REPORT #755

TAX SECTION

New York State Bar Association

Report on Governor's 1993-94 Budget Proposals

Table of Contents

TAX SECTION
New York State Bar Association

March 30, 1993

<u>Federal Express</u>

Hon. James W. Wetzler
Commissioner of Taxation and Finance
State Campus - Building No. 9
Albany, New York 12227

Dear Commissioner Wetzler:

Enclosed is a report jointly prepared by several of our committees dealing with certain of the tax provisions included in the Governor's Budget Proposals for 1993-94. In view of time constraints, we have focused on those provisions which we felt most deserved comment.

As the report notes, the Budget Proposals do not make provision for holding Administrative Law Judge hearings in locations other than Troy, New York, nor is there pending any legislation along the lines of the Uniform Procedure Bill reported on by the Tax Section in prior years. As we have previously indicated, we strongly support both provisions and would favor their adoption in the current session.

Please call me if you have any questions.

Very truly yours,

Peter C. Canellos

cc:

Hon. Saul Weprin
Speaker
The Assembly
The Capitol
Albany, New York

Hon. Sheldon Silver
Chair, Ways and Means Committee
The Assembly
The Capitol
Albany, New York

Hon. Ralph Marino
Majority Leader
The Senate
The Capitol
Albany, New York

Hon. Ronald B. Stafford
Chair, Finance Committee
The Senate
The Capitol
Albany, New York

cc:

Ms. Lee Sheppard
235 East 95th Street
Apt. 34G
New York, New York 10128

Mr. Scott Schmedel
Wall Street Journal
World Financial Center
200 Liberty Street
New York, New York 10281

Diane H. Jones
American Bar Association
Section of Taxation
1800 M Street, N.W.
Washington, DC 20036

Mr. Herman Ayayo
Tax Notes
6830 N. Fairfax Drive
Arlington, Virginia 22213

Ms. Dorothy Coleman
Daily Tax Report
1231 25th Street, N.W.
Room 517
Washington, DC 20037

Mr. Charles Davenport
Tax Notes
6830 N. Fairfax Drive
Arlington, Virginia 22213

Timothy J. McCormally, Esq.
Tax Executives Institute, Inc.
1001 Pennsylvania Avenue, N.W.
Suite 320
Washington, DC 20004-2505

Ms. Barbara Coluccio
New York State Bar Association
One Elk Street
Albany, New York 12207

Eric Kracov, Esq.
Silverstein & Mullens
1776 K Street, N.W.
Washington, DC 20006

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Governor's 1993-94 Budget Proposals[1]

Governor Cuomo's budget proposal for 1993-94 contains significant tax initiatives, including a number of tax rate extensions (certain rates and surcharges were scheduled to decrease) and several procedural and substantive amendments relating to the various taxes. The Uniform Procedure Bill, which the Tax Section has supported since its development and has endorsed in past sessions of the Legislature, has not been introduced this year.

This report focuses on the proposals that the Tax Section believes warrant comment because of technical, administrative, or conceptual issues they raise.

[1] This report was prepared by the Committees on New York City Tax Matters, New York State Tax Matters, State and Local Taxes, and Sales, Miscellaneous, and Property Taxes. It was drafted by E. Parker Brown II, Robert E. Brown, Paul R. Comeau, Craig B. Fields, J. Brian Kopp, James A. Locke, Robert Plautz, and Arthur R. Rosen. Helpful comments were contributed by Peter C. Canellos and Carolyn Joy Lee.

S.865/A.1465 - Relating to Real
Property Transfer Gains Tax

I. Existing Law

New York's 10% Real Property Transfer Gains Tax is imposed on the difference between consideration paid for the transfer of an interest in real property and the original purchase price of that interest. Tax Law Section 1440.5(a) defines “original purchase price” for purposes of the gains tax as consideration paid or required to be paid by the transferor to acquire the interest in real property and for any capital improvements made or required to be made to the realty, including solely those costs which are customary, reasonable and necessary, as prescribed in the Tax Commissioner's regulations, incurred for the construction of such improvements. By statute, original purchase price also includes amounts paid by the transferor for any customary, reasonable and necessary legal, engineering and architectural fees incurred to sell the property and customary, reasonable and necessary expenses incurred to create ownership interests in property in cooperative or condominium form, as determined under the Commissioner's regulations. See 20 NYCRR 590.14 et seg.

Tax Law Section 1440.5(a) has been interpreted by the Department of Taxation and Finance as not permitting the inclusion in original purchase price of advertising and marketing costs, costs of tax abatement certificates, and interest accrued during the construction period on loans obtained to acquire land. Additionally, while mortgage recording taxes have been viewed by the Tax Department as included in original purchase price, the special additional mortgage recording tax (“SAMRT”) paid by the transferor has not.

Tax Law Section 1446.2 provides that any person failing to file a tentative assessment and return or to pay any tax within the time required is subject to a penalty of 10 percent of the amount due plus an interest penalty of 2 percent of such amount for each month of delay after the first month, not to exceed 25 percent in the aggregate. Thus, a 35 percent maximum penalty is reached after 14 months. (Failure to pay tax required to be shown on a return, but not determined until audit, results in penalties calculated from the date the return was required to be filed.)

II. Proposed Changes

The bill would expand the definition of original purchase price to include customary, reasonable and necessary advertising and marketing costs (in addition to customary brokerage fees paid by the transferor) incurred to sell realty; mortgage recording taxes, including the SAMRT; the transferor's cost to purchase tax abatement certificates; and interest costs incurred on construction period loans provided the proceeds of the loans were used by the transferor to acquire real property and provided certain other conditions are met. This portion of the bill would take effect immediately and apply to transfers occurring on or after the effective date.

The bill would also amend the penalty provisions in the current law with a new penalty structure modeled after the Article 9-A franchise tax penalty system. Specifically, a penalty of one-half of one percent per month commencing after the issuance of the statutory Notice and Demand, to a maximum of 35 percent, would be imposed in lieu of the existing penalty with respect to failure to pay tax required to be shown which is not shown; the current penalty applicable with respect to failure to file a tentative assessment and return, or failure to pay the amount shown to be due on the tentative assessment, would remain unchanged. Additionally, franchise tax-type negligence and substantial understatement penalties would be imposed (although the subjective standards to be implemented are unknown; the standards applied by the Department in gains tax cases have been much stricter than the standards applied in personal income tax, for example). This part of the bill would take effect 150 days after enactment and apply to liabilities relating to transfers for which the statute of limitations for a determination of tax has not expired and where a notice of determination has not yet been issued.

III. Comments

The Tax Section strongly supports the definitional changes to the gains tax law included in S.865/A.1465 and applauds the administration for taking this step in rectifying the problems with the gains tax. The Section's Report on the 1989 Budget Bills (dated March 30, 1989) recommended that the statute be amended to permit deduction of all selling expenses, including advertising costs and transfer taxes, in order to take into account more of a transferor's legitimate economic costs. Inasmuch as the bill incorporates that recommendation, we support the enactment. We believe that the allowable selling expenses include a portion of investment banking or similar fees that are incurred in the transfer of a controlling interest of an entity with an interest in real property (because such transfers are treated as transfers of real property); we recommend, however, that the bill be amended to make this result clear.

The 1989 report also recommended that interest costs attributable to carrying the underlying land while property is under construction be allowed in the calculation of original purchase price. Furthermore, the Section's 1991 Report on Gains Tax and Troubled Properties cited the Tax Department's increasingly restrictive treatment of interest expense, including interest on land during the construction period, as a chief cause of overstatement of economic gain on projects. The 1991 report strongly urged, as the Section does now, that this unreasonable treatment be ended. Further rectifications to the gains tax should also be considered to reflect true economic gain better. Such changes include extending the “construction period” for which interest is recognized as part of original purchase price to reflect better the true development period for real property; and recognizing that lease-up costs should be part of original purchase price.

As set forth in the 1991 report, the Section also supports the reform of the gains tax penalty provisions. The effect of the provisions, aside from bringing the gains tax into closer conformity with the franchise tax, is to relieve taxpayers of penalties on taxes found to be owing after audit (absent negligence or substantial understatement), if such taxes are paid promptly after they are finally determined. This could, in fact, achieve real reform if, as we believe appropriate, the negligence penalty requires a higher standard of malfeasance than the Department currently employs in proposing gains tax penalties. We are, however, concerned about the possible “stacking” of penalties under the proposal. For example, it appears that a taxpayer who files a return late could be subject to higher penalties (the 35% late filing penalty, plus negligence and substantial understatement penalties) than is the case under the current penalty provisions. In addition, given the unusual nature of the gains tax and the complex legal issues that can be encountered in determining whether a transfer has occurred, the application of penalties for failure to file should take into account the possibility that, for example, taxpayers reasonably relied on professional advice in determining not to file. Finally, we question generally the appropriateness of basing penalties on the amount set forth on the tentative assessment. That is a State-generated tax return not a tax return prepared by the taxpayer, as is the case in the franchise and personal income taxes. In any event, whenever a supplemental return is filed, the tax shown on such supplemental return should serve as the basis for penalties. Compare Tax Law Section 1446-a.

In view of the pending litigation regarding the current scope of original purchase price, it should be made clear that the enactment of these provisions has no implications for pending litigation. We are also informed that the Tax Department's Processing Division requires 150 days to adapt its systems to the penalty restructuring. This helps explain the prospective effective date for penalty impositions, but it does not explain why penalties imposed after enactment could not be abated on a basis similar to the new statutory provisions. We urge the Department to adopt this approach.

S.850/A.1450 - Relating to Investment Tax Credit for Production of Electricity

I. Existing Law

This bill is an attempt to reverse two recent decisions of the Tax Appeals Tribunal (Frederick R. and Anne M. Clark, 1992-2 N.Y.T.C. T-1128 (Sept. 14, 1992) and BT Capital Corp., 1992-2 N.Y.T.C. T-1173 (Oct. 1, 1992)) whereby the Tax Appeals Tribunal held that certain costs in connection with the purchase of electrical generating equipment were eligible for the investment tax credit under both the personal income tax law and the Article 9-A corporation franchise tax law. The Tribunal reached this conclusion because it found that electricity "is a tangible commodity with an intrinsic value" and that the production of electricity was both "manufacturing" and "processing" of "goods".

II. Proposed Changes

The bill amends the personal income tax law and the Article 9-A corporation franchise tax law to override recent Tribunal decisions by specifically excluding "electricity" from the definition of "goods" so that costs for electrical generating equipment would no longer qualify for the New York investment tax credit.

III. Comments

This proposed change in law raises the tax policy issue as to whether there should be disparate treatment for other commodities (some competitive with electricity) that are generally treated in a manner similar to electricity such as gas, steam and refrigeration (see, for example, Tax Law §§ 1105(b), 1115(a)(12)). If the tax policy of New York is to be changed with respect to electricity,[2] we believe that the Legislature should

[2] It is should be noted that, while the Memorandum in Support gives the impression that electric production was never intended to be treated as a qualifying activity for purposes of the investment tax credit, the Department itself allowed investors to claim the investment tax credit for hydroelectric facilities prior to 1988 and has continued to grant the investment tax credit with respect to certain other energy-production facilities, see Parsons and

consider the proper tax policy regarding the similar commodities mentioned above so that the overall approach can be rationalized based upon a policy.

A second concern with the bill is its effective date provision. It provides that the change is effective immediately and shall apply to taxable years beginning on or after January 1, 1993. The projects in question typically have long lead times and it would appear unfair to taxpayers who have expended substantial sums prior to January 1, 1993 expecting to receive the tax credit to have such benefits taken away before they have received the full benefit. For this reason, changes in the rules governing investment tax credits at the federal level have typically grandfathered projects underway at the time of the change. While one could argue that the law was unclear prior to recent Tribunal decisions allowing the credit (the contrary position of the Department in an advisory opinion being a basis for concern), many practitioners believed there were strong arguments in favor of obtaining the credits. Thus, we believe that any change in law should not apply to payments made pursuant to binding agreements executed prior to the enactment of the legislation.

According to the Memorandum in Support, if the Legislature fails to adopt this provision a loss of as much as $10 million annually could result. Although we do not claim expertise on revenue estimating matters, there appear to be questions regarding this estimate. In order for a $10 million loss to occur, over $200 million worth of hydroelectric power facilities would have to be built in New York on an annual basis. Furthermore, even this $200 million figure assumes that the companies and individuals claiming the investment tax credit are able to use 100% of the credit in the year claimed. More than

---

Whittmore Inc., 1991-2 N.Y.T.C. T-1129 (Oct. 3, 1991) (involving waste to energy facilities).

likely, however, investors in a hydroelectric power facility will use those credits to offset taxes over a number of years, thus spreading out the cost to the State. We are therefore concerned that the stated budget implications of failing to adopt this provision may not be accurate.

Finally, we note that the proposed effective date provision is ambiguous with respect to carryforwards of credits earned in prior years. Clearly, such carryforwards should not be affected by any change in law.

S.876/A.1476
Relating to Sales and Use Tax Audit Methods

I. Existing Law

As the Memorandum in Support states, "[e]xisting statute contains no specific provisions or guidelines prescribing the sales and use tax auditing procedures which the Commissioner might employ." There is, however, substantial and well established case law on the issue. New York courts and administrative tribunals have held consistently that taxpayers whose records are available, complete, adequate and reliable have a right to insist upon complete sales and use tax audits and may not be compelled to submit to sampling techniques, including statistical sampling techniques, without their consent. It is also current law that if the taxpayer's books and records are insufficient the Commissioner may use any method of estimation reasonably designed to ascertain the taxpayer's correct tax.

As the Memorandum states, the Tax Department has long employed various sampling techniques in its audits. Because of the requirement for taxpayer consent when the taxpayer has adequate records, however, these techniques have been employed only when both the taxpayer and the Commissioner agree that the use of sampling would be accurate and expeditious.

II. Proposed Changes

The bill would amend section 1138(a) of the Tax Law to provide:

> (a) That the commissioner may use statistical sampling techniques in determining the amount of tax due even when the records of the taxpayer are “available, complete, adequate and reliable.”
>
> (b) If the taxpayer's records are unavailable, incomplete, inadequate or unreliable, the commissioner may estimate the tax due by using any method reasonably calculated to reflect the amount of the tax due even if it may be shown that another method could have been used. The availability of another method would not be evidence that the commissioner's method was not reasonable.
>
> (c) The unavailability, incompleteness, inadequacy or unreliability of a taxpayer's records could be shown by the commissioner any time before a final determination of the tax even if the commissioner requested the records late or did not request them at all.

(d) Records requested by the commissioner and not produced by the taxpayer prior to the issuance of a notice of determination could not be introduced into evidence by the taxpayer in any later proceeding unless the taxpayer could show reasonable cause and lack of willful neglect and unless the records were made available as soon as they were available.

(e) The provisions would take effect immediately and except for rule (d) above would apply retroactively even to matters which had been decided by administrative law judges, the Tax Tribunal or courts unless the tax had been finally and irrevocably fixed by the highest relevant authority or by the expiration of the time to appeal.

III. Comments

The Tax Section does not oppose the use of accurate statistical sampling techniques in sales tax audits. Indeed, they may be necessary as a practical matter in dealing with complex audits. However, the proposal to allow statistical sampling would drastically change current law with respect to audit procedures for sales and use tax and would, on its face, permit any statistical method, irrespective of its accuracy. It would also overrule the current right of taxpayers who have kept accurate records to insist on a complete audit rather than an audit based on sampling.

The Tax Section believes these are changes of considerable magnitude in the law governing sales and use tax audits and that there should be explicit legislative or Departmental consideration of the following:

> (a) The statute should explicitly provide that taxpayers may meet the burden of proof of overcoming a statistical audit by a complete analysis of their actual records or by establishing that the method used by the Department was inaccurate or unreasonable.

The memorandum in support justifies the proposed changes on the ground that it would “permit [] the Department to effectively allocate its audit staff to cover more taxpayers more efficiently.” While this is a laudatory goal and while it may be made more urgent by budget constraints, efficiency should not be impaired by allowing the the taxpayer to rebut the presumption that the Notice of Determination is erroneous by questioning the statistical method imposed by the Department or by a complete analysis of the taxpayer's own actual records.

> (b) The statute should establish or contemplate acceptable levels of precision and confidence in the statistical methods permitted to the Department.

The term “statistical sampling” does not in and of itself define the accuracy which the statistical audit would produce. There are established guidelines for statistical accuracy, and these should be explicitly referred to in the legislation, without the requirement that statistical methods meet certain standards, taxpayers, particularly large volume taxpayers more likely to be sampled, would be subjected to unwarranted uncertainty.

> (c) The cost which statistical sampling audits would impose on taxpayers.

True statistical sampling is beyond the knowledge of many taxpayers. Taxpayers who are subject to statistical sampling would incur the costs of statistical experts in order to participate effectively in the audit. Accordingly, it may be appropriate to limit statistical sampling to relatively large sellers and those who have not maintained proper records.

(d) The cost of training that would be required to make auditors conversant with statistical methods.

State auditors are by and large unfamiliar with statistics and have received little or no training. The Commissioner would need to establish a program to train auditors to implement any statistic-based system. The cost of such a training program should be explored carefully.

If these concerns are addressed, we believe that statutory recognition of statistical auditing would have merit. However, the retroactive nature of the statute as it would apply to statistical sampling is in any event troublesome. There are now cases pending which involve this very issue. To apply new law retroactively to cases currently under consideration raises serious fairness issues and would seem unwarranted. The Section believes that the Commissioner's desire for retroactive amendment may reflect the absence of a right to appeal adverse determinations of the Tax Appeals Tribunal. The Tax Section supports this right to appeal.

The proposed statute would make the Commissioner's discretion conclusive with respect to the choice among reasonable audit methods when the taxpayer's books and records were found to be insufficient. The Memorandum in Support suggests that this change is necessary because the Tax Appeals Tribunal “apparently suggested a hierarchy of estimated audit methods” in Matter of Cafe Europa (Tax Appeals Tribunal, July 13, 1989). In fact, the Tax Appeals Tribunal in that case expressly indicated its approval of the well-established Appellate Division test that if the taxpayer's records are insufficient, the Commissioner may use any method reasonably designed to ascertain the petitioner's tax. What the Tax Appeal Tribunal held in Matter of Cafe Europa was that the Commissioner had not properly determined that the taxpayer's records were insufficient and that the Commissioner's test method (in which a tax examiner stood by the cashier for each of two days and examined guest checks) was not reasonable. The Commissioner lost Matter of Cafe Europa because of failure to follow reasonable procedures not because of any statutory deficiency. Under this analysis this proposed statutory change would be an unnecessary, though harmless, clarification.

The proposal which would allow the Commissioner to declare the taxpayer's records inadequate without even requesting the records is described in the Memorandum in Support as a simple affirmation that audits could not be set aside because the Commissioner did not perform the charade of making a futile request. Unfortunately, the proposed statute as drafted could be read as going far beyond that principle. The actual statutory language should incorporate a requirement that the Commissioner reasonably determine that a request for records is likely to be futile.

The proposed provision excluding from evidence all records requested by the Commissioner and not produced by the taxpayer could prove to be unreasonably harsh in the practical context of a sales tax audit controversy. It is not uncommon for a taxpayer to be unrepresented by a professional tax adviser during an audit. In this circumstance, a broad request for records by the Commissioner could result in statutory failure to produce necessary records if the taxpayer misapprehends the legal theory behind the audit or fails to appreciate the relevance of certain records. Furthermore, the statute as drafted could require exclusion of evidence which became relevant to the determination of the tax after the notice of determination was issued because of a change in the taxpayer's legal theory or strategy. If there is a problem with the intentional failure to provide requested documents the Commissioner should be able to seek an exclusionary ruling before the relevant tribunal. Such a ruling should be in the discretion of the tribunal and should apply only to the facts of the individual case. A statutory solution is inappropriate because it does not adequately reflect the facts and circumstances of the individual case. It is too blunt an instrument to apply to the problem.

S.876/A.1476 - Relating to Sales Tax Penalties Imposed on Bulk Purchasers

I. Existing Law

On November 9, 1989 the Appellate Division, Third Department, decided Velez v. Division of Taxation, 152 A.D. 2d 87. In that case, the petitioner purchased a grocery store from the seller but did not notify the Tax Department of the bulk sale until eight months later, in contravention of Tax Law Section 1141(c) which requires notification at least 10 days before taking possession of assets in bulk or paying the purchase price. Pursuant to its regulations, the Division of Taxation subsequently sent notices of determination and demand for payment of taxes to the purchaser, assessing taxes, interest and penalties relating to deficiencies of the seller. At the Administrative Law Judge and Tax Appeals Tribunal levels, the penalties and interest were sustained. The Appellate Division, Third Department, however, compared Tax Law Section 1141(c) (which does not mention penalties or interest) with Sections 1141(a) and (b), which expressly refer to “tax, penalty and interest.” The Court referred to the legislative purpose behind the statute, noting that the State's interest in a taxpayer's unsatisfied sales tax liability would not be extinguished or impaired when the taxpayer transferred its business assets in bulk if the purchaser's “vicarious” liability were limited to the seller's taxes. The seller would still be liable for tax, interest, and penalties, and the purchaser would also be liable for an amount equal to the seller's unpaid taxes (up to the fair market value or purchase price paid for the business assets). By limiting the purchaser's exposure to the fair market value or amount paid for the assets, the Legislature “deliberately insulated the noncomplying purchaser from total liability for the seller's failure to pay his taxes.” The Court noted that a purchaser who does not pay the derivative tax in a timely manner once it is assessed is separately liable for penalties and interest commencing 90 days after receipt of the notice and demand. See Tax Law Sections 1141(c) and 1145(a). The Court said it was

> unlikely that the legislature intended to hold the purchaser personally liable for the interest and penalties assessed against the seller, when the purchaser is statutorily made responsible for any interest and penalties which accrue by reason of his own failure to timely pay the derivative tax.

The Court observed that Section 1145(a)(iii) affords those neglecting to pay any tax relief from liability for penalties and excessive interest “due to reasonable cause and not due to willful neglect.” According to the Court, it makes little sense to impose liability upon the purchaser for the seller's malfeasance, for the purchaser is then in the difficult position of proving that another's intentions were innocent.

As a result of this decision, the Division of Taxation amended Regulation section 537.4(a) to acknowledge that the purchaser may not be assessed for penalties or interest owed by the seller, but may be assessed penalties or interest on its own account if it fails to pay its derivative tax liability on time.

II. Proposed Changes

Sections 1 and 2 of the bill add new language designed to make the purchaser, transferee or assignee in a bulk sale (a “Bulk Purchaser”) liable for the penalty and interest liability of the seller, transferor or assignor in bulk (a “Bulk Seller”) under the sales and compensating use taxes. Generally, these provisions take effect September 1, 1993, but special provisions indicate that the increased liability under the bulk sales provisions will apply (1) to sales, transfers and assignments in bulk occurring on or after the date the act becomes law, and (2) to sales, transfers and assignments in bulk occurring before the date the act becomes law, if in either case the purchaser, transferee or assignee has not transferred over all or any portion of any sums of money, property, choses in action or other consideration to the seller, transferor or assignor, to the extent that such sums of money, property, choses in action or other consideration has not been transferred over to the seller, transferor or assignor prior to the date the act becomes law.

The Memorandum in Support of the bill states that increased liability for purchasers is appropriate “to protect the State's interest in collection of bulk sellers' liability for sales and compensating use taxes.” See Memorandum in Support at p. 1. Page 17 of the Memorandum in Support refers to the Velez case as a change in the law.
According to the Memorandum,

> since the inception of the State sales and compensated use taxes in 1965, the liability of purchasers under the bulk sale provisions has included penalties and interest owed by the bulk seller. In 1989, the Appellate Division construed Section 1141(c) of the tax law to hold that a bulk purchaser does not become liable for the bulk seller's penalty and interest liabilities .... The bill amends the applicable provisions of the sales and compensating use taxes to supply the missing references to penalties and interest .... This change will restore and protect the State's interest in the seller's sales and use tax debt since the seller cannot dissipate business assets without satisfying the full amount of its sales and use tax liability, including penalty and interest. Failing to provide this protection often means that the State will not collect penalty and interest owed by the seller because the seller sells it assets and leaves the State or becomes immune from judgment.

III. Comments

While the Tax Section perceives problems with the bill's proposal, it does recognize that there are serious inadequacies with the current bulk sales process. Accordingly, in addition to commenting on the bill's provisions, the Section is taking this opportunity to provide suggestions for achieving the proposal's goal of ensuring greater compliance and collectability.

Extension of Bulk Sale Liability to Include Interest and Penalties. We believe an extension of Tax Law § 1141(c) to include interest and penalties raises serious questions.

It appears that the Legislature took into account competing considerations when it adopted Section 1141(c) in its current form. It did not give the Division the strongest possible weapon, but gave the Division considerable power to pursue the purchaser as well as the seller to collect the seller's delinquent taxes. Increasing a purchaser's potential liability to both penalties and interest could have serious effects on innocent purchasers. (Collusive transactions can be caught under other existing provisions.) These should be weighed against the administrative advantage to the taxing authority. If the Legislature decides to review the bulk sale statute, we believe it should consider the changes listed below, changes designed to protect the state's revenue in a more balanced and even-handed manner.

Effective date provisions should be modified. The effective date provisions in the bill increase the liability of purchasers for transactions that may have already closed. For example, the proposed change is effective for “sales. . . occurring before the date this act shall have become a law. . . to the extent that [any portion of the purchase price] has not been transferred over to the seller. . . prior to the date this act shall have become a law.” Assume that a sale closes in March, 1993 and bulk sale notification was given but a portion of the purchase price ($100x) is withheld pending expiration of the 90 day period specified by Section 1141(c). Assume that the seller owes $60x in taxes and $50x in penalties and interest, or a total of $110x. Also assume that the bulk sale statute is amended effective June 1, 1993, a few days before the 90 day period ends. The purchaser may have conflicting obligations under his purchase contract and under the newly-enacted bulk sale provision. The new statutory provision, which increases the purchaser's liability to include penalties and interest, will not, as of the June payout date, be reflected in the Division's regulations or in standard notices such as TP-153 entitled “Notice to Prospective Purchasers of a Business or Business Assets.” The impact of this harsh change will be especially severe for purchasers caught by this transitional rule. The effective date provisions should be modified, either to tie the effective date into the date the regulations are amended or, at a minimum, to specify an effective date 90 days after the date of enactment, with an exclusion for binding sale contracts entered into before the date of enactment.

Increase efforts to collect from the seller and utilize the bulk sale provisions only as a back-up collection measure. In January, 1993, the New York State Department of Taxation and Finance's Office of Tax Policy Analysis issued a report entitled improving Sales Tax Compliance: Recommendations for a Compliance Improvement Program. Page 77 of the report notes that while collection efforts against the purchaser take place under the bulk sale provisions, “attempts to collect the tax from the seller continue unabated.” Practitioners perceive that this is often not the case: if collection activities against the buyer seem easier, efforts against the seller are abandoned.

We believe the statute should require that initial collection efforts be aimed at the seller. The seller has, after all, received the consideration for the purchased assets, and should use this money to discharge its debts, including its obligations to sales tax authorities. Unfortunately, the bulk sale provisions do not, by their terms, recognize that this is a back-up collection measure. Instead, Section 1141(c) makes the purchaser personally liable for the payment to the State of any taxes theretofore or thereafter determined to be due to the State from the seller, subject to certain limitations.

Calculate consideration in a manner that reflects economic realities. Section 1141(c) is already an extremely harsh measure because it calculates the purchaser's potential liability in a way that may be excessive. For example, assume that a seller has business assets which are fully encumbered. A purchaser who attempts to notify the State more than 10 days prior to the purchase under the bulk sale provisions and who takes possession of the encumbered assets more than 10 days after giving notice has violated the bulk sale provisions because the liabilities which encumber the assets (such as bank debt, accounts payable to suppliers, and third party liabilities) are treated as consideration paid. See, e.g. O'Brien, 1992-2 N.Y.T.C. T-348 at 352-353. In the O'Brien case, the Tribunal discussed this problem and noted the harsh effect of the bulk sale provisions:

> Petitioner attempts to limit a purchaser's personal liability by arguing that the Division's first priority right and lien under Tax Law Section 1141(c) is secondary to any lien which may exist on real property which is the subject of a bulk sale, and that debts on real property paid by a purchaser are not "other consideration" because the Division could not collect its sales tax from the seller through the mechanism of a foreclosure sale of the seller's property without the payment of these liens. . . . [T]he Division's first priority right and lien under Tax Law Section 1141(c) is not a lien on the seller's real property but on the consideration paid by the purchaser to the seller . . . . Therefore, the extent to which the real property was encumbered by prior liens does not determine the amount of the Division's lien on the consideration given for the real property. Contrary to petitioner's assertions, there is nothing in the statute which limits the purchaser's liability to the amount the Division would have received had there been a foreclosure sale on the real property.

> Instead, the purchaser's liability is limited by statute only to the greater of the purchase price or fair market value of the assets sold (Tax Law § 1141(c).
>
> Petitioner argues further that the liability of a purchaser is limited to amounts actually transferred by the purchaser to the seller, and that the payment by petitioner of outstanding liens and judgments and the assumption or payment of mortgages on the sellers' property was not consideration transferred to the sellers . . . .

The Tribunal did not accept this argument; instead, it held that the personal liability of the purchaser can be an amount including all consideration that the purchaser is required to transfer as part of the sale regardless of its form and regardless of the identity of the payee. Consideration includes the seller's relief from financial obligations, and includes items such as the purchaser's assumption of mortgages. Well-advised purchasers can avoid this harsh result by having the seller's lenders foreclose on the property prior to the sale. The purchaser then buys the property from the lender, possibly putting a new mortgage on the previously-encumbered property. Other purchasers who merely purchase from the seller and assume or take subject to existing mortgages have liability under the O'Brien rationale. A purchaser's ability to avoid Section 1141(c) in this manner indicates that this section is an imperfect collection or enforcement tool, and one which will apply unevenly to purchasers, depending upon whether they are well advised or poorly advised.

We believe the purchaser's maximum exposure under Section 1141(c) should be limited to the larger of the amount the Division could have collected (1) if it had seized the acquired assets from the seller immediately before the sale to the purchaser, or (2) if it had received the net proceeds received by the Seller. This limitation will prevent the

Division from collecting from the purchaser sales taxes attributable to the seller but not collectible from the purchased assets or the net purchase price. It might be possible to accomplish this objective by giving the Division a lien on the purchased assets (not a lien on the consideration paid by the purchaser), a lien which arises on the date of the purchase and follows the assets into the hands of the purchaser and which attaches and is limited to any equity in the acquired property. Before this approach is enacted, however, the effect on common financing structures used for business acquisitions should be determined.

The notice provisions should be modified to reverse a recent change in the regulations. The harsh results of the bulk sale provision can be avoided if the purchaser gives adequate notice, and in some instances purchasers have tried to give the Division well over 10 days advance notice. In these situations, taxpayers have been frustrated because the Division has held (and the courts have accepted) that the early notice is only effective 10 days before the sale occurs. In other words, giving notice 90 days in advance (so that the statutory audit period will conclude prior to the bulk sale) is ineffective, since the notice is deemed given 10 days before the transfer. This has been incorporated into Regulation Section 537.2(c)(6). Therefore, a purchaser who intends to take possession of encumbered assets cannot satisfy its obligations under the bulk sale provisions by giving notice to the Division 90 days or more before the closing. Notice given in this situation will be deemed given 10 days before the closing, and the purchaser, by closing the purchase and accepting the encumbered assets, will instantly violate the bulk sale provisions.

The bulk sale provisions should be modified to permit a purchaser to give notice at least ten days prior to the closing. The notice should be effective when given. The purchaser's maximum liability should not be fixed until the closing date, the date the seller actually transfers the assets to the purchaser. The 90-day period for an audit should begin when the notice is given, but the state should have the right, within 90 days following the closing, to reexamine the seller. The purchaser would have bulk sale liability for items arising during both the first 90-day period and the supplemental 90-day audit period. This approach would give the purchaser an opportunity to provide notice well in advance of the closing, obtain the benefits of an audit, and proceed toward or away from the closing after the results of the first 90-day audit are known. The procedure should help the purchaser secure maximum payments to the state.

<u>A reasonable cause exception should apply to the bulk sales penalty</u>. Section 1141(c) makes the purchaser liable for the seller's unpaid taxes, even if the purchaser has reasonable cause for its failure to comply with the bulk sale provisions. Throughout the tax law, various provisions make one person liable for taxes initially payable by another, whether through the technical tools of imposing actual tax liability or imposing a penalty equal to the tax. For example, responsible officers of a corporation may have personal liability for the corporation's unpaid sales or use taxes. <u>See</u> Tax Law §§ 1133(a) and 1131(1). Officers are relieved of this liability if they demonstrate that their failure was due to reasonable cause and not due to willful neglect. Tax Law § 1145(a)(1)(iii).

If the law is changed to hold the bulk purchaser liable for the seller's taxes, penalties and interest, the law should permit the purchaser to seek an abatement of at least the penalties and interest by showing that the purchaser's failure to comply with § 1141(c) was due to reasonable cause. Questions will arise concerning the purchaser's burden of proof, and whether the purchaser has the burden to show that the seller had reasonable cause.

S.876/A.1476 - Relating to
Exemption for Sales to Nonresidents

I. Existing Law

Section 1117 of the Tax Law exempts sales of motor vehicles to certain nonresidents. Specifically, Section 1117(a) of the Tax Law sets forth an exemption from sales tax provided the purchaser, at the time of taking delivery, meets the following requirements:

(1) is a nonresident of this state,

(2) has no permanent place of abode in this state,

(3) is not engaged in carrying on in this state any employment, trade, business or profession in which the motor vehicle will be used in this state, and

(4) prior to taking delivery, furnishes to the vendor: any affidavit, statement or additional evidence, documentary or otherwise, which the tax commission may require to assure proper administration of the tax imposed under subdivision (a) of section eleven hundred five.

II. Proposed Changes

Under the bill, the nonresident exemption will only apply if the vehicle is not registered in New York (except for the issuance of a temporary in-transit permit). This provision is intended to stop the tax loss that occurs when vehicles registered and used in New York are purchased without the payment of tax by using nonresident exemption documents. The provision will be enforced by requiring any individual who purchases a vehicle relying on the nonresident exemption to pay sales tax when registering the vehicle in New York unless the car was previously registered in another jurisdiction or sales tax was paid in another jurisdiction. The amendment would allow nonresident individuals to come into New York State and purchase motor vehicles without paying sales tax as long as the purchaser does not register the vehicle in New York. The effective date for this provision would be September 1, 1993.

III. Comments

The Tax Department believes that the nonresident exemption has fostered abusive practices. Specifically, the abuse occurs when a nonresident purchases a vehicle under the nonresident exemption and instead of removing the vehicle from New York to his home state, the nonresident registers and uses the vehicle in New York State. By doing so, the nonresident can escape paying sales or use taxes in both New York and his home state.

The proposed legislation narrows the nonresident exemption by adding an additional requirement that the nonresident cannot register the motor vehicle in New York other than obtaining an in-transit permit that allows the nonresident to transport the vehicle outside of New York. In other words, the nonresident exemption would no longer be applicable for nonresidents who purchased and immediately registered the vehicle in New York. Presumably, the policy justification for the nonresident exemption is the underlying assumption that the vehicle will be brought and primarily used outside of New York. However, it is appropriate to conclude that a nonresident individual who purchases and registers a vehicle in New York intends to use the vehicle in New York. Therefore, from a tax policy perspective, such an individual should be required to pay New York sales and use taxes on his purchase.

The proposed legislation should not substantially alter the use tax exemption for property purchased by the user while a nonresident. Tax Law § 1118(2). This use tax exemption would continue to apply in cases where the vehicle had been registered in another state prior to being brought into New York. Specifically, Section 1132(f) would provide that an individual who purchases a vehicle in New York State as a nonresident and pays sales tax or registers his car in another state can register the vehicle in New York State without being subject to sales or use taxes.

The proposed legislation properly limits the nonresident sales tax exemption to situations where a nonresident purchases a vehicle in New York State and brings the vehicle back to his home state for registration. Additionally, the provision will not affect a nonresident who moves into New York State, as long as the individual had previously registered his vehicle in another state or paid sales tax in another state. Based on the foregoing, we believe that this provision is an acceptable limitation on the nonresident exemption for motor vehicles.

S.876/A.1476 - Relating to Intrafamily Sales Exemption

I. Existing Law

Section 1115(a)(14) of the New York Tax Law provides an exemption for the intrafamily sale of a motor vehicle. Specifically, the provision exempts from sales and use taxes the sale of

> Motor vehicles . . . sold by a husband or wife to his or her spouse, or by a parent to his or her child, or by a child to his or her parent. Provided, however, this exemption should not apply if the vendor is a dealer as defined in section four hundred fifteen of the vehicle and traffic Law.

II. Proposed Changes

The bill would amend Section 1115(a)(14) to limit the intrafamily sale exemption to situations where the selling family member paid sales or use tax when purchasing the vehicle (except when the state in which the vehicle was purchased imposes no such tax and the seller was a resident of such state at the time of purchase). Section 1115(a)(14) currently enables two family members (husband, wife, and children) who are residents of New York to bring a vehicle into New York without paying sales tax. One family member can purchase a vehicle in a state in which he is not a resident and sell the vehicle to a family member. Assuming that the state in which the vehicle is purchased has a nonresident or export exemption, no sales tax is paid in that state. Additionally, no New York State sales tax is paid because section 1115(a)(14) exempts intrafamily sales. Under the proposed legislation such a transaction would be subject to sales tax based on the purchase price paid by the first family member. The effective date for this provision would be September 1, 1993.

III. Comment

The intrafamily exemption recognizes that certain exchanges between family members should not trigger sales tax because of the close relationship and interdependence of the parties. For example, if a parent incurs a loan when purchasing an automobile, and subsequently his child assumes the loan and obtains title to the automobile, a sales tax would ordinarily be due on the transfer because the assumption of a liability constitutes consideration, triggering sales tax. However, the intrafamily exemption protects such a transfer from sales tax. 20 NYCRR § 528.15(b)(2), Example 2.

While this exemption acts as an important shield to protect intrafamily transfers, the exemption should not be used as a sword to evade the sales tax. The proposed legislation is intended to prevent taxpayers from evading sales tax by using the intrafamily exemption, without undermining the purpose of the exemption. Specifically, the legislation will amend the intrafamily sales tax exemption so that it no longer applies when the family member making the sale of a motor vehicle paid no sales or use tax when the vehicle was purchased, although the exemption would still apply if the vehicle is purchased in a state which imposes no sales tax and the purchaser is a resident of that state. From a policy perspective, there is no reason why a resident who purchases a car outside New York and brings the car into New York should be taxed differently from a resident family member who purchases a car outside New York and transfers the car to a resident family member. The proposed legislation provides a level playing field by taxing these two transactions the same. In summary, the proposed change to the intrafamily exemption appears worthwhile.

S.876/A.1476 -- Relating To Requiring Vendors to Furnish a Sales Receipt, To Keep a True Copy of Such Receipt, and To Maintain Adequate Books and Records

I. Existing Law

Current law requires that when a vendor gives a customer a sales receipt, the receipt must separately state the amount of the tax, Tax Law § 1132(a)(1). Current law also requires that when a sales receipt is not given to a customer, the vendor must nonetheless keep a daily record of such sale in “. . . sufficient detail to independently determine the taxable status of each sale and the amount of tax due and collected thereon.” Reg. Section § 533.2(b)(2).

II. Proposed Changes

The bill seeks to change existing law by requiring that vendors must give a sales receipt for all taxable sales in excess of twenty dollars. The only exemption from this requirement is the sale of automotive fuel that is dispensed into a fuel tank at a filing station.

Coupled with the proposed change would be a penalty for the failure to furnish sales receipts for sales in excess of twenty dollars. The new provision would be adopted in Tax Law Section 1145(a)(6) and would impose a penalty of $100 for each month in which a vendor fails to furnish a customer with a sales receipt.

With respect to the requirement that the vendor keep a “true copy” of such sales receipt for purposes of audit, there would also be a penalty for not meeting that requirement, but it would be covered under the proposed new penalty Tax Law Section 1145(h), which, as discussed below, would impose a penalty on the failure to keep any of the records required to be kept by vendors. Presumably, the failure to keep a "true copy" of sales receipts falls within this reach.

Proposed Tax Law Section 1145(h) would impose a penalty against a vendor who "shows negligence with respect to or disregard of the requirements to keep records . . . . or who fails to make the records available . . .in accordance with an oral or written request . . . [with at least 20 days notice of such request] and before the issuance of a notice of determination . . . ." The penalty would be twenty percent of any underpayment of tax found upon audit. The penalty may be abated "if it is shown that there was . . . reasonable cause . . . and [the vendor] acted in good faith . . ."

III. Comments

For vendors that have a high volume of customer turnover, but low per-customer receipts, such as coffee shops and convenience stores, the current requirements of having to keep a "true copy" of any receipt or at least a daily record of each sale results in vendors having to keep numerous records. For a three-year audit period, these records can include thousands of "guest checks" or, at a minimum, hundreds of cash register tapes. While burdensome, vendors throughout New York State have complied. When vendors have not complied, the Tax Department has had a battery of methods available to determine the true tax collected by the vendor. Tax Law Section 1138(a)(1) provides that when the books and records of a vendor are insufficient, the Tax Department may estimate the tax due on the basis of “external indices” such as “observation test” or “mark-up test” of purchases. Frequently, these later types of “external index” audits take less time for the Tax Department to complete than an audit would take if the vendor had all of the records that are required under existing law. These “external index” audits also frequently produce large assessments.

The proposal to require vendors to provide sales receipts for all taxable sales in excess of twenty dollars would greatly exacerbate the burdens currently imposed on smaller vendors. It is not clear that this increased burden is justified by the increased compliance that may be achieved by this proposal. One way of possibly better balancing the additional burden imposed on vendors with the desired increase in sales tax compliance would be to increase the threshold level to which the provision applies to those sales where consideration exceeds, perhaps, fifty dollars.

The Tax Section believes that it would be sensible to provide that sales receipts not be required to be given where the vendor or someone on behalf of the vendor maintains information regarding each sale electronically. In this situation there is no need for the vendor to provide sales receipts since information concerning each sale is readily available and since sales tax compliance would therefore not be increased. Furthermore, imposing this requirement on sales that are maintained electronically would be contrary to the mechanization of our economy and the resulting increased efficiency that American businesses strive to achieve.

Proposed Tax Law Section 1145(a)(6), which would impose penalties for failure to supply a receipt, reads as if the penalty can be imposed upon failure to furnish a sales receipt to only one or a few customers. While all or part of the penalty may be abated “if the Commissioner determines that any such failure was due to reasonable cause and not due to willful neglect,” the Tax Section sees significant problems implementing this abatement provision. The reason is because in tax disputes the burden of proof is generally on the vendor and the vendor will therefore be required to prove that a receipt was furnished to a customer in a sale that may have occurred many years earlier. In a business with high customer turn-over, the customer will undoubtedly be unknown to the vendor. Even if a vendor could prove that receipts were furnished to a substantial number or even most customers, the wording of the statute does not appear to abate the penalty in these situations. Whether the vendor fails to furnish a receipt to one customer or a thousand customers, the proposed penalty provides for the same sanction of $100 a month.

With respect to the proposal to impose penalties for the failure to keep and make available adequate books and records, present law already imposes a penalty of as much as 30% for the late payment of sales taxes (plus statutory interest of 12% on the understatement), Tax Law § 1145(a)(1)(i). There is also an additional penalty of 10% of the understatement if the understatement is in excess of 25% percent of the amount shown on the return, Tax Law § 1145(a)(1)(vi). Of course, a vendor who has not maintained adequate books and records and is found upon audit to owe taxes is subject to these two penalties. An additional penalty of 20% would mean that such vendor would now be subject to a total penalty of 60% of any understatement found upon audit. The present fraud penalty is only 50% of the amount of the understatement.

The Tax Section opposes this proposed penalty for two reasons. First, the purpose of the penalty appears to be a belief that yet another penalty will encourage vendors to maintain “adequate” books and records. This does not necessarily follow, however. While there may be a point in which fear of an additional penalty may alter conduct, that point can not be determined with any exactitude and the present penalties approaching 40% seem more than adequate. Vendors are well aware of these present penalties and those playing the “audit lottery” can be expected to continue doing so. What does follow, however, is that imposition of an additional penalty will surely mean more disputes. The Tax Section does not believe that the costs of litigating this singular issue in all cases will appreciably match the increased revenue that the Tax Department will receive in those cases that it does win.

The second reason that the Tax Section opposes this penalty is because the penalty contains a clause that may be interpreted to abolish rights that vendors have in challenging the merits of the underlying assessment. The penalty provides that any vendor that is subject to the penalty “... may not challenge the authority of the commissioner to estimate tax due . . . .” If this clause is limited to mean nothing more than what existing law now provides, i.e., a vendor can not challenge the <u>authority</u> of the Commissioner to estimate taxes when books and records are found to be inadequate, the clause is, at best, superfluous. Case law firmly establishes this principal, <u>e.g.</u>, <u>Matter of Urban Liquors v. State Tax Commission</u>, 90 A.D.2d 576, 456 N.Y.S.2d 138, 139 (3rd Dept. 1982).

The Tax Section is concerned, however, that the clause may be interpreted by the Department to mean that a vendor can not even challenge the <u>methodology</u> used by the Commissioner in estimating the taxes due. The Tax Section would regard this interpretation as a major step backward in the rights granted to taxpayers in resolving tax disputes. Accordingly, the provision should be eliminated or clarified to permit challenges to the methodology used by the Department. Given the fact that the more reasonable interpretation of the clause would be superfluous under existing law, the Tax Section sees no reason to enact this penalty, and particularly the clause dealing with challenges to the “authority of the commissioner”.