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Use Taxes on Purchases Made by New York Residents

By: Glenn Newman

Recent newspaper articles about New York Sales and Use Taxes and the indictment of L. Dennis Kozlowski focus attention on one aspect of use taxes on purchases made by residents of New York.[1] In the past, the State Tax Department has pursued those who passed through U.S. Customs with items purchased abroad and brought into New York.[2] It has also asserted tax on the use of a private airplane hangered in New Jersey by a resident of New York when the plane was used a few times in New York.[3]

The use tax applies to any tangible personal property that a resident exercises any right or power over including "receiving, storage or any keeping or retention for any length of time" in New York.[4] While its application is very broad, taxpayer awareness and compliance are, to say the least, not widespread.

There are many examples of transactions that, to the ordinary citizen, might not be thought of as taxable but become subject to sales tax when not properly planned or executed. In one such case, a person with two wholly-owned businesses transferred assets from one entity to the other and found himself with an unexpected sales tax liability.[5]

Sales Tax on Transfer to Wholly-Owned Corporation

Robert E. Weichbrodt ("Weichbrodt" or "Taxpayer") owned eight McDonalds restaurants; four directly as a sole proprietor and four others through his wholly-owned S corporation ("Corporation"). The Corporation was formed in April 1993 and was authorized to issue 200 shares of stock. Weichbrodt was the sole shareholder, President and CEO of the Corporation. All eight restaurants were commonly managed and supervised. The payroll, purchasing, and advertising were done on a consolidated basis. The Corporation filed Federal and State tax returns and maintained separate books and records although the Corporation's profits or losses "passed-through" to Weichbrodt's personal income tax return due to the Federal and New York S elections.

As of June 30, 1996, Weichbrodt decided to transfer the assets of the sole proprietorship to the Corporation. The Corporation filed a Notification of Sale Transfer or Assignment in Bulk with the Department, showing that Weichbrodt was transferring all of the assets of the sole proprietorship to the Corporation. The stated price of the assets transferred was shown as zero. The Department started an audit of the Bulk Sale Notification and the Corporation; the audits were done on a consolidated basis.

The Department took the position that the transfer from the sole proprietorship to the Corporation was a retail sale subject to sales tax. At the conciliation conference, a copy of an Assignment, Bill of Sale and

Assumption Agreement between Weichbrodt and the Corporation was submitted. The Agreement provided that all assets owned by the sole proprietorship were transferred "in consideration for ten (10) shares of common stock" of the Corporation, subject to liabilities and obligations of the sole proprietorship. The Department estimated the sales tax due based upon the balance sheet of the sole proprietorship prior to the transfer.

That balance sheet showed the cost of assets (other than land that is not subject to sales tax), less the accumulated depreciation. The non-real estate assets included equipment, signs, leasehold improvements and vehicles. The value (after depreciation) was $929,029. Tax of $65,032.09 was assessed, as were interest, negligence and substantial understatement penalties.

Weichbrodt argued that the transfer was not a retail sale subject to tax because there was no "material consideration" for the transfer of assets; he owned 100 percent of the assets before and after the transaction, and the stock received (the ten shares) was of no financial or economic value to him. Alternatively, he argued that the consideration, if it were determined there was a taxable sale, was the increase in shareholder equity shown on the Corporation's Federal tax return (*i.e.*, $115,604), which would have resulted in a tax of about $8,092.

The Department argued that the fair market value of the assets was a proper basis for estimating the tax in the absence of an agreed upon sales price and that the Corporation's assumption of liabilities was consideration subject to sales tax.

The Administrative Law Judge ("ALJ") found that the broad definition of sale, "any transfer of title or possession or both,"[6] supported imposition of sales tax. The ALJ held the transfer, in consideration for the ten shares of stock, even where the same individual wholly owns both entities, is subject to sales tax.[7]

There are statutory exceptions to the definition of a retail sale that, with proper planning, could have eliminated this sales tax liability. First, capital contributions to a corporation (without the issuance of stock or other consideration, i.e., assumption of debt) are not retail sales.[8]

A second alternative would have been to transfer assets to a newly organized corporation upon (or at least close in time to) its formation.[9] Such transfers are also excluded from the definition of "retail sale." A subsequent statutory merger or consolidation of the two corporations would have also escaped sales tax.[10] Weichbrodt's problem was that the corporation receiving the assets was "old and cold" and he received ten shares of stock and the Corporation assumed the liabilities in exchange for the assets.

The second issue addressed by the ALJ was the consideration upon which to base the sales tax. In the absence of a stated sales price, or if the sales price is not an adequate indication of true value, the regulations provide that the fair market value of the property may be used to determine consideration in a transfer between related corporations.[11] The ALJ found that the Department's use of cost less depreciation was a reasonable method to determine the fair market value of the assets transferred. The idea that increased shareholder equity, urged by Weichbrodt, was rejected.

One cannot fault the ALJ for applying the clear, yet harsh, result of poor tax planning to the taxpayer herein. Sometimes people stumble into a situation in which a tax is imposed which might have been avoided with better planning. It is also easy to see how taxpayers make these mistakes. Some states have exceptions for casual sales (Texas, California, Massachusetts). Some states exempt intercompany sales (Texas—if there is at least 80% common ownership, Georgia—if the owners maintain the same proportionate interests). Many taxpayers forget that while some tax laws permit intercompany eliminations (the corporate income tax on combined filers) or mere changes in form of ownership (New York State and City real property transfer taxes), New York sales tax has no such exclusions.

Another "Convenience of the Employer" Case

One more in a line of New York tax cases involving the so-called "convenience of the employer" test is *Matter of Thomas L. Huckaby.* [12] In this case, the taxpayer made a new argument in an attempt to carve out an exception to the "convenience of the employer" test.

Mr. Huckaby ("Taxpayer") lived in Nashville, Tennessee, about 900 miles from New York City. He worked for the National Organization of Industrial Trade Unions ("NOITU") which had its office in New York City. Taxpayer was a computer programmer writing software programs for his employer. He was in New York for no more than 25 percent of his time spent working. When not in New York, he had an office in his home. NOITU paid for a telephone line, chairs and other office items.

The Taxpayer argued that the original reason for the "convenience of the employer test" was that in the years that New Jersey and Connecticut did not have broad-based income taxes, some people who were based in New York would claim to work from their homes in New Jersey or Connecticut and allocate part of their income outside New York. In order to avoid evisceration of New York's tax base, the rule was promulgated that in order to allocate income outside New York the work must be for performance of services which of necessity, as distinguished from convenience, obligate the employee to out-of-state duties."[13]

The Taxpayer argued that the rule was no longer needed in light of the adoption of income taxes in the states surrounding New York and more importantly, it was inappropriate to apply to someone who lived and worked 900 miles from New York. There was no subterfuge or claim of working within commuting distance in the suburbs in Mr. Huckaby's case.

The Tribunal, rejecting the Taxpayer's arguments and applying the convenience of the employer test, stated that the employer would have had no objection to Mr. Huckaby working in New York and therefore, the income was entirely New York source income. It held that the services the Taxpayer performed from his home in Tennessee could have been performed in New York. The Tribunal rejected the limitation urged by the Taxpayer that if the convenience test had any basis, it was to those who could easily manipulate their work habits to favor working within easy commuting distance of New York. The Tribunal also rejected the claim that the convenience test violates The U.S. Constitution's Commerce Clause by creating an undue burden on interstate commerce.

The Taxpayer has time to decide whether he will appeal to the Appellate Division. A previously reported case *Matter of Zelinsky*, is being taken to the courts and, the U.S. Supreme Court may ultimately be asked to consider it.

Conclusion

In the meantime, one strategy considered by employers (especially those not concerned with corporate business tax nexus such as the Union involved herein), is to establish an office in, state and assign the employee to, a state in which wishes to work. This could result in encouraging employers to locate outside New York, permit allocation of income of the company outside New York and hurt economic development in New York.

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[1] The Regulation [20 NYCRR Search7RH526.15], but not the Statute, defines a resident for sales tax as an individual maintaining a permanent place of abode without any requirement to spend a number of days in New York as found in the income tax (Tax Law Search7RH605(b)(1)(B)).

[2] *Matter of Barbara P. Billauer*,(NYS Tax Appeals Tribunal decided August 6, 1998); *Matter of Warren Grossman*, (NYS Administrative Law Judge Determination, July 6, 2000).

[3] TSB-A-90(31)S.

[4] 20 NYCRR Search7RH526.9(a). Use tax on property brought into New York may be reduced by a credit for sales tax paid to another jurisdiction and, if used for more than six months out-of-state, the tax may be computed on the lesser of the fair market value when brought into New York or the purchase price. See, 20 NYCRR 531.6.

[5] *Robert E. Weichbrodt d/b/a McDonald's*, (NYS Administrative Law Judge Determination dated January 31, 2002).

[6] Tax Law Search7RH1101(b)(5).

[7] *Matter of Sunny Vending Co. v. State Tax. Comm'n.*, 101 AD2d 666 (3rd Dept., 1984) and *Matter of P.H. Fine Arts Ltd. v. NYS Tax Appeals Tribunal*, 227 AD2d 683 (3rd Dept., 1996).

[8] 20 NYCRR Search7RH526.6(d)(8)(ii).

[9] 20 NYCRR Search7RH526.6(d)(5).

[10] 20 NYCRR Search7RH526.6(d)(6).

[11] 20 NYCRR 526.6 (d)(8)(i).

[12] New York State Tax Appeals Tribunal decided May 30, 2002.

[13] 20 NYCRR Search7RH132.18(a).

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