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Legislative Changes Affect E-Commerce Retailers, Not-For-Profits, and Tax Shelter Participants

By: Joseph Lipari and Debra Silverman Herman

On April 11, 2008, the New York Legislature enacted the New York State Budget for 2008-2009 (herein the “Budget Bill”).¹ Sorely in need of additional revenue due to the current economic climate, the Budget Bill is designed to bring into the State over a billion dollars in additional revenues.² This article focuses on two of the more sweeping changes that effect retail businesses and non-profits who make sales of goods and services over the Internet.³ In addition, as another attempt to bring in additional revenues, the Budget Bill authorizes the return of a limited amnesty program for taxpayers who engaged in certain tax avoidance transactions before January 2005, to report and pay outstanding liabilities, without incurring any penalties. The Legislature enacted a similar program as a part of the 2005 -2006 executive budget that successfully raised over \$337 million.⁴

Taxation of Internet Sales

New York, like many other states has seen a tremendous increase in sales over the Internet that has significantly undercut its sales and use tax collection. Although it has taken steps to increase enforcement of use tax against residents, including a requirement that use

tax be disclosed on an individual’s state income tax return, self-reporting of use tax attributable to Internet purchases is believed to be extremely low. Thus, New York has been looking for ways to require Internet sellers to collect and remit sales tax on sales to New York residents. The ability of states to require sales tax collection responsibilities has been limited by the U.S. Supreme Court’s decision in *Quill v. North Dakota*.⁵ That decision held, in the context of a pre-Internet out-of-state retailer who used direct mail that in the absence of a physical presence in the state where the customers lived, the seller was not required to collect tax.

In November, the Department of Taxation and Finance (the “Department”) attempted to get around the *Quill* limitations. The Department issued a Technical Services Bureau Memorandum (the “November Memorandum”)⁶ asserting that certain Internet sellers were using so-called “independent agents” resident in New York to solicit sales on their behalf and that the physical presence in the state of such agents created a basis for sales tax collection responsibility.⁷ The November Memorandum gave, as an example, a New York ski club that on its web site provided a link to the web site of an out-of-state retailer of ski equipment under an arrangement where the retailer would pay fees or commissions to the ski club based on sales attributable to

the link. The November Memorandum was pulled within days of its posting, given the backlash from the retail industry and others, who were counting on revenues during the holiday season from Internet sales.

When the 2008 Budget Bill was introduced in February by former Governor Eliot Spitzer, the position in the November Memorandum was reintroduced. The Department has taken the position that the November Memorandum simply clarified current policy and did not reflect any change in requirements for vendors doing business in New York state. Nevertheless, prior Advisory Opinions issued by the Department held that fees paid to companies for running advertisements on the Internet are exempt from sales and use tax as advertising services unless a sale of property occurs.⁸

Not surprisingly, the new legislation goes further than the withdrawn November Memorandum, by creating a rebuttable presumption that a person making sales to New York customers will be presumed to be soliciting business through an independent contractor or other representative if the seller enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an Internet website or otherwise, to the seller.⁹

Since the new legislation does not

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contain a separate definition of the term “resident,” it appears that the term has the meaning set forth in the sales and use tax law and includes individuals with a permanent place of abode in the state; corporations incorporated in New York, other businesses formed under New York law, and businesses that either maintain an office in New York or otherwise do business in the state.¹⁰ The possible reach of the legislation is remarkable. For example, if an Internet seller pays an author of a fee for any sales made via a link on the author’s personal website, the Internet seller would be considered a New York vendor if the author has a summer home in New York. Once it is characterized a New York vendor, the Internet seller would be required to collect use tax on *all* sales of *all* goods to New York customers. Although the legislation provides that the presumption may be rebutted, the state will likely attempt to tax any transaction that would satisfy the nexus requirement of the U.S. constitution. Further, under the U.S. Supreme Court precedent relied on in the November Memorandum, presence in the state of an agent is sufficient to create nexus, even if the agent is within the state engaging in activities unrelated to the sale transaction.¹¹

It is conceivable that the legislation would apply to situations where an out-of-state seller uses the virtual services of an in-state auction house to sell its goods. Previously, the Department has opined that an out-of-state seller does not become a New York vendor by virtue of making sales through Sotheby’s.com.¹²

Since this change is effective immediately it is likely that constitutional challenges to the legislation will be filed shortly. E-commerce retailers who are presumed to be vendors by virtue of the Budget Bill should also consider registering with the Department as a vendor and beginning to collect sales tax before June 1, 2008 to qualify for a limited amnesty for prior periods.

Sales by Non-Profit Entities

Another significant change of the new

legislation is an effort to level the playing field among for-profit and non-profit entities. Part KK-1 of the Budget Bill requires non-profit tax exempt organizations¹³ to collect sales tax on retail sales of property and otherwise taxable services made by remote means.¹⁴ The term “remote means” includes sales made by telephone, the Internet, mail order or otherwise. The Memorandum in Support of the Budget Bill indicates that sales of goods and services at an auction conducted by an exempt organization or its agent will fall within this provision.¹⁵

Prior to this legislative change, only sales of property made by a shop or store (or sales of food or drink in or by a restaurant or bar or establishment) operated by a qualifying charitable and nonprofit organization¹⁶ were subject to New York sales tax.¹⁷ Historically, the Department held that a website did not constitute a “shop or store.”¹⁸ As a result of the legislative change, tax exempt organizations who previously relied on these Advisory Opinions with respect to their virtual sales must begin collecting tax from customers on retail sales occurring on or after September 1, 2008. Although the legislation provides that its application is limited to remote sales made by organizations with a degree of regularity, frequency, and continuity, it seems likely that the Department will interpret this statutory language broadly.¹⁹

The Budget Bill also expands a tax exempt organization’s tax collection obligations to sales of property by lease or rental, whether or not at a shop or store, and to all taxable services set forth under the law. Previously, for example, a hospital could lease equipment to another party and such lease was not subject to sales tax.²⁰ It could also sell telecommunications services and telephone answering services to physicians without such sales being subject to tax.²¹ Under the Budget Bill, the hospital would now be required to collect sales tax from the third party lessee and physician, and remit such tax to the State.

New Registration Requirements

Taxpayers also must pay particular attention to a new re-registration program authorized by Part LL-1 of the Budget Bill for sales and use tax vendors.²² Under the New York Tax Law, every person required to collect New York sales and use taxes, with certain exceptions, must file a certificate of registration at least twenty days prior to commencing business, opening a new place of business, purchasing, selling or taking payment within New York.²³ The Budget Bill contemplates re-registration of current vendors, even vendors holding a certificate of authority for less than three years. Each person required to re-register will have to pay a \$50 filing fee; such fee will also be imposed, collected and enforced in the same manner as the vendor’s sales and use taxes. Since the Department has until March 31, 2012 to complete this program, it may be some time before taxpayers see any further guidance from the Department.

Tax-Shelter Disclosure

In contrast, the Department must act relatively quickly to implement a new revenue raising program last employed three years ago. In 2005, New York State established a Voluntary Compliance Initiative (“VCI”) to respond to tax shelter type activity, and enhance taxpayer compliance.²⁴ The 2005 VCI allowed taxpayers to avoid substantial penalties by voluntarily disclosing participation in abusive tax shelters and filing amended returns for the years at issue. Voluntary disclosure was available for all tax years prior to January 1, 2005. The Budget Bill allows taxpayers that did not participate in the initial VCI to come forward and report and pay underreported tax liabilities and interest (the “2008 VCI”) attributable to abusive tax avoidance transactions, for the same period covered by the 2005 VCI—all tax years prior to 2005.²⁵

The 2008 VCI will commence November 1, 2008 and end on January 31, 2009.²⁶ The Department is charged with administering the 2008 VCI in a similar manner as the 2005 VCI.²⁷ Thus, the

term “abusive tax avoidance transaction” includes, but is not limited to, “listed transactions.”²⁸ A “listed transaction” includes any transaction designated as a tax avoidance transaction by the IRS or the Commissioner of Taxation and Finance (the “Commissioner”). To date, the Commissioner has designated only one transaction as a New York listed transaction.²⁹

If an eligible taxpayer elects to participate in the 2008 VCI and complies with the requirements for such participation, certain penalties would be waived (depending on the participation option chosen) and the Commissioner

would not seek civil, administrative or criminal actions against the taxpayer in connection with the underreported tax liability. Taxpayers that made actual or estimated tax payments with respect to tax avoidance transactions for tax years prior to 2005 are not precluded from participating in the 2008 VCI, nor are taxpayers that previously disclosed participation in tax avoidance transactions under the 2005 VCI. Practitioners and taxpayers should keep in mind that the 2008 VCI is limited to personal income taxes, corporation franchise tax, bank franchise tax and insurance franchise tax.

We advise charitable and tax exempt organizations to review their remote sales and service contracts and determine whether such transactions are now subject to tax. We also advise e-commerce retailers to review their contracts with persons who receive commissions for sales and identify whether any of these persons are New York residents. E-commerce retailers and tax shelter participants should also consider taking advantage of the limited amnesties provided by the Budget Bill.

¹ S. 9807 - C./ A. 9807-C (herein the “Budget Bill”). As of the date hereof the Budget Bill has been delivered to Governor David A. Paterson for his signature.

² When Former Governor Eliot Spitzer released his 21-day amendments to the 2008-2009 Executive Budget, of which many are included within the Budget Bill, the press release announcing the amendments indicated that “the outlook for Wall Street, which accounts for 20 percent of state tax revenues, has continued to deteriorate” and led the Division of Budget to project “a decline in revenue of \$384 million in 2008-09” . . . , namely, “decreases of \$275 million in personal income tax collections and \$50 million in corporate franchise tax collections.” N.Y.S. Div. of Budget, Press Release, dated Feb. 11, 2008, *Governor Spitzer Outlines 21-Day Amendments To the 2008-2009 Executive Budget, Worsening Economic Climate Requires Additional Savings Actions to Address Decline in Expected Revenues*. Governor Paterson had to reach a budget compromise with Senate Republican Leader Joseph L. Bruno and Assembly Leader Sheldon Silver shortly after replacing former Governor Spitzer as governor of New York.

³ Budget Bill Parts KK & OO, amending Tax Law §§ 1116(b)(1), 1101(b)(8).

⁴ N.Y.S. Dept. Tax’n & Fin., Office of Tax Policy Analysis, *New York State Tax Shelter Voluntary Compliance Initiative October 1, 2005 through March 1, 2006*, Jan. 2007 (hereinafter “Tax Department Summary of 2005 VCI”). It should be noted that the effect of tax amnesties is often the subject of debate.

⁵ 504 U.S. 298 (1992).

⁶ N.Y.S. Dept. of Tax’n & Fin., TSB-M-07(6)S, Nov. 9, 2007 (withdrawn Nov. 15, 2007); N.Y.S. Dept. of Tax’n & Fin., TSB-M-07(6.1)S, Nov. 15, 2007 (Notice of Withdrawal of TSB-M-07(6)S).

⁷ The November Memorandum cited *Scripto v. Carson*, 362 U.S. 207 (1960). In *Scripto* the U.S. Supreme Court held that the in-state presence of agents is sufficient to confer nexus to tax the principal. *Id.*

⁸ See e.g., N.Y.S. Dept. of Tax’n & Fin., TSB-A-95(33)S, Aug. 14, 1995.

⁹ Budget Bill Part OO-1, amending N.Y. Tax Law §1101(b)(8). The provision also requires that the cumulative gross receipts from sales by the seller to customers in the state who are referred to the seller by all state residents with this type of agreement exceeds \$10,000 over the course of four quarters. *Id.*

¹⁰ N.Y. Regs. §526.15(a)(1).

¹¹ *Scripto v. Carson*, 362 U.S. 207 (1960).

¹² N.Y. Dept. of Tax’n & Fin., TSB-A-99(49)S, Nov. 17, 1999.

¹³ An organization that is exempt from federal income tax pursuant to I.R.C. §501(c)(3) is not automatically entitled to New York exempt status in New York. Rather, the organization must meet the requirements set forth in N.Y. Tax Law §1116(a)(4).

¹⁴ Budget Bill Part KK-1, amending N.Y. Tax Law §1116(b)(1).

¹⁵ 2008-2009 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support, Part L, available at <http://publications.budget.state.ny.us>.

¹⁶ Retail sales made in shops or stores operated by certain members of the armed forces of the U.S. and certain Indian nations or tribes are also subject to tax. See N.Y. Tax Law §§ 1116(a)(5) & (6). The changes made by the Budget Bill apply equally to these vendors.

¹⁷ Former N.Y. Tax Law §1116(b)(1); N.Y. Regs. §529.7(i)(2).

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- ¹⁸ N.Y.S. Dept. of Tax'n & Fin., TSB-A-03(14)S, April 4, 2003; *see also* N.Y.S. Dept. of Tax'n & Fin., TSB-A-86(11)S, Mar. 26, 1986 (mail order sales).
- ¹⁹ The frequency, continuity and regularity requirement likely is meant to conform to the existing “shop or store” rule regulation that provides that a taxable “shop or store” includes any place or establishment where goods are sold from display with a degree of regularity, frequency and continuity. N.Y. Regs. §529.7(i)(2). This regulation also provides, however, that sales made through a temporary shop or store located on the same premises as persons required to collect tax constitutes a “shop or store.” At this point in time, it is unclear whether this rule will apply to remote sales or would be contrary to the law.
- ²⁰ Sales or leases of medical equipment would be covered by a separate exemption. N.Y. Tax Law §1115(a)(3).
- ²¹ N.Y.S. Dept. of Tax'n & Fin., TSB-A-00(46)S, Oct. 19, 2000.
- ²² Budget Bill Part LL-1.
- ²³ N.Y. Tax Law §1134.
- ²⁴ 2005 N.Y. Laws Ch. 61, Part N; *see also* Tax Department Summary of 2005 VCI, *supra* note 4.
- ²⁵ Budget Bill Part CC-1.
- ²⁶ Budget Bill Part CC-1, §2.
- ²⁷ Publication 671 (9/05) describes, in question and answer format, many of the features of the 2005 VCI. N.Y.S. Dept. Tax'n & Fin., Publication 671 (9/05) *Voluntary Compliance Initiative*, available at <http://www.tax.state.ny.us>. While instructive, this Publication should not be viewed as setting forth the guidelines for the 2008 VCI.
- ²⁸ The term “tax avoidance transaction”, is defined broadly as “a plan or arrangement devised for the principal purposes of avoiding tax.” N.Y. Tax Law §25(h).
- ²⁹ See N.Y.S. Dept. Tax'n & Fin., TSB-M-07(5)C, (5)I, June 13, 2007 (identifying a transaction involving certain charitable contribution deductions as a “New York Listed Transaction”); *see also* N.Y. Regs. §§2500 et. seq. (setting forth general definitions and rules relating to New York reportable transactions, including New York listed transactions).

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