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MoFo New York Tax Insights

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Appellate Court Rejects Facial Constitutionality Challenge to "Amazon" Tax

By Paul H. Frankel and Irwin M. Slomka

In what is in all likelihood only an interim decision in a case with far-reaching constitutional implications, the New York State Appellate Division, First Department, has rejected the facial unconstitutionality challenge to New York's so-called "Amazon tax." ***Amazon.com, LLC v. New York State Dep't of Taxation & Fin., et al.***, **2010 NY Slip Op. 7823 (1st Dep't, Nov. 4, 2010). Although the court upheld the law as facially constitutional, it remanded the case to consider whether the law is constitutional "as applied."**

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Amazon's Facial Constitutionality Challenge Rejected

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Background. The New York "Amazon tax," which was enacted in 2008, is actually a *statutory presumption* of nexus contained within the existing New York sales tax law. Based on agency nexus principles, the law amended the definition of a "vendor" by creating a presumption that an out-of-state seller is soliciting business in New York State through independent contractors or other representatives, and is therefore required to collect sales tax on its in-State sales, if the following criteria are met: (i) "the seller enters into an agreement with a resident of [New York State]"; (ii) under that agreement "the resident, for a commission or other consideration"; (iii) "directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller"; and (iv) "gross receipts from sales by the seller to [customers in the State referred to the seller under the agreement exceed $10,000] during the preceding four quarterly periods." Tax Law § 1101(b)(8)(vi).

Under the law, this presumption can be rebutted by proof that the in-State resident "did not engage in any solicitation in the state on behalf of the seller that would satisfy the nexus requirement of the United States Constitution." If the presumption is not successfully rebutted, however, the out-of-State seller must collect sales tax on *all* sales to New York customers, not only on those sales "referred" by in-State residents.

Amazon is an internet retailer that does not have offices, employees, or property in New York State; all technical support for customer orders is handled from outside the State. It is common knowledge that the "Amazon" tax was drafted by the Department using the Amazon "Associates Program" as its underpinning. Under that program, Amazon enters into agreements with hundreds of thousands of independent third parties (the "Associates"), which are usually for-profit businesses and nonprofit organizations. The Associates advertise the "Amazon.com" website on their own websites. Visitors to the Associates' websites can click on an Amazon link and automatically get directed to the Amazon.com website. If the visitor makes a purchase from Amazon through the Amazon.com website, the Associate receives a commission from Amazon.

Days after the Amazon tax was signed into law in 2008, Amazon (and another internet retailer, Overstock.com) brought declaratory judgment actions challenging the constitutionality of the new law. Amazon claimed that the law violated the Commerce, Due Process and Equal Protection clauses of the U.S. Constitution. In 2009, a lower court upheld the constitutionality of the Amazon tax and dismissed Amazon's complaint in its entirety. Amazon appealed.

Court's Decision. On November 4, 2010, the Appellate Division, in a decision joined by four judges (with one concurring opinion, and no dissents), rejected Amazon's facial challenge. Amazon had argued that the law on its face violated the Commerce Clause because it was based on activities that did not meet the "substantial nexus" requirement. The court found that the law did not violate the Commerce Clause because it applies only when there is nexus through in-State representatives who engage in actual solicitation. As factual support for the Department's position that direct solicitation was likely under the presumption, the court pointed to an Amazon marketing document touting its "Associates Program," which stated what was readily apparent: "The higher your referrals, the greater your earnings will be."

IT SHOULD BE KEPT IN MIND THAT THE APPELLATE DIVISION DID NOT HOLD THAT AMAZON HAD NEXUS, ONLY THAT THE STATUTORY PRESUMPTION OF NEXUS WAS NOT FACIALLY UNCONSTITUTIONAL.

The court was clearly swayed by what it referred to as "a ready escape hatch or safe harbor"— the Department's two TSB-Ms issued soon after the law went into effect, which allow the presumption of solicitation to be rebutted by meeting two conditions: (i) the written agreements with the resident representatives must explicitly prohibit the resident from engaging in prohibited solicitation; (ii) and the seller must obtain from each resident representative an annual certification that the representative complied with the non-solicitation provision in the agreements. "New Presumption Applicable to Definition of Sales Tax Vendor," TSB-M-08(3)S (N.Y.S. Dept. of Taxation & Fin. May 8, 2008); "Additional Information on How Sellers May Rebut the New Presumption Applicable to the Definition of Sales Tax Vendor as Described in TSB-M-08(3)S," TSB-M-08(3.1) (N.Y.S. Dept. of Taxation & Fin. June 30, 2008).

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Amazon's Facial Constitutionality Challenge Rejected

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Amazon also raised a Due Process Clause argument, claiming that the presumption was both irrational and, in effect, irrebuttable. The court concluded that a presumption of taxability based on a commission per sale arrangement was not irrational, viewing the possibility of solicitation under such an arrangement as "extremely plausible" and an activity that "any competent businessperson" would undertake to maximize revenues. As for Amazon's claim that the statutory language regarding *indirect* referrals was unconstitutionally vague, the court disagreed, finding that the reference to indirect referrals was clear, and spoke to referrals made in a "manner other than a direct click."

Although the court rejected all of Amazon's facial challenges, it concluded that the factual record was insufficient to determine whether the tax was unconstitutional "as applied" and reversed that portion of the lower court's decision. ("[W]e are unable to conclude as a matter of law that plaintiffs' in-state representatives are engaged in sufficiently meaningful activity so as to implicate the State's taxing powers….") Consequently, the court remanded the case to the court below for further fact-finding proceedings.

Additional Insights

The Appellate Division's decision undoubtedly will not be the final word on the constitutionality of the Amazon tax. The Department attempted to have the case dismissed on the grounds that the State had not yet commenced enforcement action. (Amazon is currently collecting New York sales tax, and Overstock terminated its New York Associates program.) The court rightly rejected this attempt, noting that Amazon "require[d] finality and clarity" regarding its tax obligations. "Finality and clarity" remain elusive, however, and more than 2 ½ years after the Amazon tax was enacted, the legality of the statutory presumption of nexus remains an open question. The lack of a dispositive decision has encouraged, and will no doubt continue to encourage, other states to enact their own sales tax nexus presumptions. Those nexus presumptions could extend beyond the realm of sales tax and internet sellers.

In some respects the court's reasoning seems circular. It found the statutory presumption to be facially constitutional because it applies only when there is actual solicitation, but the statutory presumption applies even if there is no solicitation. The court was correct in stating that the Department's TSB-Ms gives sellers the opportunity to rebut the presumption, but should a policy pronouncement not specifically provided in the law be relevant to a *facial* challenge of the law itself? Indeed, there is nothing to stop the Department from scaling back its policy on rebutting the presumption in the future. Also, the court did not appear to appreciate the practical difficulties that a seller (like Amazon) with a large Associates Program must face to obtain the necessary certifications from *all* its in-State representatives in order to rebut the presumption.

It should be kept in mind that the Appellate Division did not hold that Amazon had nexus, only that the statutory presumption of nexus was not facially unconstitutional. By keeping open the question whether the Amazon tax is unconstitutional "as applied," the court placed the burden of proof squarely upon Amazon to prove that its Associates were not engaged in prohibited solicitation. It remains unclear what level of proof will be required in order to meet that considerable burden.

The U.S. Supreme Court has noted that its decision in *Scripto, Inc. v. Carson*, where it found that the in-state presence of several part-time independent salespersons who solicited customers on behalf of an out-of-state seller conferred nexus on the seller, represents "[t]he furthest extension" of a state's power to tax an out-of-state corporation under the Constitution. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). It seems inevitable that the Supreme Court eventually will be called upon to again consider a state's constitutional authority to impose a tax collection obligation on an out-of-state seller, this time through a statutory presumption of nexus.

NYC Hotel Tax Changes Concerning Room Remarketers Withstand Constitutional Challenge

By Hollis L. Hyans and Amy F. Nogid

In 2009, the New York City hotel room occupancy tax (the "HROT") was amended by local law to apply to the entire amount paid by a hotel guest for a hotel room, including fees and other amounts paid to a new defined category of entities,

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NYC Hotel Tax Upheld

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"room remarketers." A State constitutional challenge to the amendments brought by a number of third-party travel intermediaries ("TPIs") was recently rejected by the trial court. *Expedia, Inc. et al. v. City of New York Dept. of Fin. et al*., No. 650761/09 (Sup. Ct. N.Y. County Oct. 21, 2010).

The HROT imposes a tax for occupancy of each hotel room in New York City, comprised of two components: a per-day room rate and 5.875% of the rent charged. Until last year, the tax was based on the price paid to the hotel for the room, and required only a hotel "operator" to collect and remit the tax. An operator is defined as anyone "operating a hotel in the city of New York." Effective September 1, 2009, the HROT was amended to expand the scope of those required to collect and remit tax to include a "room remarketer," defined as "[a]ny person, excluding the operator, having any right, accessibility or authority, through an internet transaction or any other means whatsoever, to offer, reserve, book, arrange for, remarket, distribute, broker, resell, or facilitate the transfer of rooms the occupancy of which is subject to tax under this chapter." N.Y.C. Admin. Code § 11-2501(12) (as effective Sept. 1, 2009, through Sept. 1, 2010). It also imposed the tax on the entire amount paid by a consumer, adding new defined terms: "net rent" (the amount received by a hotel operator from a room remarketer) and "additional rent" (the excess amount, over the net rent, received by the room remarketer). Room remarketers were also required by the 2009 amendments to inform hotel room occupants of the amounts of tax attributable to the net rent and the additional rent, which must be separately stated, and to collect tax on the net rent as well as the additional rent.

A number of TPIs, including Expedia, Travelocity.com and Priceline.com, filed suit in New York Supreme Court challenging the new statute. The first argument on which they based their challenge was that the new statute violates the New York State Constitution, because the City had exceeded the authority provided to it by state law, contending that the expansion of the City's HROT base requires legislative action by the State, and that the new law was not consistent with the existing State sales tax statutes.

The judge rejected the TPIs' challenge to the constitutionality of the City's enactment. He found that, while the exclusive power of taxation is held by the New York State Legislature, the State may delegate that power to the City through enacting enabling legislation. In broad enabling legislation enacted in 1970, as amended, the State granted the City power to impose tax, including tax on hotel rooms that "shall be paid… to the owner of the hotel room… or to the person entitled to be paid the rent or charge for the hotel room…." N.Y. Unconsolidated Laws Ch. 288-C § 1(1) ("Enabling Legislation"). The judge found, first, that the fact that the State had made budget proposals imposing sales tax and HROT on TPIs, and that those proposals were not enacted, did not mean that State action was required in order for such taxes to be imposed. Failure of the State to enact similar legislation did not, in the judge's view, preclude the City from acting on its own under the authority granted by the Enabling Legislation.

Second, he found there was no authority requiring the HROT to be consistent with the State sales tax, and that the Enabling Legislation provided that the HROT was enacted "[n]otwithstanding any other provision of law to the contrary' and in addition to any tax authorized…."

The judge granted the City's motion to dismiss the first cause of action, but directed that an answer be filed to the remainder of the complaint.

Additional Insights

There has been widespread litigation across the country over the imposition of municipal hotel occupancy taxes on hotel room charges paid by consumers through TPIs such as Expedia.com, Priceline.com and Travelocity.com. While many municipalities express dismay over what they regard as a dwindling hotel tax base, litigation results have been decidedly mixed, varying with the language of the many statutes involved, but often concluding that only hotel operators are required to collect and remit tax.

New York City tried a different approach by amending its statute in an attempt to more clearly impose the tax on the TPIs' charges. The City thus far has been successful in defeating the challenge based on the State Constitution, but the second argument raised by plaintiffs—that the new statute does not apply to them because not all of the fees they receive are paid as conditions of occupancy—remains to be resolved.

After the *Expedia* case was filed, New York State enacted legislation, effective September 1, 2010, expanding the definition of the class of persons who are required to collect tax and the definition of rent, and modifying the definitions of those terms in the City's HROT. See "Amendments Affecting the Application of Sales Tax to Rent Received for Hotel Occupancy by Room Remarketers," TSB-M-10(10)S (N.Y.S. Dept. of Taxation and Fin., Aug. 13, 2010); New York City Finance Memorandum No. 10-3 (N.Y.C. Dept. of Fin., Sept. 1, 2010).

Taxpayer Relieved of Burden of Proving that Sales Tax Was Paid 25 Years Ago

By Kara M. Kraman

In a decision that will no doubt be welcomed by taxpayers, an Administrative Law Judge has held that the New York State Department of Taxation and Finance could not assess sales tax on a sailboat purchased more than 25 years earlier, even though the taxpayer was unable to provide any documentary evidence to back up his claim that he paid the tax. *Matter of Carl Noor*, DTA No. 823008 (N.Y.S. Div. of Tax App., Oct. 28, 2010). The ALJ found that the Division's belated demand for evidence of the payment of sales tax subjected the taxpayer to substantial prejudice and held that, under the circumstances, the taxpayer was entitled to relief.

In 1981, the taxpayer purchased a 36-foot sailboat through a corporation that was created to hold title to the boat. The taxpayer admitted that the corporation did not pay taxes at the time of purchase. A little more than a year later, the taxpayer dissolved the corporation and took ownership of the boat himself. In 1983, the Division contacted the taxpayer regarding the lack of payment of sales taxes on the boat and the taxpayer subsequently paid the sales tax in full.

In 2007, the Division examined the records of all of the vessels moored at Shelter Island Marina in New York, where the taxpayer's boat was located. In 2008, the Division contacted the taxpayer and asked if sales tax had ever been paid on the boat. The taxpayer responded that he had paid the sales tax in 1983 but no longer had proof of payment due to the great length of time that had passed since he made the payment. The Division subsequently issued the taxpayer a Notice of Determination for the sales tax due on the original purchase, plus interest and penalties.

The taxpayer was unable to locate the cancelled check for his payment of the sales tax. The bank on which the check was drafted was also unable to locate the check since it had changed names and ownership several times since 1983. The lawyer who advised the taxpayer regarding the tax had passed away, and the taxpayer's accountant had retired. In short, the taxpayer found it impossible to provide documentary evidence that he had paid the tax. The only proof that the taxpayer produced, other than his own word, were documents showing that a corporation purchased the sailboat in 1981 and that the boat had been moored at Shelter Island since 1983.

The Division argued that the burden of proof to show that sales tax was paid on the boat was on the taxpayer and that the taxpayer failed to meet this burden. The Division argued that it had the right to assess sales tax, along with penalties and interest, because the taxpayer failed to meet that burden. The taxpayer countered that he paid the tax in 1983 but that, like most people, he did not keep records from more than 25 years earlier, and therefore he had no documentary evidence to prove he paid the tax.

The ALJ declined to address the issue of whether the taxpayer met his burden of proof that sales tax had been paid on the boat. Instead, the ALJ held that regardless of whether the taxpayer could produce documentary evidence that he paid the tax, under the circumstances of the case, the taxpayer was entitled to relief. Citing *Matter of Corning Glass Works v. Ovsanik*, 84 N.Y.2d 619 (1994) and *Matter of Heller v. Chu*, 111 A.D.2d 1007 (3d Dept. 1985), appeal dismissed 66 N.Y.2d 696 (1985), the ALJ stated that, "a substantial delay when coupled with actual prejudice may warrant granting relief to the party that had been prejudiced." In this instance, the ALJ found that the taxpayer was subject to "substantial prejudice" as a result of the lapse of time between the time he paid the tax and the time the Division asked for proof of payment. The ALJ went on to state that "taxpayers should be able to plan for their future with some idea of their tax liability. This cannot occur if the Division is permitted to inquire about the payment of sales tax more than 25 years after the purchase." The ALJ concluded that under the circumstances of the case, the private interest of a taxpayer in being able to plan for his future with some idea of his tax liability clearly outweighed the public interest in collecting taxes. Accordingly, the ALJ ordered that the Notice of Determination be cancelled.

Additional Insights

The *Noor* determination demonstrates that the Division cannot simply rely upon the taxpayer's burden of proof where it is unreasonable to expect a taxpayer to have retained documentary evidence. The ALJ in *Noor* did not identify any specific amount of time that must pass between payment of sales tax and a request for proof of payment that would per se constitute substantial prejudice to the taxpayer. Whether or not a delay is long enough to be grounds for relief will depend on the facts and circumstances of each case. The *Noor* decision is noteworthy both because it recognizes that a delay in demanding proof of payment of sales tax may constitute prejudice to the taxpayer substantial enough to warrant granting the

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Taxpayer Relieved of Burden of Proving Tax Paid

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taxpayer relief, and because it affirms the principle that at some point the taxpayer's interest in being able to plan with some certainty for his future outweighs the state's interest in collecting taxes. Although *Noor* involved the sales tax, the same equitable principles should apply to income taxes as well.

Sales Tax Advisory Opinions Apply "Primary Function" Test, but Continue Questionable Taxation of Software

By Irwin M. Slomka

Two recent Advisory Opinions issued by the New York State Department of Taxation and Finance are a reminder of some of the lurking issues that many service providers face with regard to the sales tax on information services and on pre-written software.

One Advisory Opinion addressed the situation where information is being furnished that is personal and individual in nature, but also includes information that is not personal and individual in nature. Advisory Opinion, TSB-A-10(47)S (N.Y.S. Dept. of Taxation & Fin., Sept. 29, 2010). It involved a company that furnishes services to financial institutions throughout the United States; those financial institutions in turn provide wealth management services to investors through their affiliated financial advisors. Investors give their financial advisors permission to access their own financial information, which the service provider gathers from financial and securities clearing institutions, and then "normalizes" so that it is presented in a uniform format. The information principally consists of each investor's investment portfolio and transactional information, but also includes market data, all of which the company furnishes electronically.

The company offers several service options to its financial institution customers. Under one option, financial advisors who are affiliated with the financial institutions are given access to information with respect to their specific investor clients. The financial institution can also arrange so that the financial advisor has direct on-line access to information about the client investors, which the advisor may export onto its own computer hard drive.

The Department first ruled that while the company was indeed furnishing "information," most of the information qualified as exempt from sales tax because it is "personal or individual in nature" and cannot be substantially incorporated into reports furnished to other persons. Tax Law § 1105(c)(1). However, the Department noted that at least some of the information being furnished included market data and "related bench-marking information" that was not personal or individual in nature. It stated that, if such data was furnished alone, it would be considered a taxable information service. However, the Department ruled that "[o]n balance, of the two types of information the Company is selling, *the portfolio information seems to predominate in importance over the market information*." (Emphasis added.) Accordingly, it concluded that the information services qualified for the personal or individual exclusion and were not taxable, notwithstanding the furnishing of some market-type information.

THE ADVISORY OPINION CONTAINS A POTENTIALLY HELPFUL DEVELOPMENT— THE RECOGNITION THAT WHERE WHAT IS BEING FURNISHED INCLUDES BOTH TAXABLE AND NONTAXABLE SERVICES, IT IS THE PREDOMINANT SERVICE THAT DETERMINES TAXABILITY.

The Advisory Opinion is also an important reminder that the Department continues to be on the lookout for what it considers the taxable furnishing of pre-written software. The company also provides a service option in which the financial advisor is permitted to log onto the company's web portal to view each investor's data, and to access other analytical tools and investment strategies. The Department ruled that this arrangement constituted the transfer of pre-written software on the company's website, which the Department considered the taxable sale of pre-written software.

In another Advisory Opinion, the Department ruled that certain services provided to railroads by an information technology management services company constituted the sale of taxable information services. Advisory Opinion, TSB-A-10(52)S, (N.Y.S. Dept. of Taxation & Fin., Oct. 18, 2010). The services in

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Sales Tax Advisory Opinions

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question were specific to the railroad business. For example, the taxpayer provides services to a company that facilitates the borrowing of railcars between railroad companies to enable the parties to ascertain the charges for the borrowing; the Department considered this a nontaxable data processing service. On the other hand, it ruled that the furnishing to railroads of current railcar hire rate information was a taxable information service, which did not qualify for the personal or individual exclusion because the information was obtained from a "common database."

The taxpayer also provided various services which customers accessed through its website. For instance, a customer could enter data into the taxpayer's system in order to monitor railcars and produce reports, or to generate railcar "repair cards." A customer could also retrieve information that the customer previously inputted by accessing the taxpayer's website. The Department ruled that each of these activities constituted the taxable sale of pre-written software, which it stated should be sourced based on the location of the purchaser's employees who use the software.

Additional Insights

Many of the Department's more recent pronouncements in this area remain controversial and have yet to be reviewed by the Tax Appeals Tribunal and the New York courts. Advisory Opinion TSB-A-10(47)S contains a potentially helpful development—the recognition that where what is being furnished includes both taxable and nontaxable services, it is the *predominant* service that determines taxability. While such an approach seems unremarkable under the "primary function" test—the test is supposed to predicate taxation based on the *primary* function of the service—there have been instances where the Department has taken the position that where a taxpayer furnishes both taxable and nontaxable information services, the result is a "mixed transaction." In that event, the Department would claim that the taxpayer's failure to separately state the charges for the nontaxable and taxable components rendered the *entire* charge taxable. It appears that the Department has rejected that approach—if true, a welcome development—although it should be cautioned that Advisory Opinions are only binding on the Department with respect to the named taxpayer.

On the other hand, many taxpayers will not be pleased that both Advisory Opinions continue the Department's trend of finding that there has been a taxable sale of pre-written computer software. This is a troubling trend, in part because it is not clear from some of the Department's pronouncements—including in the two Advisory Opinions discussed here—that pre-written software has been sold or licensed, and also in part because of the absence of any meaningful regulatory guidance from the Department. The Department continues to find sales of pre-written computer software even where there is no clear showing that use and possession of pre-written software has been transferred to the customer, and even where there is no written sale or license agreement allowing the customer to use the software.

THE DEPARTMENT CONTINUES TO FIND SALES OF PRE-WRITTEN COMPUTER SOFTWARE EVEN WHERE THERE IS NO CLEAR SHOWING THAT USE AND POSSESSION OF PRE-WRITTEN SOFTWARE HAS BEEN TRANSFERRED TO THE CUSTOMER

ALJ Upholds State's Allocation Method for Sales Tax on Receipts from Electronic Data Services

By Hollis L. Hyans

In the third decision to be issued in a case involving the imposition of sales tax on electronic data services, an Administrative Law Judge, on remand from the Tax Appeals Tribunal, has upheld the New York State Department of Taxation and Finance's allocation of receipts between intrastate and interstate sales. *Matter of Easylink Servs. Intl., Inc.*, DTA No. 821440 (N.Y.S. Div. of Tax App., Oct. 14, 2010).

This case involves the imposition of New York State sales tax on various electronic data services under New York's statute imposing tax upon the receipts from the sale of intrastate "telephony and telegraphy and telephone and telegraph service of whatever nature." Tax Law § 1105(b). The services at issue included (1) fax messaging and telex; (2) electronic data interchange ("EDI"); and

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Sales Tax on Electronic Data Services

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(3) electronic mail, through a secured and closed "proprietary" system isolated from the public internet. In 2008, an ALJ concluded that none of the services were taxable. He held that the terms "telephony and telegraphy" should be interpreted as commonly understood, that tax imposition statutes should be narrowly construed, with any ambiguity construed in favor of the petitioner, and that the nature of the electronic data service business was not telegraphy or telephony as those terms are commonly understood. He held it was "not for the Division to enlarge the meaning of telephony and telegraphy to something which the Legislature could easily have expressed… but did not."

In 2009, in a brief opinion, the Tax Appeals Tribunal reversed. The Tribunal relied on the Division's regulations, which called for a "broad construction" to be given to the items taxed. Because it found that the acceptance and delivery of data "resembles the role of a traditional telephone or telegraph company," it held that the receipts from such services are taxable as telephony or telegraphy. The Tribunal remanded the case for a determination on how much of petitioner's receipts were subject to tax as arising from intrastate activities.

On remand, a different ALJ (the ALJ who had made the original decision having since retired) reviewed the allocation of receipts made by the Division's auditor. The auditor largely relied upon information involving tax and telex services, identified transactions involving a New York customer with a billing address in New York and assumed such transactions originated in New York, and extrapolated information based upon transactions where destinations could be identified over all of the petitioner's receipts. The auditor did not consider relevant the fact that all the data transmissions were routed through the petitioner's facility in Missouri, since Missouri was not the ultimate destination.

The ALJ upheld the auditor's allocation methods. He found no basis for the petitioner's contention that its services were interstate or international in nature and not allocable to New York, stating that "this position is directly contrary to the holding of the Tribunal" since it had determined that the services were taxable. The ALJ found that the Division need only adopt an audit method "reasonably calculated to determine the amount of tax due," and that the method used was reasonable. He rejected the petitioner's argument that the Division had failed to submit any evidence to substantiate its basis for determining known and unknown destinations for electronic data interchange, on the grounds that the issue was not raised in the petition or the hearing memorandum. He also rejected the argument that it was not possible to isolate an intrastate component because all EDI messages were routed through the Missouri facility, since the Tribunal had found that the services were taxable as telephony or telegraphy.

THE ALJ FOUND THAT THE DIVISION NEED ONLY ADOPT AN AUDIT METHOD "REASONABLY CALCULATED TO DETERMINE THE AMOUNT OF TAX DUE," AND THAT THE METHOD USED WAS REASONABLE.

However, the ALJ did set aside the penalties. He found that the failure to pay was due to reasonable cause and not willful neglect, and noted that the ALJ who originally heard the case had agreed that no tax was due.

Additional Insights

This decision on the allocation of receipts is another step in the development of tax policy through audit and litigation rather than through legislation. Here, a statute written long before electronic data services were invented was interpreted by the Tribunal to cover modern electronic data transmission, and then interstate/intrastate allocations methods were devised to accommodate the taxation of new technologies under old taxing statutes.

The ALJ did waive the penalties that had been imposed, and he particularly noted not only the lack of clarity on whether these services were "telephony or telegraphy," but that the ALJ who first heard the case had agreed with the petitioner's position that the services were not subject to tax. When a taxpayer's interpretation of an ambiguous statute, particularly one written long before the services sought to be taxed were even contemplated, is accepted by a judge of a specialized tax forum, continued attempts to impose penalties seem decidedly inappropriate, even if the ALJ's determination is later reversed.

Insights in Brief

Cruise Lines Taxed as Transportation Businesses

A New York State ALJ has upheld the position of companies operating cruise ships that they are entitled to file franchise tax reports under Article 9, which is applicable to transportation and transmission corporations. *Matter of Celebrity Cruises, Inc., et al.*, DTA No. 822986 et al., (N.Y.S. Div. of Tax App., November 10, 2010). The Division had argued that the cruise lines should instead file returns under Article 9-A, claiming that the transportation activity provided by the cruise ships was secondary to the entertainment provided. The ALJ rejected this argument as "without merit," finding that the companies' largest investments were in vessels and equipment necessary for ship operation, and most of their income derived from ticket revenue, while the provision of entertainment, accommodations, and dining were "merely incidental" to the main function of transporting passengers.

State's Refusal to Exercise Discretionary Authority to Grant Time-Barred Refunds Is Upheld

A New York State ALJ held that New York State properly refused to exercise its discretionary authority under Tax Law § 697(d) to grant time-barred personal income tax refunds to a trust. Under § 697(d), the State has the authority to refund taxes "erroneously or illegally collected from any taxpayer," or paid "under a mistake of facts," *without regard to any period of limitations*, where there are no questions of law or fact. The ALJ found that the erroneous filing by a CPA firm of resident trust returns for the years 1996 – 2000 for a trust that held investments, where the trustee was domiciled outside the State, was not shown to be clearly based on a mistake of fact, since the trustee knowingly furnished to the CPA firm the trust's address as "c/o" a New York City law firm. Accordingly, the ALJ concluded it could not be said that the return was prepared and signed under a mistake of fact. *Matter of Rice, III Family 1992 Trust*, DTA No. 822892 (N.Y.S. Div. of Tax App., Nov. 4, 2010).

Taxpayer Not Entitled to Administrative Hearing on Notice of Additional Tax Due

A New York State ALJ held that a taxpayer was not entitled to an administrative hearing with respect to a Notice of Additional Tax Due issued as a result of the taxpayer's failure to report to the State of New York final changes to his federal income tax return. *Matter of Charles L. Kyte*, DTA No. 823713 (N.Y.S. Div. of Tax App., Oct. 28, 2010). The ALJ found that the Division properly issued the Notice of Additional Tax Due to the taxpayer when he failed to report the federal changes to New York State within 90 days pursuant to Tax Law § 681(e). The ALJ held that Tax Law § 173-a specifically provides that a taxpayer is not entitled to a hearing before the Division of Tax Appeals with respect to a Notice of Additional Tax Due.

Insurance Company Reimbursements Are Not Taxable "Premiums"

A New York State ALJ has held that deductible reimbursements accrued or received by an affiliated group of New York licensed insurance companies from their insured policyholders are not "premiums" under Tax Law § 1510(c)(1) and are therefore not taxable. *Matter of American Zurich Ins. Co.*, DTA Nos. 822840, *et al*. (N.Y.S. Div. of Tax App., Oct. 14, 2010). The insurance companies all offer workers' compensation insurance policies, which include a deductible endorsement, under which the policyholder retains a certain dollar portion of the risk of workplace injury by agreeing to reimburse the insurance companies for compensable claims up to the amount of the deductible endorsement. The ALJ held that these deductible amounts do not constitute "premiums" as defined by Tax Law § 1510(c)(1), which narrowly defines "premiums" as consisting of only eight specified items, none of which include deductible reimbursements.

State Cannot Assess Husband's Warrants Against Wife

The Department of Taxation and Finance has issued an Advisory Opinion providing that a wife's separate assets are not subject to the liens of unpaid warrants that were filed and docketed against her husband prior to their marriage, nor is she liable for her husband's tax debts, despite the filing of a joint tax return. Advisory Opinion, TSB-A-10(9)I (N.Y.S. Dep't of Taxation & Fin., Oct. 19, 2010). However, if the taxpayer and her husband receive a tax refund, the Department may offset the entire refund, including the taxpayer's portion, against her husband's tax debt, unless the wife seeks relief from the Department under a process known as "nonobligated spouse relief" as described in New York Department of Taxation & Finance Publication 89.