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MoFo New York Tax Insights

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Tribunal Reverses Itself in *Gaied* "Permanent Place of Abode" Decision

By Irwin M. Slomka

In a decision that will undoubtedly generate further debate regarding the statutory residency rule, the New York State Tax Appeals Tribunal, in a majority decision, has taken the rare step of withdrawing its earlier decision, which involved the "permanent place of abode" definition, and reversing itself by holding that an individual's Staten Island home occupied by his parents was, after all, his permanent place of abode for statutory residency purposes. *Matter of John Gaied*, DTA No. 821727 (N.Y.S. Tax App. Trib., June 16, 2011).

As we reported in the April 2011 issue of *New York Tax Insights*, on February 24, 2011, the Tribunal granted the Department's motion for reargument of the Tribunal's July 8, 2010 decision in *Gaied*. In that decision, the Tribunal held that a New Jersey domiciliary's second home in Staten Island, part of which was occupied by his parents (and part leased to tenants), was not his permanent place of abode. The Tribunal had concluded that, in making its determination, it

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was appropriate to look to "the physical attributes of an abode, as well as its use by a taxpayer." The Department, in seeking reargument, asserted that the Tribunal had failed to reconcile the *Gaied* decision with its decision in *Matter of Robert & Judith Roth*, DTA No. 802212 (N.Y.S. Tax App. Trib., Mar. 2, 1989), where it held that "there is no requirement that the petitioner actually dwell in the abode, but simply that he maintain it."

Now, following reargument, two of the Tribunal's three Commissioners have reversed the July 8, 2010 Tribunal decision, and instead held that the Staten Island property was the taxpayer's permanent place of abode. The Tribunal first concluded that its July 8, 2010 decision was in error:

> We have concluded upon further reflection that our July 8, 2010 decision is an improper departure from the language of the statute, regulations, and controlling precedent. A review of our decisions from both prior to and [in *Matter of Barker*] subsequent to our July 8, 2010 decision, indicates that *where a taxpayer has a property right to the subject premises, it is neither necessary nor appropriate to look beyond the physical aspects of the dwelling place* to inquire into the taxpayer's subjective use of the premises.

(Emphasis added.)

The Tribunal then proceeded to address afresh what it considered to be the relevant factors:

- *Maintenance.* The Tribunal concluded that Mr. Gaied maintained the Staten Island house, both owning it and paying expenses for its upkeep. The Tribunal held it did not matter whether or not the premises were maintained for the taxpayer's own use.
- *Access to Premises.* The Tribunal held that the taxpayer did not establish that the Staten Island home was maintained exclusively for his parents, noting that the ALJ (who had ruled that the home was a permanent place of abode) found the taxpayer's claim that he did not have unfettered access was not credible.
- *Investment Purpose.* The Tribunal also concluded that the taxpayer did not prove that the home was maintained solely as an investment, inasmuch as he occasionally stayed over, and he did not receive rent from his parents.

Stating that its prior decisions in *Matter of Roth* ("there is no requirement that petitioner dwell in the abode were controlling") and *Matter of Boyd* (holding that a home owned and occupied by the taxpayer's mother, but for which the taxpayer paid over 50% of the expenses, was the taxpayer's permanent place of abode) were controlling, the majority held that the taxpayer permanently maintained the Staten Island home, which had the requisite physical attributes as a dwelling. This was sufficient for the Tribunal majority to find it was a permanent place of abode.

The dissent found that the July 8, 2010 decision correctly applied the legal standards regarding "maintenance" and "permanent place of abode." The dissent pointed out that "maintenance" has been interpreted in a practical manner, generally based on a taxpayer doing what is necessary to live in the dwelling. The term "permanent" is not based solely on the physical attributes of the dwelling, or on ownership, but also on the taxpayer's ability to access the dwelling. Here, the fact that the taxpayer occasionally stayed at his parents' residence did not prove he had unfettered access. The dissent distinguished the case from *Matter of Barker* (involving a vacation home in the Hamptons), because the taxpayer here did not have unfettered access to the Staten Island home.

Additional Insights. Having granted the Department's a motion for reargument, the Tribunal's reversal of its earlier decision should come as no great surprise. However, the Tribunal's decision appears to say, as no prior decision did before, that a taxpayer's access to the abode is irrelevant, and that the taxpayer's ownership and maintenance of a fully usable dwelling is determinative.

The decision certainly raises many questions. For instance, what if the taxpayer leases the property to a tenant? Under the Tribunal's holding, a taxpayer's actual use (or, put another way, non-use) of the abode appears to be irrelevant. Will the Department now view even an abode that the taxpayer leases to a third party as the taxpayer's permanent place of abode (and also the third-party tenant's permanent place of abode)?

The *Gaied* decision may still be appealed to the Appellate Division. As we went to press, the Tribunal denied a motion for reargument — this time made by the taxpayer — in *Matter of John J. and Laura Barker*, DTA No. 822324 (N.Y.S. Tax App. Trib., June 23, 2011), perhaps an even more controversial decision. As we discussed in the February 2011 issue of *New York Tax Insights*, the Tribunal previously held in *Barker* that a Connecticut couple's vacation home in the Hamptons constituted a permanent place of abode causing the husband, who worked in New York City, to be considered a New York State resident.

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Given the well-known inequities regarding application of the permanent place of abode rule for statutory residency, going far beyond the original purpose for the rule, the Tribunal's decision will likely fuel efforts to substantially change, or eventually eliminate altogether, the current statutory residency rules.

Tribunal Finds No Responsible Person Liability

By Hollis L. Hyans

Upholding a decision issued by an Administrative Law Judge, the New York State Tax Appeals Tribunal has held that an individual did not have personal responsibility for the unpaid sales and use taxes of a company for which he acted as an advisor and incorporator, as well as a landlord, but over which he had no actual authority or control. *Matter of Tomonari Nomura*, DTA No. 822181 (N.Y.S. Tax App. Trib, May. 12, 2011).

The alleged responsible party, Mr. Nomura, was president of Nomura Management, Inc., which held a lease on third-floor premises located on East 52nd Street in New York, NY, as well as other nearby premises on East 53rd Street which served as the company's offices. In 2002, Nomura Management subleased the East 52nd Street premises, vacant at the time, to Masaaki Hirano, the manager of a restaurant located on the first floor of the same building, for use as a bar. Mr. Nomura also generally assisted Mr. Hirano, who did not speak English and initially lacked the proper immigrant status to obtain credentials to engage in business in the U.S. Mr. Nomura served as the initial incorporator of Mr. Hirano's company, called Queen Group, Inc., opened a bank account for the business, and provided advice on tax filing obligations, including a recommendation of an accountant. He was listed on Queen Group's initial federal income tax return as the owner of 100% of its stock, but the subsequent returns for 2002 through 2004, including federal and New York State and New York City returns, list *Mr. Hirano* as owning 100% of the stock.

Nomura Management was paid rent, and additional amounts for building maintenance and repairs, and wages were paid to Mr. Hirano, but no payments were made by Queen Group to Mr. Nomura individually, or to Nomura Management for anything other than rent or building maintenance and repairs. Mr. Nomura also assisted Mr. Hirano in opening another bar in 2001 at the East 53rd Street premises to which Nomura Management held the leasehold.

The Department conducted a field audit, and assessed sales and use tax against Queen Group, and personal liability for those taxes against Mr. Nomura. The Department relied in part on statements that Mr. Hirano's attorney had told the auditor that all records were transferred to Mr. Nomura, who was "the business manager and partner in the business." The Department also relied on a settlement agreement between Mr. Nomura and Mr. Hirano, giving Mr. Hirano exclusive use of the East 52nd Street premises in return for specified payments and waiver of any interest at the East 53rd Street premises.

After a hearing, an ALJ had held that Mr. Nomura was not a person under a duty to collect and remit sales and use tax for Queen Group, since there was no evidence he had any connection with the business beyond incorporating it, providing some advice, and signing the initial corporate tax return.

The Tribunal affirmed, finding it clear that Mr. Nomura had met his burden of proving he was not responsible. The Tribunal, like the ALJ, appeared to give substantial weight to Mr. Nomura's "credible" testimony that he was not an officer or owner, that he incorporated the business as a favor, and that he thereafter transferred all the stock to Mr. Hirano. The Department established no check-signing authority, no benefits that inured to Mr. Nomura, and no evidence of any kind that he was a signatory on bank accounts or that he received any wage or salary or anything other than lease payments.

The Tribunal gave short shrift to the Department's arguments based on its claim that Mr. Hirano had informed the auditor that Mr. Nomura had managed the business, noting that the argument was based not only on hearsay — out-of-court statements introduced for the facts contained therein — but on *double* hearsay: the auditor testified concerning statements that Mr. Hirano's representative had made about what Mr. Hirano had said. The Tribunal also rejected the Department's attempt to rely on the settlement agreement, despite broadly worded descriptions of Mr. Nomura and the capacity in which he was signing, finding that the agreement itself dealt only with cancellation of one lease and entry into another, and did not indicate that Mr. Nomura and Mr. Hirano were business partners.

Additional Insights. While it can be difficult to establish lack of personal responsibility for sales tax, this case demonstrates it is indeed possible and that sometimes the Department appears to reach too far in its attempt to find personal liability. At least as described in the Tribunal decision, the connection between Mr. Nomura and the business of Queen Group seems quite remote. He was not an officer, owner, or employee; he signed no checks; he received no income other

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than as landlord; and there seemed to be no evidence of any real connection. The attempt to rely on statements purportedly made by a representative for Mr. Hirano to the auditor — without any supporting documentary evidence — seems particularly weak. Although hearsay evidence can be admissible in administrative hearings — unlike formal court proceedings, where such evidence is generally barred — it can be of little value, and denies the opposing party the ability to cross-examine. Here, in the absence of any real documentary evidence of Mr. Nomura's involvement, he was absolved of personal liability.

Court of Appeals to Hear Taxpayer Appeal of State's Denial of Purchase for Resale Exclusion

On June 7, 2011, the New York Court of Appeals granted the taxpayer's motion seeking permission for leave to appeal in *Matter of Echostar Satellite Corp. v. Tax Appeals Tribunal*, (Motion No. 2011-420) (N.Y. June 7, 2001). Echostar had requested permission to appeal a decision of the Appellate Division, Third Department, which had upheld the Department's denial of a purchase for resale exclusion from sales tax for Echostar's purchases of satellite television equipment that it, in turn, leased to its customers for a fee. Echostar had collected and remitted more than $2 million in sales tax on those lease charges. However, the Department concluded that $1.8 million in tax was instead due on the equipment purchases, and the Tax Appeals Tribunal agreed. The Court of Appeals has now taken the somewhat unusual step of granting permission and will hear Echostar's appeal.

Among the important issues that the Court is expected to consider is whether imposition of sales tax on Echostar's equipment purchases is contrary to the fundamental sales tax principle that the tax should be imposed on end-users, not on interim purchasers of property. Also likely in issue will be whether it is manifestly inequitable to permit New York State to retain the sales tax collected on the equipment lease charges, as well as assess additional tax on Echostar's purchases of the same equipment.

Paul H. Frankel, Irwin M. Slomka, and Kara M. Kraman of Morrison & Foerster LLP are representing the taxpayer in the *Echostar* appeal.

Sales Tax Regulation Regarding One-Week Rentals Invalidated by ALJ

By Hollis L. Hyans

In *Matter of Old Forge Kampgrounds, LLC*, DTA No. 823254 (N.Y.S. Div. of Tax App., June 2, 2011), a New York State Administrative Law Judge has held that camp cottage rentals, no matter their duration, qualify as nontaxable occupancy for sales tax purposes, despite the Department's regulation limiting the exemption to rentals of at least one week.

Old Forge Kampgrounds provided tent sites, RV sites, log cabins, and two-room cottages, with beds, light, electricity and heat, kitchenettes, dining table and chairs, and an attached bathroom. The facilities contained no telephones or televisions, and guests had to supply their own cooking items, linens or sleeping bags, soap, and towels. A grocery store on the premises sold food, beverages, clothing, fuel, and other supplies, and also rented linen packages for an additional charge. The Department conducted a sales and use tax audit for 2005 through 2008 and, while agreeing that no sales tax was due on the charges for tent sites, RV sites, and log cabins, as well as rentals of cottages for seven or more days, asserted that tax was due on cottage rentals of less than seven days.

New York imposes sales tax on the rental of hotel rooms, Tax Law § 1101 (c)(1), and the Department's regulations add "[b]ungalows or similar living units" as examples of "hotels." 20 N.Y.C.R.R. 527.9(e). As in effect for the years in issue, the regulation provided that rents for the occupancy of bungalows limited to single family occupancy are not for the taxable rental of hotel rooms, as long as no maid, food, or other common hotel services are provided, and the rental is for more than one week.

Both parties agreed that the cottages at issue were bungalows within the meaning of the regulation, and therefore the sole issue concerned the validity of the regulation's one-week rental requirement. The ALJ reviewed the Department's regulation, which he found created a special definition of a "hotel" for bungalows that met certain conditions. The first condition, the presence of common hotel services, was found to be implicit in the statutory definition of hotel in Tax Law § 1101(c)(1) and therefore supportable. However, the one-week stay requirement had no

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One-Week Rule Invalidated

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support in the statute or the common law, and the ALJ found the Department had offered no argument as to why the length of stay should be "uniquely relevant or rational in determining whether a bungalow — and no other type of accommodation — should be considered a hotel for sales tax purposes." The regulatory distinction meant that the cottages would be taxable hotels for a six-day stay, but the same spaces would not be considered hotels and would not be taxable beginning on the seventh day. The ALJ found that "[t]his juxtaposition of similar circumstances and contrary results shows the illogic and irrationality of the regulation." He found that the one-week requirement did not exist in the statute, and therefore the regulation exceeded the Department's authority and was invalid.

Additional Insights. As the ALJ noted in the decision, tax regulations are generally entitled to deference, and are upheld unless they are shown to be irrational or inconsistent with the statute. When, as here, a regulation adds a requirement not set forth in the statute, and no rationale for the distinction could be found, the regulation was not sustained. However, an ALJ decision has no precedential value, so the regulation is not automatically invalidated for all taxpayers, unless an appeal is taken by the Department and the decision is affirmed.

In addition, the regulation also contained the requirement that the bungalows be "furnished living units limited to single family occupancy." It is not clear that the cottages at issue were limited in that way, since they contained two separate rooms, and could conceivably be used by a group of people other than a single family. No mention of this requirement was made by the ALJ in the decision, however, and it does not seem to have been an issue raised by either party.

Tribunal Finds for Taxpayers in Pair of Capital Improvement Cases

by Kara M. Kraman

The New York State Tax Appeals Tribunal recently held for the taxpayer in two cases on the issue of whether or not construction projects constituted capital improvements. Although the facts of each case were different—one involved a roller coaster and the other a temporary facility constructed as part of a bridge-painting project—the Tribunal held each was a capital improvement.

Matter of Amusements of WNY, Inc.

In *Matter of Amusements of WNY, Inc.*, DTA No. 822534 (N.Y.S. Tax App. Trib., May 26, 2011), the Tribunal ruled that the purchase and installation of a wooden roller coaster constituted a capital improvement, and therefore was not subject to sales tax. The taxpayer, an operator of an amusement park, owned real property on which it contracted to have a roller coaster built. The operator treated the entire cost of the roller coaster as a capital improvement and did not pay sales tax on its purchase and installation.

Upon audit, the Department determined that only certain parts of the roller coaster were properly treated as capital improvement—specifically, the concrete footings, station house, and electrical and labor costs associated with those parts. However, the Department assessed sales tax on the steel superstructure and wooden track (and the related labor costs) on the grounds that they were not capital improvements because the steel superstructure could be unbolted from the cement footings and re-erected elsewhere without causing material damage to the real property or to the roller coaster itself. An Administrative Law Judge disagreed, holding that the entire purchase and installation of the roller coaster was not subject to sales and use tax. The Department filed an exception.

Sales tax is imposed on the receipts from every sale (except for resale) of the service of installing tangible personal property, except for installing property which, when installed, will constitute a capital improvement to real property. The term "capital improvement" is defined in Tax Law § 1101(b)(9)(i) as:

An addition or alteration to real property which:

> (A) Substantially adds to the value of the real property, or appreciably prolongs the useful life of the real property; and
>
> (B) Becomes part of the real property or is permanently affixed to the real property so that removal would cause material damage to the property or article itself; and
>
> (C) Is intended to become a permanent installation.

The Tribunal affirmed the decision of the ALJ, adopting the ALJ's reasoning in concluding that the entire roller coaster installation was an exempt capital improvement. The ALJ had found that the installation of the roller coaster met each of the requirements in Section 1101(b)(9)(i).

First, the ALJ held that, at a cost of nearly $2 million, the roller coaster substantially added to the value of the property. Next, the ALJ determined that it was intended

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to be permanent, noting, among other things, that the roller coaster had a 1.8-acre footprint and could not be easily removed, as its foundation included concrete slabs and piers to attach the structure to the ground. The ALJ also noted that it is the intention of the person requesting the installation that determines intent, and in this case, it appeared that the amusement park operator requesting the installation intended for the roller coaster to be permanent because, among other things, it owned the real property on which the improvement was being made.

Finally, the ALJ examined whether the roller coaster was permanently affixed to the real property so that its removal would cause material damage to the property or to the roller coaster itself. The ALJ found that, although the steel superstructure of the roller coaster could be moved and re-erected, doing so would cause material damage to the roller coaster itself because it would damage the wooden boards and wooden supports, without which the steel track was unusable. The Tribunal affirmed the ALJ's decision in full and held that the entire cost of the purchase and installation of the roller coaster was exempt from sales tax as a capital improvement.

Matter of L & L Painting Co., Inc.

A week later, the Tribunal again held for the taxpayer in a capital improvement case. In *Matter of L & L Painting Co.*, DTA Nos. 822266 & 822227 (N.Y.S. Tax App. Trib., June 2, 2011), the Tribunal held that, since applying a protective coating of paint to a bridge was a capital improvement, the installation of a temporary platform to contain

[T]HE PAINTING OF THE BRIDGE WAS A CAPITAL IMPROVEMENT AND THAT THEREFORE THE CONSTRUCTION OF THE POLLUTION CONTAINMENT SYSTEM WAS A NECESSARY PREREQUISITE TO A CAPITAL IMPROVEMENT AND EXEMPT

pollutants and debris during that project was a necessary prerequisite to the construction of a capital improvement, and was not subject to sales tax under Regulation 541.8.

The taxpayer was a commercial painter with a "steel bridge division" whose painting projects included bridges such as the George Washington Bridge, the Williamsburg Bridge, and the 59th Street Bridge. The taxpayer contracted with the New York City Department of Transportation to paint the Pulaski Bridge linking Brooklyn and Queens. The contract called for the taxpayer to completely remove the bridge's existing painting by abrasive blasting down to the steel, and to then cover the bridge with a new protective coating of paint. The taxpayer was required by contract to install a temporary containment system to contain pollutants and debris during the blasting. The painting job was designed to protect the bridge from corrosion and would, if done properly, last at least 20 years and possibly as long as 40 years.

Upon an audit of the taxpayer's purchases, the Department determined that the taxpayer's payment to a third-party contractor to install the temporary pollution containment system at the Pulaski Bridge was not exempt from sales tax. The Department argued that the painting of the Pulaski Bridge was not a capital improvement, but rather was taxable as repair and maintenance work under Regulation 527.7(a). Accordingly, it argued that the pollutant containment system was not exempt from sales tax because the painting of the bridge was not itself a capital improvement.

In determining whether certain services are properly classified as capital improvements or as repair or maintenance, Regulation 527.7(a)(1) provides:

> The imposition of tax on service performed on real property depends on the *end result* of such service. If the end result of the services is the repair or maintenance of real property, such services are taxable. If the end result of the same service is a capital improvement to the real property, such services are not taxable.

(Emphasis added.)

Regulation 541.8(a) provides that temporary facilities that are a "necessary prerequisite to the construction of a capital improvement" are also exempt from sales tax. Thus, in order for the containment system to be exempt, the painting of the bridge had to be exempt as a capital improvement.

The ALJ held that the painting of the bridge was a capital improvement and that therefore the construction of the pollution containment system was a necessary prerequisite to a capital improvement and exempt from sales tax under Regulation 541.8(a). The Tribunal found that the "end result" test under the regulation supported the ALJ's determination because the end result of painting the bridge met the definition

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of a capital improvement under Section § 1101(b)(9)(i). The application of paint prolonged the life of the bridge by protecting it from corrosion. The paint was permanently affixed to the bridge and could not be removed without materially damaging the paint and the bridge itself, since the only way to remove the paint was to do another abrasive blasting, and the painting was clearly intended to be permanent. Accordingly, the Tribunal held that the pollution containment system was also exempt from sales tax.

Additional Insights. The Tribunal's holding in *Amusements of WNY* suggests that, in certain circumstances, the Tribunal will not allow the Department to, in effect, break a single, integrated project into multiple parts, asserting that some parts are capital improvements and other are not, particularly when each part is useless without the other, and the items may be damaged by separating them. The decision, while involving a highly specific set of facts, reveals that the Tribunal may be willing to look to the overall nature of an improvement in determining whether it is a capital improvement, rather than analyzing each of the component parts.

The Tribunal's ruling in *L & L Painting* is a reminder that even services specifically listed as potentially taxable maintenance, service, and repair items in the regulations, such as painting, sewerage service, and tree removal, can still qualify as capital improvements if the *end result* of the performance of the services is a capital improvement.

Price of Cigars Established Based on Intercompany Prices, Industry Survey

By Hollis L. Hyans

A New York State Administrative Law Judge has held that a tobacco wholesaler successfully demonstrated that the "wholesale price" of cigars purchased from a related party is the price paid by that related party to the manufacturers, and that statistical data can be used to determine the wholesale price of cigars purchased from third-party wholesale suppliers. *Matter of Davidoff of Geneva (NY), Inc.*, DTA No. 822752 (N.Y.S. Div. of Tax App., May 26, 2011).

Davidoff of Geneva (NY), Inc. ("Davidoff"), obtains its Davidoff brand cigars from a related party, Oettinger IMEX AG ("IMEX"), headquartered in Switzerland. IMEX purchases the cigars from its manufacturing subsidiaries, five companies located in the Dominican Republic, referred to collectively by the ALJ as "Davidoff of the Dominican Republic." IMEX consigns all the Davidoff cigars it purchases, except for those sold to third parties, to Davidoff of Geneva (CT), Inc. ("CT"), its American distributor, another related party, which then in turn sells the cigars to wholesalers and retailers, including Davidoff, throughout the United States. CT maintains a single price list for sales to all retailers. Davidoff, the petitioner, imports the Davidoff brand cigars consigned by IMEX to CT for sale at retail and possibly wholesale, and pays the same price for Davidoff brand cigars that is paid by unrelated retailers. Davidoff also purchases cigars from third parties.

Purchases from Related Parties. Under Tax Law § 471-b(1), a tobacco products tax is imposed on all tobacco products possessed in the state for sale. The distributor is liable for tax at stated percentages of the "wholesale price," which is defined as the "established price for which a manufacturer sells tobacco products to a distributor . . . . In the absence of such an established price, a manufacturer's invoice price shall be presumptive evidence of the wholesale price . . . and in its absence the price at which such tobacco products were purchased shall be presumed to be the wholesale price, unless evidence of a lower wholesale price shall be established or any industry standard of markups . . . shall be established." Tax Law § 470(6). Based on this statute, Davidoff determined that the average manufacturer's invoice price charged by Davidoff of the Dominican Republic (the manufacturer) to IMEX (the consignor) was a certain percentage, referred to in the decision as "A%" to protect confidential information, of the amount that CT (the distributor) had charged Davidoff for the same cigars. This A% ratio was used to determine the wholesale price for filing the tobacco products tax return, both for purchases from CT and from third-party wholesalers. While the auditor initially accepted this method, the Department ultimately took the position that the purchase price must be Davidoff's purchase price from CT, rather than the price paid by IMEX.

The ALJ agreed with Davidoff, relying on the clear direction provided by the statute for determining wholesale price. He rejected the Department's argument that the prices between Davidoff of the Dominican Republic and IMEX should be disregarded because they were purchases between related parties and not necessarily at arm's length. Davidoff was able to produce the manufacturers' invoices, and the statute provides a presumption that the invoice prices are

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Taxpayer Proves Cigar Prices

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the wholesale prices. The ALJ found no evidence in the record that the prices were not arm's length, and in fact noted that Davidoff had introduced a transfer pricing analysis which, while correlating to only part of the audit period and dealing with the prices charged by IMEX to CT, did establish that pricing between at least some of the related entities can be at arm's length, and "serves to undermine the Division's position that the mere fact that IMEX controls the manufacture and distribution of its branded merchandise means that the price at which the manufacturer sells its product is not a fair, arm's-length price."

Purchases from Third Parties. With regard to the purchases from third-party suppliers, since there was no evidence of either established prices or invoice prices that would meet the statutory presumption, the next alternative was the price at which the products were purchased, unless evidence of a lower wholesale price is established or any industry standard of markups is demonstrated. Here again the ALJ agreed with Davidoff, finding that the results of a survey conducted by the Cigar Association of America ("CAA"), introduced into evidence and accompanied by an affidavit of the president of the CAA, provided sufficient evidence of a lower wholesale price than the one used by the Division. While the Department objected to use of the study, arguing that the individual preparer was not present to testify, and that it was not independent because the CAA represents cigar companies, the ALJ rejected these arguments, noting that affidavits are admissible; that Davidoff's own sales were a tiny fraction, less than 1%, of the total information surveyed; and that the Department had the authority to obtain information from every tobacco distributor but did not do so. While the Department did not have the burden of establishing the price, once Davidoff introduced what the ALJ found to be "credible evidence" of a lower wholesale price, it was incumbent on the Department to come forward with contrary evidence, and not merely speculate on possible weaknesses in the CAA survey.

[O]NCE DAVIDOFF INTRODUCED WHAT THE ALJ FOUND TO BE "CREDIBLE EVIDENCE" OF A LOWER WHOLESALE PRICE, IT WAS INCUMBENT ON THE DEPARTMENT TO COME FORWARD WITH CONTRARY EVIDENCE

Additional Insights. The decision demonstrates that a taxpayer with good records, which carefully follows the statutory framework, can make a sufficient showing to convince an ALJ of the validity of its position, particularly where, as seems to be the case here, the contrary arguments raised by the Department are based on mere allegations of lack of arm's length pricing and valid studies, with no introduction of actual competing evidence.

Also interesting is the ALJ's willingness to use the protective tactic of describing the ratio used by Davidoff simply as "A%," in order to protect confidential pricing information. Even though proceedings before the Division of Tax Appeals are confidential, ALJ decisions are public, and taxpayers are often concerned that confidential information produced during the course of a tax audit could inadvertently become public simply because the taxpayer is exercising its right to contest a tax liability. This decision demonstrates an excellent compromise that allows the issues to be raised, and the decision to be issued publicly, without revealing confidential information.

City ALJ Rules Dock Rents Subject to Commercial Rent Tax

By Irwin M. Slomka

A New York City Administrative Law Judge has ruled that a cruise ship operator's payments to dock its boats at Chelsea Piers in Manhattan are subject to New York City commercial rent tax. *Matter of Spirit Cruises, Inc.*, TAT(H) 09-18(CR) (N.Y.C. Tax App. Trib., Admin. Law Judge Div., June 2, 2011). The ALJ also rejected the taxpayer's attempt to rely on the results of a prior audit to collaterally estop New York City from assessing the tax.

Spirit Cruises operated dining, entertainment, and sightseeing cruises on the Hudson River. It subleased dock space, as well as office space and storage facilities, from Chelsea Piers LLC, which leased the space from New York State. The principal dispute concerned whether the separate dock rent charges under the sublease were taxable payments for commercial premises in Manhattan, or instead nontaxable payments for water areas in the Hudson River.

The commercial rent tax ("CRT") applies to a lessee's base rent for taxable premises, which include

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Dock Rentals Subject to CRT

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"[a]ny real property or part thereof, and any structure thereon or space therein" within portions of New York City. N.Y.C. Admin. Code § 11-701.4. On audit, the Department of Finance ("City") determined that the dock rents were for land, improvements, and an appurtenant right of access, making the rents payments for taxable premises. Spirit Cruises claimed that the payments, which were separate from its payments for office and storage space, were payments for "water areas."

Taxable premises. The ALJ held that the dock rents were taxable payments for the right to dock boats alongside a physical structure affixed to land, and to give customers access to the boats. In the ALJ's view, what was being rented was the appurtenant physical structure, which was essential to the taxpayer's cruise boat business. In support of its position, Spirit Cruises had submitted an affidavit of its chief financial officer stating her belief as to what was being rented. Over the City's objection, the ALJ admitted it into the record, but gave it no weight, noting that the affidavit merely reflected the CFO's "understanding" of what others told her the payments were for, and that she was not subject to cross-examination. Although the City also took the more far-reaching position that CRT would be due even if the payments were for water areas, the ALJ did not address that issue because the record did not support the taxpayer's factual premise.

Collateral estoppel. Spirit Cruises also claimed that the City should be collaterally estopped from imposing the tax because, in a prior audit several years earlier, the City did not impose commercial rent tax on the dock rents. Moreover, the City did not audit the taxpayer's CRT returns in the five years immediately preceding the periods years in issue, during which dock rents were also not reported in its returns. In reliance on that prior audit, and the absence of a follow-up audit, Spirit Cruises stopped filing CRT returns, since the balance of the rent paid for taxable premises – the storage and office space – did not meet the minimum dollar threshold for taxability.

IN THE ALJ'S VIEW, WHAT WAS BEING RENTED WAS THE APPURTENANT PHYSICAL STRUCTURE, WHICH WAS ESSENTIAL TO THE TAXPAYER'S CRUISE BOAT BUSINESS.

The ALJ held that collateral estoppel could not be invoked against the City. The ALJ noted that the purpose for collateral estoppel is to bar parties from re-litigating issues where there was a full and fair litigation of the issue in a prior action. Since there was no prior litigation here, merely a desk audit, there was no final court judgment that could bind the City for future periods. The ALJ did abate penalties, however, finding that the taxpayer had reasonable cause for not paying tax on the dock rents by having relied on the prior audit results.

Additional Insights. The ALJ's decision that the dock rents were being paid for the use of taxable premises, under the particular facts, and in the absence of evidence to the contrary other than the CFO's affidavit, is not surprising. Although not in issue in *Spirit Cruises*, rents paid for use of "piers" in interstate or foreign commerce are exempt from the CRT. In *Matter of Circle Line Statue of Liberty Ferry, Inc.*, TAT(H)08-82(CR) (N.Y.C. Tax App. Trib., Admin. Law Judge Div., Apr. 27, 2010), the same ALJ held that rent paid to the New York City Parks Department by an operator of a ferry service between Battery Park, Liberty Island, and Ellis Island for access to landing slips did not qualify for that exemption, because the slips were not "piers" under common parlance, or under state, federal and maritime law.

The ALJ's discussion of the taxpayer's collateral estoppel argument is of more widespread interest. The ALJ correctly noted that collateral estoppel applies only when there has previously been a full and fair opportunity to litigate an issue. She also stated, seemingly in *dicta*, that collateral estoppel cannot be asserted against the government, particularly in tax matters. Although collateral estoppel may not have been the appropriate legal remedy in this case, the taxpayer raised a valid concern regarding the inequities resulting from an unannounced change in a government tax policy. The ALJ acknowledged that "the Department published no notice advising an industry of what is, in practice, a change in its position" regarding dock rentals. The City's apparent retroactive change of policy does raise questions of fundamental fairness and, ultimately, of whether the taxpayer's due process rights were violated.

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"Hosted Marketing Services" Are Taxable Sales of Pre-written Software

By Irwin M. Slomka

In yet another reminder of the uncertainties involving the taxability of computer-related services, the Department of Taxation and Finance has ruled that "hosted marketing services" constitute the sale of pre-written software and are subject to sales and use tax to the extent accessed by clients in New York. *Advisory Opinion*, TSB-A-11(17)S (N.Y.S. Dep't of Taxation & Fin., June 1, 2011).

The taxpayer, a California-based service provider ("Host Marketer"), offers marketing services to clients that use email, direct mail, and other marketing channels to reach potential customers. Under the taxpayer's "Hosted Offering" program, clients acquire information about their own customers (*e.g.*, email address, demographic data, and web browsing history) and load that information, via the Internet, onto the Host Marketer's servers in California. Using the Host Marketer's software, a client can derive a list of targeted recipients for messages the client wants to send based on the client's criteria that it also enters. Messages are then sent from the Host Provider's servers to the targeted recipients, usually via email. Clients are able to monitor activity on their email campaigns by logging onto the Host Marketer's website.

As a condition of the service, the Host Marketer licenses to clients the right to use its proprietary software for a specified number of users. The software cannot, however, be downloaded onto the client's computers. The Host Marketer does not charge a software license fee. Instead, clients pay an initial set-up fee to establish connectivity to the Host Marketer's data centers. There is a separate charge based on the number of marketing messages that the client has the Host Marketer send to customers, typically via email.

ALTHOUGH THERE ARE NO DESIGNATED SOFTWARE LICENSING FEES, THE DEPARTMENT RULED THAT THE SET-UP FEE AND MESSAGING CHARGES WERE PAYMENTS FOR THE RIGHT TO USE THE HOST MARKETER'S PRE-WRITTEN SOFTWARE.

The Department ruled in its Advisory Opinion that the host marketing services constitute the sale of pre-written software and are taxable to the extent they are used by clients in New York State. Noting that a sale includes a "license to use" tangible personal property, the Department pointed to the fact that the Host Marketer grants clients a license to use the software. Although there are no designated software licensing fees, the Department ruled that the set-up fee and messaging charges were payments for the right to use the Host Marketer's pre-written software.

As for how to determine where the charges are taxable, the Department concluded this should be based on the location of the client's employees who access the website. Where the client has employees both within and outside the State who access the website, sales tax should be collected based on non-estimated information as to usage location provided by the client.

Additional Insights. The Advisory Opinion reflects the Department's increasing tendency to find that there has been a taxable sale of pre-written software in order to tax computer-type services that are not enumerated taxable services under the Tax Law, and to do so through the Advisory Opinion process. Advisory Opinions are binding only on the Department, and apply only to the party requesting the opinion. Moreover, neither the Tribunal nor the New York courts have addressed whether, applying the "primary function" test, what is being furnished in these situations is indeed a taxable sale of pre-written software. It also remains an open question whether there is truly a transfer of actual or constructive possession of software where the software is not downloaded onto the customer's computers.

Insights in Brief

Update on Cigarette Tax

In last month's *New York Tax Insights*, we reported that a federal appeals court had lifted an injunction staying enforcement of the State's regulatory mechanism for collecting taxes on reservation sales of cigarettes to non-Indians, but that the next day a State court entered another injunction, in an action brought by the Seneca Nation of Indians claiming the regulations implementing the 2010 amended statute were adopted without proper public input. This month, the State trial court rejected the challenge, finding that the regulation was merely implementing the statute and had fulfilled all regulatory requirements, and lifted the State injunction. *Seneca Nation of Indians v. State of New York*, Index No. 2011-000714 (Sup. Ct. Erie Cnty. June 8, 2011). An immediate appeal was filed, seeking a preliminary injunction, and the Appellate Division entered a temporary restraining order again staying enforcement. On June 21, the Appellate Division issued its decision, No. CA 11-01197 (3d Dep't June 21, 2011), denying a preliminary injunction and vacating the temporary restraining order. This cleared the way to implementation of the regulations — which the Department announced would begin immediately (TSB-M-11(4.2)M, TSB-M-11(7.2)S (N.Y.S. Dep't of Taxation & Fin., June 21, 2011)) — unless an appeal is sought with the Court of Appeals, New York's highest court. Stay tuned!

NYS Rules on Gambling Loss Deductions Differ from Federal

The Appellate Division has confirmed the decision of the Tax Appeals Tribunal that, under New York law, a taxpayer's personal deductions, including those for gambling losses, were reduced by 25% in 2003, since her adjusted gross income exceeded $150,000, and by 50% in 2004, when her adjusted gross income exceeded $525,000. *Matter of Kathleen Karlsberg v. Tax App. Trib.*, No. 509668 (3d Dep't June 9, 2011). Although the limitations on itemized deductions produced a New York State tax liability that exceeded the taxpayer's entire amount of non-gambling income, the court held that this result was mandated by the statute. The court rejected the arguments based on federal conformity, noting that, while New York does generally conform to federal treatment of similar issues, here Tax Law § 615(f) explicitly reduces all itemized deductions based on AGI, and does not follow the federal exemption for treatment of gambling losses.

"Disputed Income" Rule Does Not Apply to Former Real Property Gains Tax

In *Matter of Malba Cove Properties, Inc.*, DTA No. 823671 (N.Y.S. Div. of Tax App., May 26, 2011), the taxpayer disputed the imposition of the former real property transfer gains tax (repealed in 1996) on property to which the City of New York took title to in a condemnation proceeding. Although title to the property passed to the City prior to repeal of the tax, the City did not compensate the taxpayer for the property until several years after the gains tax was repealed because of ongoing litigation between the City and the taxpayer regarding who owned the condemned property. The taxpayer asserted that the "disputed income" rule, which prevents the taxation of income in dispute until the taxpayer actually receives such income, prevented application of the gains tax, because no income was received from the condemnation proceedings until after the gains tax was repealed. The ALJ, holding that gains tax was due on the transfer of the condemned property, found that the disputed income rule was applicable to income tax, but not to the gains tax, where the taxable event was the transfer of real property.

Taxpayer Advocate Bill Approved by Legislature, but Will Tax Department Oppose?

The "Taxpayer Advocate Bill" that would formalize the existing New York State Office of the Taxpayer Advocate, making it independent of the Tax Commissioner, has now been approved by both the New York State Senate and Assembly, and will be sent to Governor Cuomo for approval. S. 1072-2011 (discussed in the February 2011 issue of *MoFo New York Tax Insights*). While the bill is strongly supported by many practitioners, professional organizations and business groups, as we went to press it was unclear whether it would be opposed by the Department of Taxation and Finance, which opposed a similar bill in 2009 leading to its veto.