STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
ANDRE EMMERICH GALLERY, INC.	:	DECISION DTA No. 810639
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1987, 1988 and 1989.	:	

Petitioner Andre Emmerich Gallery, Inc., 41 East 57th Street, New York, New York 10022, filed an exception to the determination of the Administrative Law Judge issued on February 24, 1994. Petitioner appeared by Rosenman & Colin, Esqs. (Eugene L. Vogel and Gilbert S. Edelson, Esqs., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Vera R. Johnson, Esq., of counsel).

Petitioner filed a brief on exception. The Division of Taxation relied on its brief filed below. Petitioner filed a reply brief. Oral argument, at petitioner's request, was heard on October 20, 1994, which date began the six-month period for the issuance of this decision.

Commissioner Dugan delivered the decision of the Tax Appeals Tribunal. Commissioner Koenig concurs.

ISSUES

I. Whether the commissions received on the sales of art works, held by petitioner on consignment, should have been characterized as receipts for services performed, rather than receipts from sales of personal property, for the purpose of calculating the New York portion of the receipts factor component of the business allocation percentage.

II. Whether petitioner has established that its exclusion of said receipts from the receipts factor, as a result of having characterized them as receipts from sales of personal property, was due to reasonable cause and not due to willful neglect.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "9" and "11" which have been modified. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

Petitioner, Andre Emmerich Gallery, Inc. ("Andre"), owned and operated an art gallery in New York City, selling works of art, such as paintings and sculpture, to the general public, to museums, and to other dealers within and without the State of New York. Andre also sold art works through exhibitions, shows and catalogues. The majority of the art sold by Andre consisted of twentieth century American and European modern art. It also sold a limited amount of pre-Columbian art and classical antiquities.

Andre maintained its gallery on two floors at 41 East 57th Street and employed approximately 20 persons, all of whom were based in New York State. Andre also had an upstate New York exhibition "garden" for outdoor sculptures. All employees were paid a straight salary and received neither commissions nor incentive compensation.

Andre obtained art work by either purchasing it outright or taking it from artists, collectors and others on consignment, in which case the consignor generally waited until the sale of the art work to receive payment for the work. The amount of the commissions received by petitioner on all works of art ranged from 20 to 50 percent of the sales price. There were no written contracts with the consignors and no corroborating evidence was submitted of alleged oral contracts with them.

The works of art were inventoried according to their status as either purchased ("regular" inventory) or consigned ("consigned" inventory). All inventory was treated in the same manner, i.e., all art work was handled, stored, exhibited, advertised and sold by Andre in the same manner.

All inventory was in the possession and control of petitioner and insured without distinction between the consigned and regular inventory. Andre bore the risk of loss of the

works of art and assumed all credit risks. There was no distinction made between the two inventories on the selling floors and a customer never knew whether a work of art was on consignment or part of the regular inventory. However, if a consigned work of art remained unsold for an extended period of time, it could be returned to the artist. Conversely, the artist could demand the return of the work of art at any time prior to its sale. Petitioner was not related to or affiliated with any of the artists and other consignors.

The consignment technique presented business advantages to all parties. It moved works of art into a superior selling position without the need for the consignor to bear the costs of advertising, restoration or insurance. At the same time, the art gallery acquired merchandise to sell without having to pay for it, thus alleviating the need for a large amount of capital.

Regardless of the arrangement for sale, the bill of sale issued by petitioner was identical for both types of inventory. Petitioner warranted good title and authenticity for all works of art it sold.

For all works of art, Andre advertised in the New York Times and various trade journals, paid the costs of opening receptions, exhibitions and other gallery events, and paid for catalogues. Petitioner collected the appropriate sales tax on all sales. However, petitioner did not produce any invoices, other sales receipts or any other evidence at hearing.

We modify finding of fact "9" of the Administrative Law Judge's determination to read as follows:

> Petitioner called only one witness, Mr. Max M. Gold, who was a certified public accountant and who had served as Andre's secretary-treasurer since 1962. Mr. Gold testified that he was familiar with the operation of petitioner's business and had prepared the New York corporation franchise tax returns and the United States income tax returns for an S corporation for each of the years in issue.
>
> Mr. Gold testified that petitioner recorded gross profits on sales of consigned works of art under the category "commissions" in its financial statements. He asserted that it was a way of distinguishing the "gross profit" earned on consigned works from that earned on the sale of regular inventory items. Mr. Gold testified that his understanding of the term "commission" as used in the art field meant the "difference between the selling price and the purchase price." On cross examination, Mr. Gold testified that he treated all the consignments on a sale or return basis.

> Mr. Gold conceded that he never included the consigned works of art in inventory, and reported only the "commissions" as "other income" on Andre's United States tax returns for an S corporation for all years in issue. Said "other income" was included in total income from which deductions were made to arrive at ordinary income which was carried to the New York corporation franchise tax returns for each of the years in issue. However, commission income was categorized as receipts from sales of tangible personal property as opposed to receipts from services performed for the purpose of calculating the receipts factor of the business allocation percentage.[1]

In 1991, the Division of Taxation ("Division") conducted an audit of the books and records of petitioner for the years 1987, 1988 and 1989.

The auditor testified that there were four areas of adjustment identified on audit. Two adjustments were made to entire net income: a tax addback and a bookkeeping error concerning depreciation expense. The other two adjustments were made to the receipts factor of the business allocation percentage. The first adjustment regarding the receipts factor concerned sales of tangible personal property from the regular inventory and whether or not those sales were properly allocated within and without New York State. A minor adjustment was made to those sales.

The most significant adjustment, and the only one which is at issue herein, concerned the allocation of "commission" income, which Andre had allocated on a destination basis because of its characterization of such as receipts from the sale of tangible personal property. The auditor found that such allocation was appropriate for inventory sales but not "commission" income. It was the auditor's opinion that commissions, which he characterized as services performed, should be allocated to the place where the service was performed. In this case, all of the services were determined by the Division to have been performed in New York.

Specifically, the Division found that commissions earned on sales of consigned art were erroneously allocated according to destination because the underlying services for which the commissions were received were performed entirely within New York State. In examining

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[1] We modified finding of fact "9" of the Administrative Law Judge's determination by adding the last sentence to the second paragraph in order to more fully reflect the record.

petitioner's sales journal, the auditor discovered that Andre segregated "commissions" from other sales. The auditor took all the commission income, deducted from it commission income that was already allocated to New York and added back the remainder to New York receipts. Therefore, to the total New York business receipts set forth on each of the New York corporation franchise tax returns on Schedule B, Part I (computation of business allocation percentage), the Division added back those commissions on consigned art as follows:

Year	Commissions
1987	$3,258,726.00
1988	4,052,896.00
1989	6,977,401.00

We modify finding of fact "11" of the Administrative Law Judge's determination to read as follows:

> Because of the additional New York receipts, the business allocation percentage for the three years in issue was recomputed and determined to be as follows:
>
> | Year | Business Allocation Percentage after Addback of Commissions |
> |---|---|
> | 1987 | 77.6430% |
> | 1988 | 76.6819% |
> | 1989 | 80.3913% |
>
> With this new allocation percentage and the other adjustments previously mentioned, petitioner was assessed additional corporation tax and metropolitan transportation business tax surcharge of $227,255.00, plus penalty and interest. The audit report (Exhibit "G") indicates that "[p]enalties are being imposed for substantial understatement of tax liability . . . . Taxpayer stated that there were no unreported Federal audits. No evidence was found to the contrary."
>
> During the pendency of the audit, Andre executed a consent extending the period of limitation for the year 1987 to September 12, 1992. Subsequently, petitioner received a timely Notice of Deficiency, dated January 6, 1992, assessment number L-005024387-5, which set forth additional tax due of $227,255.00, plus penalty and interest. On March 20, 1992, petitioner timely filed a petition in response to said Notice of Deficiency.[2]

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[2] We modified finding of fact "11" of the Administrative Law Judge's determination by adding the second and third sentences to the second paragraph to more fully reflect the record.

On May 3, 1993, Eugene L. Vogel, Esq., petitioner's representative, and Vera R. Johnson, Esq., the Division's representative, entered into a stipulation of facts which has been substantially incorporated into these Findings of Fact.

OPINION

Tax Law § 210(3) provides for the allocation of a portion of a taxpayer's entire net income to New York on the basis of a formula consisting of three factors (expressed in percentages): the taxpayer's real and tangible personal property, business receipts, and payroll. The percentages of these three factors result from fractions, the numerator of which is the property, receipts or payroll within New York and the denominator of which is all property, receipts or payroll of the taxpayer. The receipts factor is weighted twice and the four resulting percentages are totaled and divided by four to arrive at the taxpayer's business allocation percentage (20 NYCRR 4-2.2).

In the present case it is the calculation of the receipts factor that is at issue. Tax Law § 210(3) provides, in pertinent part, that:

> "The portion of the entire net income of a taxpayer to be allocated within the state shall be determined as follows:
>
> "(a) multiply its business income by a business allocation percentage to be determined by
>
> * * *
>
> "(2) ascertaining the percentage which the receipts of the taxpayer, . . . arising during such period from
>
> "(A) sales of its tangible personal property where shipments are made to points within this state,
>
> "(B) services performed within the state" (Tax Law § 210[3]).

The issue is whether subsection (A) or (B) applies to the receipts in issue. If it is found that the receipts were from the sale of tangible personal property, then petitioner's tax liability will be substantially less than that determined by the Division, given that many of its sales were

allocated outside New York. However, if it is determined that the receipts were from services performed by petitioner, the additional taxes determined by the Division will be sustained. The characterization of the receipts depends on the relationship between petitioner and the artists. Factors showing an agency relationship support a finding that the receipts were derived from the performance of services. Factors which show that petitioner took title to the art work support the characterization as receipts from the sale of tangible personal property. Since no clear indicia are set forth in either Tax Law § 210(3) or the Division's regulations, it is appropriate to seek guidance elsewhere (Matter of Tradearbed, Inc., Tax Appeals Tribunal, January 12, 1989).

The Administrative Law Judge, citing to Arts and Cultural Affairs Law §§ 11.01(12) and 12.01(1), concluded that petitioner was acting as the agent for its consignors.[3] Section 12.01(1) "was specifically written to protect consignors, by superseding all provisions of the Uniform Commercial Code, laws, statutes, requirements or rules or any other agreement, note, memorandum or writing to the contrary" (Determination, conclusion of law "B").

On the basis of his analysis of the Arts and Cultural Affairs Law, the Administrative Law Judge rejected petitioner's assertion that under the Uniform Commercial Code ("UCC"), petitioner had title to the works of art consigned to it by various artists. He also found the specific treatment of artists and art dealers in the Arts and Cultural Affairs Law distinguished

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[3]Section 11.01(12) provides, in relevant part, that the term "on consignment" means that "no title to . . . the work of fine art that is superior to that of the consignor vests in the consignee . . . ." Section 12.01(1) of the Arts and Cultural Affairs Law provides, in pertinent part:

> "Artist-art merchant relationships
>
> "1. Notwithstanding any custom, practice or usage of the trade, any provision of the uniform commercial code or any other law, statute, requirement or rule, or any agreement, note, memorandum or writing to the contrary:
>
> > "(a) Whenever an artist . . . delivers . . . a work of fine art . . . to an art merchant for the purpose of exhibition and/or sale on a commission, fee or other basis of compensation, the delivery to and acceptance thereof by the art merchant establishes a consignor/consignee relationship as between such artist . . . and such art merchant with respect to the said work, and;
> >
> > "(i) such consignee shall thereafter be deemed to be the agent of such consignor with respect to the said work" (Arts & Cultural Affairs Law § 12.01[1][a][i]).

this case from Matter of Tradearbed, Inc. (supra), in which there was no statute analogous to the Arts and Cultural Affairs Law.

The Administrative Law Judge concluded that, based on the

> "statutory presumption of an agency relationship [in the Arts and Cultural Affairs Law] . . . coupled with petitioner's bookkeeping and business practices which were consistent with the Division's finding that petitioner was receiving 'commissions earned' on the sale of works of art and reporting same, separately stated, on its Federal income tax returns. Concededly, petitioner did not enter the consigned goods into inventory or cost of goods sold and segregated 'commissions earned' from gross receipts for Federal purposes. For the first time, on its New York corporation tax returns in its computation of business allocation percentage, Schedule B, Part I, petitioner chose to equate its 'commissions earned' on the sale of works of art to receipts received on the sale of tangible personal property, thus allocable to the place where the property was sold rather than to the place where the services were rendered. For all of the reasons stated above, that characterization was improper and the Division's addback of commissions earned to services performed within New York was proper" (Determination, conclusion of law "B").

On exception, petitioner asserts that it conducts a retail business selling works of art and not services.

> "The notion that, when [petitioner] sells a work of art which it has purchased, it is performing personal services is absurd. The same conclusion follows when a consigned work is sold -- for [petitioner] does nothing different; the entire process is the same for both works.
>
> "Common sense tells us that a retail establishment, such as that which [petitioner] conducts, is not in the business of rendering personal services; it derives its income from the sale of the tangible property which it offers to its customers, and not from services rendered to its suppliers" (Petitioner's brief, p. 7).

Petitioner asserts that its position is supported by the UCC.

> "Under Section 2-326 of the UCC consigned goods are treated as sold to a retailer with right of return. Thus, under the UCC, a retailer, such as [petitioner] acquires title to consigned inventory [footnote omitted]. When the inventory is sold, title is passed by the retailer to its purchaser. Thus, when [petitioner] sells a consigned work, it passes title to its customer using its standard bill of sale, together with its warranty of title and authenticity. It is true that the original consignment to [petitioner] is not a completed sale and that the sale or return transaction can be reversed, but that is of no particular importance. Likewise, it is not important whether or not consigned works are shown on the books as inventory. The issue herein is the proper tax characterization of the completed sale by [petitioner] to a customer, not return transactions or inventory book entries.
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> "The Uniform Commercial Code thus recognizes the essential unity

> of objects sold by a retail merchant, such as [petitioner], whether purchased or acquired on a sale or return basis, this Tribunal should do the same" (Petitioner's brief, pp. 9-10).

Petitioner urges that the Administrative Law Judge erred in resting his finding on the Arts and Cultural Affairs Law arguing that nothing in that statute suggests that it was intended to affect tax determinations.

Petitioner also argues that applying the factors relied upon by this Tribunal in Matter of Tradearbed, Inc. (supra) leads to the result that petitioner sold tangible personal property, not services.

Petitioner's examination of the factors in Tradearbed, in light of the facts in this case, is as follows:

> "1. That the consignee receives legal title and possession of the goods.
>
> "Under the UCC, consigned works are treated as sold to [petitioner] with a right of return. [Petitioner] receives title. [Petitioner] also clearly receives possession of the goods.
>
> "2. That the consignee becomes responsible for an agreed price, either at once or when the goods are sold.
>
> "[Petitioner] is responsible for the agreed price.
>
> "3. That the consignee can fix the price at which he sells without accounting to the transferee for the difference between what he obtains and the price he pays.
>
> "[Petitioner] determines the price for the works of art which it offers for sale without the need for consignor approval. There is no accounting for proceeds to anyone in the sense of setting out cash received and disbursed. Of course, if the consignment is on a percentage basis it is necessary to disclose the selling price to the consignor, but nothing more.
>
> "4. That the goods are incomplete or unfinished and it is understood that the transferee is to make additions to them or to complete the process of manufacturers.
>
> "Generally, goods are delivered to [petitioner] in a finished state; this factor is not usually applicable. [Petitioner], however, does at times frame and restore works to make them ready for sale.
>
> "5. That the risk of loss is upon the transferee.
>
> "The risk of loss is on [petitioner].

> "6. That the transferee deals, or has the right to deal, with the goods of persons other than the transferor.
>
> "This is the case with [petitioner] which deals with the goods of many persons.
>
> "7. That the transferee deals in his own name and does not disclose that the goods are those of another.
>
> "Again, this is clearly the case with [petitioner] which deals in its own name and does not disclose the source of works of art offered for sale.
>
> "Applying these seven factors, it is clear that [petitioner] falls within all which are applicable" (Petitioner's brief, pp. 11-13).

In essence, petitioner's argument is that, in fact, its case is very much stronger than that of the taxpayer in Tradearbed since, unlike that taxpayer, petitioner: maintains an inventory of art; is in possession of the art that it sells and insures it against risk of loss; is not required to (nor does it) obtain approval from the consignors before making a sale; is unrelated to the consignors; and has profit margins that are substantial, while in Tradearbed, they were not.

On exception, the Division asserts that the determination of the Administrative Law Judge is correct.

We affirm the determination of the Administrative Law Judge.

The crux of the matter is that Tax Law § 210(3)(a)(2)(A) requires that the sale by the taxpayer be of "its tangible personal property" in order for the receipts to be treated as receipts from the sale of tangible personal property and allocated on a destination basis. Petitioner here has not demonstrated that the consigned works of art are "its" tangible personal property. First, we agree with the Administrative Law Judge that the Arts and Cultural Affairs Law, by its specific terminology, negates petitioner's reliance on the UCC, i.e., that "[u]nder the UCC, consigned works are treated as sold to [petitioner] with a right of return. [Petitioner] receives title. [Petitioner] also clearly receives possession of the goods" (Petitioner's brief, p. 11). Specifically, sections 11.01(12) and 12.01(1) of the Arts and Cultural Affairs Law, read together, supersede the provisions of the UCC and establish a consignor/consignee/agent relationship between petitioner and the artists with which it deals pursuant to which petitioner

gets no title superior to that of the artist.

Second, petitioner's reliance on Tradearbed is misplaced since in Tradearbed the taxpayer "received all documents of title in its own name and had legal title to all goods purchased from both related and unrelated mills . . . it is significant that legal title is held in each case even if just for an instance" (Matter of Tradearbed, Inc., supra). We note that while acquisition of title to the tangible personal property is essential in order to come within the purview of the statute, it is not conclusive when there are other facts which indicate that the taxpayer may be acting as agent for some other person. Thus, our analysis in Tradearbed of other factors in the case.

Based on this analysis, we affirm the determination of the Administrative Law Judge that the commissions received by petitioner from the sale of consigned works of art are receipts from the sales of services performed within this State and are not to be allocated on the basis of the destination to which the works of art are shipped. Any such allocation of these service receipts would require legislative action such as that accorded certain receipts received for services by other specific taxpayers as delineated in Tax Law § 210(3)(a)(2)(A).[4]

We deal next with the issue of penalties.

The Administrative Law Judge indicated that the penalty was imposed pursuant to Tax Law § 1085(a)(3) which sets forth a reasonable cause standard for waiver of penalty. Citing to Matter of Auerbach v. State Tax Commn. (Sup Ct, Albany County, July 7, 1987, Williams, J., affd 142 AD2d 390, 536 NYS2d 557), the Administrative Law Judge rejected petitioner's

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[4]Tax Law § 210(3)(a)(2)(B) provides for the allocation of receipts for certain services as follows:

> "provided, however, that (i) in the case of a taxpayer engaged in the business of publishing newspapers or periodicals, receipts arising from sales of advertising contained in such newspapers and periodicals shall be deemed to arise from services performed within the state to the extent that such newspapers and periodicals are delivered to points within the sate, (ii) receipts from an investment company arising from the sale of management, administration or distribution services to such investment company shall be deemed to arise from services performed within the state to the extent set forth in subparagraph six of this paragraph and (iii) in the case of taxpayers principally engaged in the activity of air freight forwarding acting as principal and like indirect air carriage receipts arising from such activity shall arise from services performed within the state as follows: one hundred percent of such receipts if both the pickup and delivery associated with such receipts are made in this state and fifty percent of such receipts if either the pickup or delivery associated with such receipts is made in this state" (Tax Law § 210[3][a][2][B], emphasis added).

request that penalty be abated "because it [petitioner] reported its taxable income in good faith based upon its [petitioner's] incorrect interpretation of substantial authority and case law" (Determination, conclusion of law "C").

On exception, petitioner asserts that the penalty was imposed under Tax Law § 1085(k) for substantial underpayment of tax and not section 1085(a)(3), as indicated in the Administrative Law Judge's determination. Petitioner points out that, under section 1085(k), the penalty is imposed to the extent "there is or was no substantial authority for the tax treatment of the item resulting in the understatement . . . [and, as relevant here, there is a] showing by the taxpayer that there was reasonable cause for the understatement and that the taxpayer acted in good faith" (Petitioner's brief, pp. 17-18). Petitioner, citing to 20 NYCRR 46.1(f)(1) and (2), asserts that it acted in "good faith" (1) by relying on the advice of its accountant in preparing and filing its tax returns; (2) in relying upon its interpretation of Tradearbed; and (3) by having an honest misunderstanding of whether the Arts and Cultural Affairs Law was applicable for tax purposes. Petitioner asserts that "[u]ncertainty with respect to the proper treatment of an item has been held to constitute reasonable cause. See Matter of BAP Appliance Corp. (Tax Appeals Tribunal, June 22, 1989)" (Petitioner's brief, p. 20).

The Division did not address the issue of penalty in its post-hearing brief nor does it address the issue on exception.

We reverse the determination of the Administrative Law Judge on the imposition of penalties.

We agree with petitioner that the penalty was imposed under Tax Law § 1085(k) for the substantial underreporting of tax (see, Exhibit "G" of Audit Report). The Division's regulations concerning waiver of penalty for substantial underreporting, in addition to the reasonable cause standard, also provide for waiver upon a showing of good faith by the taxpayer. Specifically, the regulations provide, in relevant part, that:

> "(2) In determining whether reasonable cause and good faith exist, the most important factor to be considered is the extent of the taxpayer's

> efforts to ascertain the proper tax liability. In addition to any relevant grounds for reasonable cause as exemplified in subdivision (d) of this section, circumstances that indicate reasonable cause and good faith with respect to the substantial understatement of tax, where clearly established by or on behalf of the taxpayer, may include the following:
>
> "(i) an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer;
>
> "(ii) a computational or transcriptional error;
>
> "(iii) the reliance by the taxpayer on any written information, professional advice or other facts, provided such reliance was reasonable and the taxpayer had no knowledge of circumstances which should have put the taxpayer upon inquiry as to whether such facts were erroneous" (20 NYCRR 46.1[f][2]).

Under the facts of this case, petitioner has shown that it acted in good faith as described by the Division's regulations.

Petitioner's Federal and State tax returns for all the years at issue were prepared by Mr. Gold, a certified public accountant and petitioner's Secretary-Treasurer since 1962. Petitioner reported fully the amount of receipts from sale by petitioner of art work. Petitioner made no attempt to hide or otherwise obfuscate the "consigned inventory"; rather, the record shows petitioner inventoried the works according to their status as purchased or consigned. Petitioner insured all the inventory, bore the risk of loss for all the inventory, assumed all credit risks and warranted good title to the works sold. The underreporting of income was due solely to the characterization of the receipts as those from the sale of tangible personal property. While we have resolved the characterization of the inventory by reference to a non-tax statute, i.e., the Arts and Cultural Affairs Law, we cannot conclude that petitioner's failure to abide by this statute and its treating the transactions as "sale or return" under the UCC, as Mr. Gold indicated in his testimony, was not reasonable under the circumstances or was evidence of a lack of good faith by petitioner.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Andre Emmerich Gallery, Inc. is granted with respect to the waiver of penalties but in all other respects is denied;

2. The determination of the Administrative Law Judge is modified in accordance with paragraph "1" above;

3. The petition of Andre Emmerich Gallery, Inc. is granted with respect to the waiver of penalties but in all other respects is denied; and

4. The Division of Taxation is directed to modify the Notice of Deficiency, dated January 6, 1992, in accordance with paragraphs "1" and "3" above, but such Notice is otherwise sustained.

DATED: Troy, New York
March 30, 1995

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner