruway in upstate New York were blockaded by tribal members challenging cigarette taxes not with injunctions but with violence and burning tires. The Seneca Nation has also reportedly proposed to collect its own tolls on sections of the Thruway that run through reservation land, saying it was rescinding a 1954 agreement that allowed construction of the Thruway on the grounds the agreement had not received proper federal approval. No matter how the new State court challenge is ultimately adjudicated, it is hard to say with confidence that this long-simmering issue is finally headed to resolution.

(Continued on page 8)

ALJ Accepts Vendor's Proof of Resales Despite Absence of Completed Resale Certificates

By Irwin M. Slomka

In a decision that serves as a reminder of both the consequences and limitations of resale certificates, a New York State Administrative Law Judge has held that an apparel wholesaler and distributor proved that its sales qualified for the sale for resale exclusion under the New York sales tax law, notwithstanding the absence of fully completed New York State resale certificates. *Matter of San Mar Corp.*, DTA No. 822993 (N.Y.S. Div. of Tax Appeals, Apr. 14, 2011).

San Mar's Business. San Mar is a clothing wholesaler and distributor based in the State of Washington, with sales representatives in many states, including New York. San Mar specializes in selling apparel that can be imprinted or embroidered with logos and designs. The vast majority of San Mar's customers were either (i) decorators that put the logos or designs on the San Mar's products, who then resold the decorated products to their own customers, or (ii) promotional products distributors that typically sold a wide variety of decorated products, such as apparel, pens, and mugs. For those customers, San Mar usually shipped the apparel orders to a third-party decorator hired by the promotional products distributor, who in turn shipped the decorated product directly to that distributor's end-user customer. San Mar sold only to customers within its "distribution channel" (typically, the decorators and promotional products distributors), and not to retail customers, and it had procedures in place to insure that potential customers were in fact resellers and not end-users. This was consistent with the company's goal of not competing with its own customers.

Department's Audit. The Department commenced a sales tax audit of San Mar, and a one-month test period was selected involving approximately 200 customer sales. On audit, San Mar was required to establish that it made sales for resale to these customers. It furnished the auditor with various New York State Resale Certificates (Form ST-120), many of which were rejected because of such deficiencies as discrepancies involving the purchaser's name or missing information about the purchaser, including the failure to include a New York State Sales Tax Certificate of Authority number or a non-New York sales tax registration number. Some resale certificates were rejected because there was no check mark in the box located next to the statement affirming that the purchaser agrees to remit use tax if it consumes the property it purchased. In some instances for out-of-state purchasers, New York State Resale Certificates could not be provided, and San Mar did not have taxpayer identification numbers for those purchasers.

Proof at the Hearing. At the administrative hearing, San Mar provided testimony and documentation regarding the nature of its wholesale business, including its internal procedures to insure that it only sold to resellers. This included copies of San Mar's product catalogs that were customized to show the name and identifying information of its customers, rather than its own name, in order to show that it was not marketing to end-users. Specifically with regard to the incomplete or missing ST-120s, the vendor furnished a variety of evidence to address the missing or incomplete information that the properly completed resale certificates would have included. Among the items submitted into evidence were such things as customers' non-New York identification numbers, multijurisdictional resale certificates, specific out-of-state retail or exemption certificates, and customer affidavits.

Although not all of its arguments are completely spelled out in the decision, the Department did take the position that it was not obligated to accept any document (such as multijurisdictional resale certificates or an affidavit) other than a timely and properly completed New York State Resale Certificate.

The ALJ ruled in favor of the taxpayer. The ALJ first summarized the nature and purpose of resale certificates as follows: Under the sales tax law, the burden of proving that a transaction is nontaxable is on the vendor. The Department prescribes certain documents, including resale certificates, which when properly and timely completed satisfy the vendor's burden of proving nontaxability and relieve it of the obligation to collect and remit sales tax on that transaction. However, as the ALJ pointed out, the presumption of taxability is not irrebuttable. A vendor's failure to receive a properly completed resale certificate means only that the vendor cannot rely solely on that resale certificate, but must prove that the transaction was in fact for resale, obviously a more difficult task.

In light of these principles, and after considering the evidence, the ALJ concluded that the vendor met its burden of proving that the disputed sales were in fact nontaxable sales for resale. He first concluded that San Mar

(Continued on page 9)

Sale for Resale Established

(Continued from Page 8)

had established that it was engaged in wholesaling and distributing, and not in making retail sales, and noted that the company showed that it went to great effort to avoid selling to end-users. According to the ALJ, this proof "at a minimum" gave rise to a reasonable inference that the vendor was not engaged in making retail sales.

However, the ALJ recognized that it remained possible that at least some of the sales in question were isolated retail sales, which meant specific proof regarding the transactions was necessary. The ALJ accepted the vendor's additional proof (discussed above) which, when coupled with the other evidence regarding San Mars' business, he found sufficient to meet its burden of proving nontaxability.

Additional Insights. The ALJ's decision makes clear that the Department has the right to reject incomplete resale certificates on audit, but that the taxpayer still retains the right to prove that its sales are not taxable even in the absence of properly completed New York State Resale Certificates. In substantial part, the decision is based on the specific facts of the case regarding evidence of the taxpayer's business and of the purchasers in question. Notwithstanding the taxpayer's victory, the ALJ's decision is a reminder of the importance of obtaining resale certificates, in order to avoid having to go through the level of proof that was furnished in this case.

The Department took the position at the hearing that the judge should give little weight to the affidavits furnished by San Mar's customers, inasmuch as they had an ongoing business relationship with the taxpayer. The ALJ noted that any concern regarding impartiality was offset by the fact that the customer affidavits in question explicitly admitted that the customer made sales of the San Mar products that were purchased, potentially opening that customer to liability for sales tax due, but not paid, on those sales.

As we went to press, it remained unclear whether the Department intends to file an exception with the Tribunal, and, of course, ALJ determinations are not precedential.

One interesting issue that was not addressed was the vendor's argument that requiring a non-New York customer that had its purchases shipped into New York to provide a *New York* taxpayer identification number violated the Commerce Clause of the U.S. Constitution. The ALJ declined to rule on this constitutional issue since he concluded that all of the disputed sales were nontaxable.

Telecom Equipment "Shelters" Held to Be Exempt from Sales Tax

By Hollis L. Hyans

A New York State Administrative Law Judge has held that Nextel Partners N.Y. ("Nextel") is entitled to a refund of sales tax it paid on the purchase of "shelters" used to contain telecommunications equipment. *Matter of Nextel Partners N.Y. (Nextel Partners of Upstate New York, Inc.)*, DTA No. 823195 (N.Y.S. Div. of Tax App., Apr. 28, 2011).

Nextel provides commercial mobile radio services to business and residential customers. The equipment contained in the shelters receives, initiates, transmits, switches or monitors the switching of telecommunications services for sale. The shelters themselves are precast steel reinforced enclosures, cost approximately $28,000 each, and are installed adjacent to cell towers containing antennae, where they are bolted to concrete pads. They contain racks or cabinets to hold the equipment; power panels; connecting wiring necessary for the equipment to operate; backup batteries; and heating, ventilation and air conditioning equipment necessary to maintain the interior temperature within the proper range. They protect the telecommunications equipment from the elements and from animals, dust, theft, and vandalism.

Nextel paid sales tax when it purchased the shelters, and then filed claims for refund on the grounds that the shelters were covered by the exemption from tax provided by Tax Law § 1115(a)(12-a) for tangible personal property "for use or consumption directly and predominantly in the receiving, initiating, amplifying, processing, transmitting, retransmitting, switching or monitoring of switching of telecommunications services for sale . . . ." Nextel claimed that the shelters are used directly and predominantly in the provision of telecommunications services for sale, while the Department argued that the shelters are not "'inextricable components of mechanical equipment' operating as 'a single, integrated and synchronized system.'"

The ALJ held that the shelters were covered by the exemption. He noted that the Tribunal and the courts had taken a broad view of the category of property encompassed within the exemption. For example, in *Matter of People's Telephone Co.*, DTA No. 816253 (N.Y.S. Tax App. Trib., Jan. 16, 2001), the Tribunal held that pay phone pedestals and enclosures were exempt from tax under a

(Continued on page 10)

Equipment Shelters are Exempt

(Continued from Page 9)

predecessor statute, since the finished product was a telecommunications service on which tax was eventually imposed. The pedestals and enclosures were found to have an "'active causal relationship'" in the production of telephone communication. Similarly, the ALJ held in *Nextel* that the shelters are "close, integral, dependent and necessary" for the telecommunications services, and that without them, Nextel would be unable to provide the services. Accordingly, they qualified for the exemption.

Additional Insights. While, as the ALJ noted, tax exemptions are generally strictly construed, and the burden of demonstrating entitlement rests with the party claiming the exemption, here the ALJ found a clear history of the Tribunal and the courts taking a broader view of what constitutes exempt telecommunications property, in light of the statutory purpose that the tax not be pyramided and only be imposed on the end sale to the customer.

Sole Shareholder of Corporation Personally Liable for Sales Tax

By Kara M. Kraman

A wife who was the sole shareholder of a corporation, but who was not involved in any aspect of the management or operations of the company, was nonetheless held to be a responsible person under Tax Law § 1131(1) and was personally liable for the company's sales tax liability. *Matter of Jessie Luongo*, DTA Nos. 822823 & 822517 (N.Y.S. Div. of Tax App., Apr. 28, 2011).

Tax Law § 1131(1) provides that persons required to collect sales and use tax shall include, among other persons, any officer, director, or employee of a corporation, or any member of a partnership or limited liability company. Tax Law § 1133(a) imposes personal liability on any individual required to collect tax under § 1131(1).

THE QUESTION OF RESPONSIBILITY HINGED ON WHETHER THE INDIVIDUAL HAD OR COULD HAVE HAD SUFFICIENT AUTHORITY AND CONTROL OVER THE AFFAIRS OF THE CORPORATION TO BE CONSIDERED RESPONSIBLE FOR THE ENSUING TAX LIABILITIES.

Mrs. Luongo was the sole shareholder of Fifth Avenue Corporation, a company formed to acquire the assets of a bankrupt holding company that had operated the Tuscan Grill restaurant in Manhattan, of which her husband had been the CEO. As a condition of the creditors' approval of the acquisition of the assets of the bankrupt company by Fifth Avenue, the creditors required that Mrs. Luongo's husband not be a shareholder in the acquiring company. Mrs. Luongo became the sole shareholder of Fifth Avenue, but upon its formation, she immediately appointed her husband as the sole board member, and he appointed himself as president, treasurer, and secretary of the company. As the sole officer and board member, Mrs. Luongo's husband was the sole signatory on Fifth Avenue's bank accounts, hired and fired all of the employees, and was in charge of the management and operations of the corporation. He was identified by the company in correspondence with the Department as a responsible person for sales tax purposes. Mrs. Luongo did not participate in the business or operations of Fifth Avenue.

On audit, the Department determined that the company had underreported gross sales on its sales tax returns, and issued assessment notices for sales tax to both the company and Mrs. Luongo. The Department claimed that as the sole owner of the Fifth Avenue Corporation, Mrs. Luongo was a responsible person, and was therefore personally liable for the company's sales tax liability. Mrs. Luongo argued that she was not personally liable because she was not an officer or employee, and had no involvement in the company's business operations.

The ALJ, citing *Matter of Ianniello*, DTA Nos. 805106 & 806698 (N.Y.S. Tax App. Trib., Nov. 25, 1992), held that the question of responsibility hinged on whether the individual had *or could have had* sufficient authority and control over the affairs of the corporation to be considered responsible for the ensuing tax liabilities. The ALJ agreed that the facts that Mrs. Luongo had no signatory authority over the company's bank accounts, did not sign any tax returns for the company, and was never involved in the operations of the company, were important facts to consider. Nonetheless, the ALJ found that as the sole shareholder, Mrs. Luongo had a fiduciary duty to the corporation and the legal authority to act for it in complying with the sales tax laws.

(Continued on page 11)

Personal Liability for Sales Tax

(Continued from Page 10)

("[P]etitioner's duty as the sole shareholder did not cease at the appointment of the board, and at all times, she had the authority and control, by mere virtue of her complete ownership, to oversee the decisions of [her husband] in the running of Fifth Avenue, or act to remove him if he was not acting in the best interest of the corporation.") The ALJ also found Mrs. Luongo's testimony lacked credibility, and noted that by designating her as the sole shareholder, she and her husband had managed to avoid the Bankruptcy Court's ruling that it would not approve the sale if her husband was a shareholder. The ALJ held that Mrs. Luongo was personally liable for the company's sales tax liability.

Additional Insights. Although not binding precedent, the ALJ's decision illustrates the Department's policy of creating a "per se" personal liability for the sole owner of a corporation, whether or not the individual chooses to participate in the business operations. As the ALJ noted, it is often the case that in closely held family businesses, a family member who is a sole shareholder may take a hands-off approach and appoint a spouse or other close family member to run the company, but that does not relieve the shareholder of his or her fiduciary duty to oversee the running of the company. Although the determination of whether an individual is responsible for a corporation's tax collection obligations is inherently a fact-based one, in cases where a corporation has only one owner, it is likely that sole ownership of a business gives the owner the requisite authority and control over the corporation's affairs to be personally liable for the corporation's sales tax liability.

Insights in Brief

Motion to Reopen Record in *Puccio* Residency Case Denied

In the March 2011 issue of New York Tax Insights, we reported on an ALJ decision in *Matter of Thomas P. and Kathleen H. Puccio*, holding that a Connecticut domiciliary with an apartment in New York City, and a job in the City, failed to prove he was not present in the City for more than 183 days of the year, and thus was held to be a New York State and City resident. Subsequently, the taxpayer filed a motion to reopen the record in order to submit newly discovered evidence regarding his day count. The ALJ has now issued an Order denying the taxpayer's motion, finding that the taxpayer did not adequately explain why the newly discovered evidence could not have been uncovered in time for the administrative hearing. The ALJ also noted that the taxpayer was made aware at the hearing that no further evidence would be allowed after the close of the hearing. *Matter of Thomas P. and Kathleen H. Puccio*, DTA No. 822476 (N.Y.S. Div. of Tax App., Apr. 28, 2011).

Demand for Bill of Particulars Vacated

A New York State ALJ has granted the Department's motion to vacate a demand for a Bill of Particulars served by the plaintiff in a case challenging the audit methodology employed in a sales tax audit. *Matter of Lower Eastside Entities, LLC*, DTA No. 823839 (N.Y.S. Div. of Tax App., Apr. 28, 2011). Under New York law, a party can only be required to serve a Bill of Particulars providing further information on issues that the party has the burden to prove. Here, the burden of proof to challenge the assessment fell entirely on the taxpayer, so the Department could not be required to provide the Bill.

Agent of an Industrial Development Agency Not Entitled to Sales Tax Exemption

In *Henrietta Building Supplies, Inc.*, DTA No. 822268 (N.Y.S. Tax App. Trib., Apr. 21, 2011), the New York State Tax Appeals Tribunal affirmed an ALJ determination that the company, a wholesaler and retailer of building supplies, was not entitled to an exemption from sales tax for trucks it purchases as an agent of the County of Monroe Industrial Development Agency. While the term "project" as used in the statute was broad enough to include motor vehicles, the company showed only that the trucks were garaged at the facility, and failed to demonstrate how they were actually used in connection with the facility. In addition, the company could not demonstrate that use of the trucks outside Monroe County related to the project at issue, or that it had obtained consents from the governing bodies of other municipalities in which the property was used.

To ensure compliance with requirements imposed by the IRS, Morrison & Foerster LLP informs you that, if any advice concerning one or more U.S. federal tax issues is contained in this publication, such advice is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein. For information about this legend, go to www.mofo.com/circular230.

This newsletter addresses recent state and local tax developments. Because of its generality, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. If you wish to change an address, add a subscriber, or comment on this newsletter, please email Hollis L. Hyans at hhyans@mofo.com, or Irwin M. Slomka at islomka@mofo.com, or write to them at Morrison & Foerster LLP, 1290 Avenue of the Americas, New York, New York 10104-0050.

©2011 Morrison & Foerster LLP | mofo.com

ABB v. Missouri
Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
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. NJ
Current, Inc. v. California
Deluxe Corp. v. California
DIRECTV, Inc. v. Indiana
DIRECTV, Inc. v. New Jersey
Dow Chemical Company v. Illinois
Express, Inc. v. New York
Farmer Bros. v. California
General Mills v. California
General Motors v. Denver
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
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
Nabisco v. Oregon
National Med, Inc. v. Modesto
Nerac, Inc. v. NYS Division of Taxation
NewChannels Corp. v. New York
OfficeMax v. New York
Osram v. Pennsylvania
Panhandle Eastern Pipeline Co. v. Kansas
Pier 39 v. San Francisco
Reynolds Metals Company v. Michigan Department of Treasury
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
Sears, Roebuck and Co. v. New York
Shell Oil Company v. California
Sherwin-Williams v. Massachusetts
Sparks Nugget v. Nevada
Sprint/Boost v. Los Angeles
Tate & Lyle v. Alabama
Toys "R" Us-NYTEX, Inc. v. New York
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
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

When these companies had difficult state tax cases, they sought out Morrison & Foerster lawyers.

Shouldn't you?

For more information, please contact
Craig B. Fields at (212) 468-8193,
Paul H. Frankel at (212) 468-8034, or
Thomas H. Steele at (415) 268-7039

MORRISON | FOERSTER

©2011 Morrison & Foerster LLP | **mofo.com**