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Part-Time Residents; Use of Catalogues

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The New York State Tax Appeals Tribunal has issued the final word, at least for now, on how part-year residents determine how much of their income is subject to New York personal income tax. The State Tribunal also issued two noteworthy decisions regarding sales and use tax; one regarding 'use' of catalogues sent into New York and the other involving a sales tax deficiency based upon information gathered from the taxpayer's suppliers. Finally, a recent case in the New York City Tax Appeals Tribunal highlights a difference between New York State and New York City law on when a taxpayer can have a prepayment hearing protesting a notice issued by the tax department.

Income Tax on Part-Year Residents

The New York State Tax Appeals Tribunal has affirmed the Administrative Law Judge determination (discussed previously) invalidating an income tax regulation prohibiting proration of income when a taxpayer changes resident status during the year. In the *Matter Robert T and Susan M. Greig,*[1] the State Tribunal held the regulation invalid "to the extent it does not permit taxpayers to prorate" their income and allocate to the resident and nonresident period.

Mr. Greig, a partner in Cleary, Gottlieb, Steen & Hamilton, took assignments at overseas offices of the firm and moved back to New York on July 4, 1992. On his 1992 New York personal income tax return, the taxpayer pro rated his distributive share of partnership income treating 51% as attributable to his period of nonresidence and 49% attributable to his period of residence in New York. He then apportioned the distributive share for his nonresident period according to the allocation determined on the partnership's 1992 tax return. (Using the partnership's allocation of income to New York is the proper way for a nonresident partner to determine his New York source income.)

The State asserted a tax deficiency based upon a regulation[2] that provides that the distributive share of partnership income to be included in New York source income for a part year resident depends upon the taxpayer's residency status at the date the partnership's tax year ends. In this case, since the taxpayer moved into New York before the December 31st tax year end of his partnership, the State contended that the entire amount of the partnership distribution was attributable to his period of residency.

The ALJ reviewed Federal income tax principles applicable to partnership distributions and prior cases involving part year New York residents[3] and found that proration of partnership income over the tax year is an appropriate way to determine New York income tax due for part year residents. The ALJ invalidated the regulation at issue and held for the taxpayer.

On exception, the Tribunal affirmed the ALJ and found the regulation in question invalid "to the extent that it does not permit taxpayers to prorate the annual amount of their partnership distributions and allocate that amount proportionately between resident and nonresident periods." The decision does not *require* taxpayers to prorate income nor does it invalidate the regulation insofar as it directs part year residents with income from partnerships to determine New York source income based upon their resident or nonresident status at the point in time in which the partnership tax year ends.

Under the regulation, if the partnership year ends during the period that the individual was a resident, the distributive share of partnership income, gain or loss and deduction is included in the numerator of the New York source income fraction. Where the tax year of the partnership ends during the period the individual was a nonresident, the distributive share included in the numerator of the New York source income fraction is only the portion such items that are derived from New York sources.

Until such time as the Department of Taxation and Finance promulgates an amended regulation, it is difficult to see how the Department could require taxpayers to disregard the existing regulation which, as noted by the Tribunal, was only invalidated to a limited extent.

Use Tax on Catalogues

Effective March 1, 1997, New York's sales tax law exempts promotional materials sent into the State[4]. However, for periods prior to that date, the cost to produce promotional materials delivered or used in New York were subject to tax. In *Matter of Sharper Image Corporation*,[5] the Tribunal rejected the taxpayer's claims that: (1) its catalogues were periodicals exempt from sales and use tax[6] and that imposing such tax violated the First Amendment of the U.S. Constitution by discriminating against the content of its publications; (2) it did not make a taxable use of the catalogues in New York since it had no control over the catalogues which were delivered by the Post Office upon receipt from the printer and; (3) since the taxpayer was based in San Francisco and all decisions and activities related to the catalogues took place outside New York, it is not an in-state vendor as required under a 1989 amendment to the Tax Law.[7]

Notwithstanding the (often amusing) writing in the catalogues, the State Tribunal found that the purpose of the material was clearly for selling products and that the Court of Appeals had already upheld a regulation requiring at least 10 percent of a publication be devoted to news of general or community interest to be exempt.[8] The Tribunal found the regulation did not selectively tax a targeted group, nor was it content-based.

The Tribunal also held that there was a taxable use in New York based upon the statutory language that, "use also shall include the distribution of only tangible personal property, such as promotional materials."[9] Finally, the Tribunal found that the 1989 amendment applied to the taxpayer since it was a New York vendor having three retail stores in New York and directed the mailing of the catalogues to individual New Yorkers as well as to its retail stores.

Sales Tax Audit Procedures

The other sales tax decision highlights an area that is not as well-known as the ordinary audit process. In *Matter of Roebling Liquors, Inc. and Sidney Cooper, as Officer*,[10] a sales tax audit was undertaken by the Department and the taxpayer's books and records were reviewed and found to be adequate. After looking at the records, the auditor indicated that she was going to recommend a "no-change" audit (i.e., the sales

tax returns would be accepted as filed and no deficiency would be found). Upon submitting that recommendation to her supervisor, the auditor was informed that there was information from the Revenue Opportunities Division ("ROD") of the Department indicating that the taxpayer had made greater purchases from suppliers than the taxpayer showed in its books and records.

The ROD unit (now known as the Research and Discovery Bureau) is a part of the State's Department of Taxation and Finance that identifies nonfilers and obtains information from third parties to enforce the tax laws. It is part of the Audit Division but will, in appropriate circumstances, refer matters to the Office of Tax Enforcement (the State's counterpart of the IRS' Criminal Investigations Division).

The ROD unit had been asked by audit staff to develop a third party database of purchases by local businesses. The audit staff felt that there were many businesses where the books and records tied into the sales tax returns but it was suspected that there was more business activity than shown in the books and records. The ROD unit put together a list of 400 beer, wine and liquor wholesalers which did business with 30,000 retailers and asked for records of sales. The request for information stated that if there was no response, either a subpoena for the information would be issued or a referral of the file for audit (for sales tax or other tax compliance) would be made. It then compared what was reported by the wholesalers to the sales volume shown on the tax returns of the customers to determine their compliance with the tax laws. The ROD unit found 6000 retailers whose reported purchases were greater than reported sales. The Audit Division decided to audit 1700 of those with the greatest difference between purchases and reported sales; it also decided to send 600 cases to the District Offices for audit as an experiment. Roebling Liquors, Inc. was one of the 600.

Deficiency Calculated

After looking at the information the ROD unit had compiled on the taxpayer, the auditor contacted the suppliers and asked for information regarding the amount of merchandise sold to the taxpayer during the audit period and whether the goods were delivered to the taxpayer's place of business. A sales tax deficiency was then calculated using the information from the wholesaler and applying a mark-up of 7.07% determined from the federal income tax returns. The taxpayer claimed that the wholesaler information failed to account for a 1% purchase discount and a 3% allowance for pilferage. The taxpayer also claimed a discrepancy in the inventory of goods on hand led to an overstatement of tax. (It also argued the statute of limitations had expired for one period prior to the date of the Notice of Determination and a failure to properly send the Notice to Roebling.)

The Tribunal upheld the deficiency as revised by the ALJ, giving the taxpayer credit for the 1% purchase discount and 3% pilferage, but reversed as to the inventory adjustment since that was an issue of credibility of the taxpayer which the Tribunal had the right to review.[11]

The Tribunal also reviewed the statute of limitations and mailing issues but those are of far less interest than the basic issue of gathering third party information and its use. The 'bulk' of the taxpayer's protest challenged the Department's authority to engage in a "massive and coercive fishing expedition" into the records of the wholesalers and that the use of the evidence so obtained was impermissible. The Tribunal, as had the ALJ, rejected that challenge stating that every vendor must keep accurate records and make them available to the tax authorities. The Tribunal quoted the ALJ stating such "records are not afforded the traditional protections of the Fourth or Fifth Amendments." In the context of a civil tax assessment,

the protections against unreasonable searches and self incrimination are not the same as in a criminal proceeding.

Prepayment Procedures

In a recent decision, an Administrative Law Judge in the New York City Tax Appeals Tribunal held that under the City Administrative Code, a Notice and Demand issued by the City Department of Finance does not give the taxpayer a right to a prepayment hearing. In *Matter of Hillary David Corp.*,[12] the taxpayer filed its City General Corporation Tax returns late. The taxpayer paid the GCT due for each year, but did not include payments for late filing and late payment penalties, or for interest.

The City sent Notices and Demands to the taxpayer asserting penalties and interest due and the taxpayer filed a petition protesting the Notices and Demands and requesting abatement of the penalties "for good cause." The City filed a motion to dismiss the petition on the grounds that the Tribunal lacked jurisdiction to hear the petition. The taxpayer did not respond to the motion to dismiss.

The ALJ granted the City's motion to dismiss in holding that the Tribunal did not have jurisdiction over the taxpayer's protest of the Notices and Demands issued by the City. Under section 11-680.2, a taxpayer has the right to protest a notice of deficiency by filing a petition and is afforded the right to a hearing before the Tribunal. However, no similar provision applies to notices and demands issued under section 11-676. Therefore, the taxpayer did not have a right to a hearing challenging the City's Notices and Demands.

The reason this case is of interest is that, as the ALJ noted, the State law is different in this context. In *Matter of Donal A. Meyers v. Tax Appeals Tribunal*,[13] additions to tax were imposed under Tax Law section 685(c) by means of a notice and demand. The taxpayer argued that he was entitled to a prepayment hearing. This argument was rejected by the State Tax Appeals Tribunal,[14] which found that the only State income tax provision allowing for a prepayment hearing is in Tax Law section 689(b), which applies to notices of deficiency. The Appellate Division agreed that the state income tax provisions did not appear to give the taxpayer the right to a prepayment hearing. However, Tax Law section 2006, which establishes the jurisdiction of the State Tax Appeals Tribunal, provides for hearings "as a matter of right" upon request, "unless a right to such a hearing is specifically provided for, modified or denied by another provision of this chapter." The Appellate Division held that because the right to a prepayment hearing was not specifically provided for, modified or denied by another Tax Law provision, the taxpayer was entitled to a prepayment hearing protesting the notice and demand issued by the State.

In contrast to the State Tax Appeals Tribunal, under City Charter section 168(a), the jurisdiction of the City Tax Appeals Tribunal is limited to petitions filed by taxpayers who protest notices for which the Code provides a right to a hearing, such as a notice of deficiency. Of course, a taxpayer has the option of paying the penalty and claiming a refund, and in the event of a denial of the refund claim, have a hearing on the issue of reasonable cause.

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1 New York State Tax Appeals Tribunal (decided September 16, 1999).

2 20 NYCRR 154.6(a)(3)(i)(a).

3 *Matter of McNulty v. NYS Tax Comm'n.*,70 NY 2d 788 (1987); *Matter of Wertheimer,* (NYS Tax Appeals Tribunal, decided January 12, 1995).

4 ax Law Search7RH1115(n).

[5] New York State Tax Appeals Tribunal (decided November 24, 1999).
[6] Tax Law Search7RH1115(a)(5).
[7] Tax Law Search7RH1101(b)(7).
[8] *Stahlbrodt v. Commissioner of Taxation & Fin.*, 92 NY2d 646 (1998),upholding 20 NYCRR 528.6(c)(3).
[9] Tax Law Search7RH1101(b)(7) as amended by section 242 of Chapter 61 of the Laws of 1989.
[10] New York State Tax Appeals Tribunal (decided November 24, 1999).
[11] Although the Tribunal usually defers to the ALJ's evaluation of credibility, Tax Law Search7RH2006(7) and 20 NYCRR 3000.17(e)(1) permit a review of the record and a different finding.
[12] NYC Tax Appeals Tribunal, Administrative Law Judge Division (decided September 3, 1999).
[13] 201 A.D.2d 185 (3d Dept. 1994), *lv. to appeal denied*, 84 N.Y.2d 810 (1994).
[14] *See*, *Matter of Donal Meyers*, NYS Tax Appeals Tribunal (decided June 3, 1993).