STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions :

of :

CLAYTON FUNDING CORPORATION : DETERMINATION
AND ROBERT J. TADLER, AS OFFICER
DTA NOS. 802638 AND 802639 :
for Revision of Determinations or for Refund
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period September 1, 1980
through February 29, 1984. :

Petitioners, Clayton Funding Corporation and Robert J. Tadler, as officer, 82 Main Street, P.O. Box 534, Mineola, New York 11501, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 1980 through February 29, 1984.

A hearing was held by Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on January 8, 1991 at 1:15 P.M., with all briefs to be submitted by June 28, 1991. Petitioners' brief was received on April 15, 1991. The Division of Taxation did not file a brief. Petitioners appeared by Robert J. Tadler. The Division of Taxation appeared by William F. Collins, Esq. (Robert J. Jarvis, Esq., of counsel).

ISSUES

I. Whether the sales tax assessments were issued within the statutory period of limitation.

II. Whether consents to extend the statutory period of limitation for assessment of sales taxes due from Clayton Funding Corporation, executed by Robert J. Tadler as president of that corporation, served to extend thestatutory period of limitation for assessment of taxes due from Mr. Tadler as officer of the corporation.

III. Whether agreements entered into by Clayton Funding Corporation were true leases or security agreements.

IV. Whether, if the agreements were true leases, petitioners were responsible for collection of sales tax on each rental payment, after assignment of the lease to a third party.

V. Whether the audit methodology utilized by the Division of Taxation may be accurately characterized as an estimating procedure, and if so, whether such a methodology was authorized by the Tax Law.

VI. Whether the Division properly treated certain transactions as taxable where petitioners were furnished with and provided the Division with properly completed resale certificates or certificates of capital improvement.

VII. Whether petitioners have established that any failure to comply with the Tax Law was due to reasonable cause and not due to willful neglect.

FINDINGS OF FACT

Petitioner Clayton Funding Corporation ("Clayton") began doing business in New York in 1978. During the audit period, petitioner Robert J. Tadler was Clayton's sole stockholder and president of the corporation. Clayton's business can best be described as equipment leasing and financing. A typical transaction involving Clayton occurred in this manner. A person wishing to purchase office equipment (a copying machine, telephone system, etc.) who was unable to finance the transaction himself or to obtain bank financing contacted Clayton. Usually, the potential purchaser had been in contact with the manufacturer or supplier of the equipment who referred the purchaser to Clayton. Clayton investigated the potential purchaser's financial condition and credit standing, and, if the purchaser's finances proved satisfactory, Clayton then approached a bank or other funding source to obtain the necessary financing. Once the funding source agreed to finance the transaction, Clayton purchased the desired equipment for the sole purpose of leasing it to the purchaser. Clayton entered into an agreement with the purchaser which most often took the form of a document characterized as a "lease", with Clayton identified as the "lessor" and the purchaser as the "lessee". The equipment was shipped directly to the purchaser/lessee by the equipment supplier. The purchaser/lessee made an advance payment to Clayton consisting of the first lease installment payment and the last two payments plus sales tax calculated on the total amount of the payments made to Clayton. The "lease" was then assigned to the bank or finance institution for collection of the remaining payments.

The Division of Taxation ("Division") began a sales tax field audit of Clayton early in September 1983. The auditor originally assigned to the case was named Mitchell Ackerman. The Tax Field Audit Record (commonly referred to as the "contact sheet") completed by Mr. Ackerman indicates that he spoke with Victor Della Fave, Clayton's accountant, and requested Clayton's books and records for the audit period. A checklist of records made available indicates that the Division was provided with the following documents for the period under audit: sales tax returns and related worksheets; Federal and State income tax returns, a sales journal, a cash receipts journal, sales invoices, a check disbursements journal, a general ledger, monthly bank statements, resale certificates, exempt organization certificates, and exempt use certificates. There are no entries under the heading for books requested but not made available.

Mr. Ackerman completed transcripts of Clayton's Federal income tax returns and cash receipts journal and a schedule of expense purchases. He also obtained a copy of the lease form typically used by Clayton, samples of other documents exemplifying a typical transaction and a brochure describing Clayton's services.

In December 1983, the audit was transferred to a second auditor, John Perotti. During the audit, Mr. Della Fave contended that after a lease was assigned to a third-party, Clayton was no longer responsible for collection of sales tax on the individual installment payments. Based upon its analysis and understanding of the nature of Clayton's business, the Division determined that Clayton was responsible for collecting sales tax on each and every installment payment, whether that payment was paid or payable to Clayton or to another party. The Division then attempted to calculate the total amount of all payments made to Clayton or Clayton's assignees during the audit period. The Sales Tax Field Audit Report completed by Mr. Perotti states:

> "All of the vendor's leases that were entered into since the inception of the business were analyzed for installments due within the audit period, 9/1/80 - 9/29/84".

This is not a completely accurate statement. Referring directly to this statement in the audit report, the Administrative Law Judge conducted the following questioning of Mr. Perotti:

> "Q: When you say they were analyzed, just explain to me exactly how you did that.
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> A: These invoices per se?
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> Q: Did you look at the invoices themselves, one by one?
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> A: These were summaries of the lease agreements. This had the information on the lease agreement, such as who is the lessee, the date that it was entered into, the term that it would run for, the amount of the monthly leasing, lease payments, the amount of the monthly sales tax payment." (Transcript at 66.)

The "summaries" referred to by Mr. Perotti were computer-generated schedules created by Mr. Tadler and his children in an attempt to estimate Clayton's future income. The lease summaries did not show actual amounts collected by Clayton. That information was contained in Clayton's cash receipts journal. The Division's determination of sales tax due for the audit period was based primarily upon information taken from the summaries.

The auditor obtained the following information from the summaries: the lease number, the name and address of the lessee, the taxing jurisdiction (the jurisdiction in which the lessee was located), the term of the lease, the amount of each monthly payment, the purchase option amount (if any), the name of the assignee, the date discounted, and the option due date. A computer program was used to segregate each lease transaction by taxing jurisdiction, and then, based upon the number of installment payments falling due within each sales tax quarter, the computer program calculated audited sales receipts per quarter. The amount of the purchase option was treated as a receipt received on the option due date. In this way, audited sales receipts were calculated by quarterly period, within sales tax jurisdictions. The appropriate tax rate was applied by jurisdiction to determine tax due per quarter. Sales tax remitted was subtracted from audited sales tax due to calculate a sales tax deficiency for each quarterly period.

Mr. Perotti asked to be provided with the actual lease document for each transaction shown as nontaxable on the summaries. Based upon the following lease provision, the Division determined that none of the leased equipment was or could have been incorporated into a capital improvement project:

> "Equipment to remain unattached to real property. Each item of equipment leased hereunder shall at all times remain the property of the Lessor and Lessee shall have no right, title or interest therein or thereto except as expressly set forth in the lease. The equipment is, and shall at all times remain, personal property irrespective of the way it may be affixed to the realty, and lessee shall maintain each item so that it may be removed from any building in which it is placed without damaging such building. The Lessor, at its option, shall be permitted to display notice of its ownership of the equipment by affixing to each item of equipment an identifying stencil, plate, decalomania, or any other indicia of ownership" (Clayton Lease, paragraph 7).

The Division also determined that leased equipment, by definition, could not be resold. Furthermore, Mr. Perotti testified:

> "The resale certificates were not accepted because I believe in the lease agreement itself the leased equipment could not be resold" (transcript at 45).

The Clayton lease states:

> "Lessee shall not, without Lessor's prior written consent, remove the equipment from such location, part with possession or control of the equipment or sell, pledge, mortgage or otherwise encumber the equipment or any part thereof or assign or encumber any interest under this lease" (Clayton Lease, paragraph 9).

Based on its examination of the lease agreements, the Division treated as taxable each sale for which a resale certificate or certificate of capital improvement was provided to Clayton. This amounted to 22 transactions out of a total of over 900 transactions. Clayton was unable to produce certificates for 12 transaction shown as nontaxable on the summaries, and these too were treated as taxable sales. Tax due on these transactions was calculated in the manner described in Finding of Fact "5". Clayton produced exemption certificates for all transactions claimed to involve parties exempt from taxation. No sales tax was found due in the areas of recurring expense purchases or fixed asset acquisitions.

As a result of its audit, the Division issued to petitioner Clayton Funding Corporation a Notice of Determination and Demand for Payment of Sales and Use Taxes Due, dated September 20, 1985, for the period September 1, 1980 through February 29, 1984, assessing tax of $376,748.26 plus penalty and interest. A notice of determination, assessing identical amounts of tax, penalty and interest, was issued to petitioner Robert J. Tadler on or about September 20, 1985. The notice issued to Mr. Tadler contains this explanation:

> "You are personally liable as officer of Clayton Funding Corp. under Sections 1131(1) and 1133 of the Tax Law for the following taxes determined to be due in accordance with Section 1138(a) of the Tax Law".

The Division and Clayton, by Mr. Tadler as president of Clayton, executed a series of four consents extending the period of limitation for assessment of sales and use taxes under articles 28 and 29 of the Tax Law. Together the consents extended the final date for assessment of taxes for the period September 1, 1980 through February 28, 1982 to June 20, 1985. Each consent identifies the "vendor" to whom it applies as Clayton. No consents were obtained extending the period of limitation for assessment of taxes due from Mr. Tadler.

The notices of determination issued to petitioners have a checkmark in a box next to the following statement: "The tax assessed above has been estimated in accordance with the provisions of section 1138(a)(1) of the Tax Law".

With regard to the audit methodology used, the Administrative Law Judge and Mr. Perotti had the following exchange:

"Q: ...Maybe you should look at the listing of records available during audit. Is this your memory of what was provided?

A: Yes.

Q: Did you determine that these were adequate for audit purposes? Was there an adequate set of books and records here?

A: Yes.

Q: My understanding is that it was the books and records themselves that were used to assess the tax. The notice indicates that the tax was estimated. I will show it to you. There's an X next to the estimate box.

A: Yes.

Q: Was it estimated?

A: In my opinion, it was not. I myself didn't prepare the assessment document. I feel that I did a detailed audit. I don't believe I did any estimates.

Q: Were there any projections?

A: No." (Transcript, 33-34.)

After Clayton assigned a lease, it did not and could not know whether timely payments were being made to the assignee. Clayton's books and records did not show actual amounts collected by the assignees. The Division calculated taxable sales for each lease by multiplying the amount of each installment payment by the number of payments to be made in a sales tax quarter. Actual amounts received by Clayton or its assignees were not considered. Purchase option amounts as shown on the lease summaries were treated as received on the option due date, and no attempt was made to determine whether the purchase options were actually exercised and whether Clayton received the full option amount.

Clayton provided the Division with a brochure used in its business entitled "To Buy or To Lease?" The brochure contains the following statements:

"Leasing makes good business sense. It generally provides a more economical way to use hard-earned capital to acquire equipment than a bank loan or an outright purchase.
...Leasing allows a company to use the equipment while it pays for it, thus enjoying a better profit picture when current income covers current expenses.
CASH PURCHASE VS. LEASING
By purchasing equipment for cash a company may be tying up scare, productive capital that would provide extra income if properly invested. When a cash purchase is made, the earning power of that cash is lost to the company.

> Equipment purchased with cash must be paid long before it can generate any profits. Under a leasing arrangement, the equipment is paid for as it generates profits."

The brochure asserted that leasing through Clayton provided the lessee with investment tax credits which would be assigned to the lessee automatically along with full depreciation benefits.

During the audit period, approximately 90% of Clayton's transactions were written on a standard form, identifying Clayton as the lessor. The material provisions of the agreements between Clayton and its lessees, in addition to those discussed above, provided as follows:

Paragraph 1 provided for the leasing by Clayton of a particular piece of equipment to be delivered to the lessee and correspondingly provided for the making of monthly payments by the lessee "until the total rent shall have been paid in full".

Paragraph 2 contained Clayton's agreement to order equipment from the supplier and the lessee's agreement to arrange for delivery of that equipment.

Paragraph 3 contained the lessee's acknowledgement that it had been given notice of Clayton's intention to assign its interest in the lease. The lessee represented that it had selected the equipment prior to having asked Clayton to purchase the same and agreed that Clayton made no representations or warranties as to the condition, merchantability or fitness for particular purpose of the equipment. Clayton disclaimed any obligation to install, erect, test, adjust or service the equipment.

Paragraph 4 relieved Clayton of any liability "for loss or damage occasioned by any cause, circumstance or event of whatsoever nature".

Paragraph 5 required the lessee to supply insurance coverage on the equipment.

Paragraph 6 required the lessee to assume the risk of loss to the equipment. Upon destruction of the equipment, the lessee was to repair or replace the equipment or to pay a stipulated loss value to Clayton. The stipulated loss value was equal to the aggregate amount of unpaid total rent for the balance of the term of the lease, less any recovery received by Clayton from insurance.

Paragraph 8 required the lessee to bear the cost of all taxes, licensing and registration relating to the equipment, including sales taxes, and to assume responsibility for filing all required returns.

Paragraph 10 contained the lessee's agreement to indemnify Clayton against any loss arising out of the use of the equipment.

Paragraph 12 provided that, upon the lessee's default, Clayton could terminate the lease and declare the entire amount of the unpaid rent for the balance of the lease term immediately due and owable. Clayton was authorized to take possession of the leased equipment and to dispose of it as it chose without in any way affecting the obligation of the lessee to make payment of the balance of the rent.

Paragraph 13 provided:

> "Lessee shall have no option to purchase or otherwise acquire title to or ownership of any of the equipment and shall have only the right to use the same under and subject to the terms and provision of the lease."

Paragraph 20 authorized Clayton, at its option, to file a Uniform Commercial Code financing statement covering the equipment and signed only by Clayton. The lessee agreed to pay Clayton the actual fee for the filing.

Paragraph 25 required the lessee, upon the termination of the lease, to deliver the equipment to Clayton, or to an address designated by Clayton, freight prepaid.

As stated above, the lease utilized by Clayton contained a specific provision stating that the lessee had no option to purchase at the end of the lease term. The pre-printed Clayton lease did not provide for a purchase option. The computer generated summaries used by the auditor to determine petitioners' sales tax liability did show purchase option amounts for each lease. Between 20 and 25 percent of the purchase option amounts were for amounts of $1.00 or less. The remaining purchase options were for amounts equal to 10 percent of the actual cost of the equipment. Depending on Clayton's agreement with a particular bank, leases were sometimes reassigned to Clayton at the end of a lease term and sometimes not. It was Clayton's hope, where the lease was reassigned, that Clayton would be able to sell the equipment to the customer at a price equal to 10 percent of its original cost. The purchase option amounts shown on the lease summaries represented amounts Clayton hoped to collect based on this estimated value. Mr. Tadler testified that each lease would have to be examined separately to determine whether or not a purchase option actually existed.

The amounts of the purchase options actually collected by Clayton were recorded in Clayton's cash receipts journal. The auditor segregated purchase option amounts for each tax jurisdiction but did not total the purchase option amounts for all tax jurisdictions for the entire audit period. According to Mr. Tadler's calculations, the Division determined that Clayton collected purchase option amounts totalling approximately $96,400.77. Mr. Tadler reviewed Clayton's cash receipts journal and, on the basis of that journal, determined that Clayton actually collected $11,827.14 in purchase options.

Petitioners provided a comparison of purchase option amounts shown on the lease summaries with actual amounts collected as shown in Clayton's cash receipts journal. In most instances where the option was actually exercised, the amount paid amounted to either approximately 10% of the original cost of the equipment or $1.00. In two instances, invoice numbers 1024 and 1343, the amount paid was approximately 20% of the original cost of the equipment.

It is not known whether Clayton ever took possession of the equipment at the end of a lease term.

Documents submitted in evidence show that, under the terms of the leases, total rental exceeded the purchase cost of the equipment by 35% to over 60%.

Clayton's transactions took several different forms depending on the requirements of the purchaser and funding source. In some instances, Clayton served only as a broker bringing together the potential purchaser and the funding source. In other instances, Clayton was the primary lessor entering into an agreement with the lessee and immediately assigning the lease to a third party. Clayton had different arrangements for reporting and paying sales tax to New York depending on the requirements of the funding source. It was Clayton's understanding that it was not under a duty to collect sales tax after a lease was assigned; however, it generally agreed to any arrangement for reporting and payment of sales tax required by its funding sources.

Transactions involving Beneficial Commercial Corporation ("Beneficial") and Walter Heller were written on Beneficial invoices which identify Beneficial as the lessor. Clayton served only as a middleman in these transactions, receiving a set number of monthly payments as a commission for its service of bringing together the potential purchaser and the funding source. The auditor's workpapers show 12 transactions involving either Beneficial or Walter Heller. In each case, the purchase option amount was zero. Clayton was found liable for collection of sales tax on each installment payment made to Beneficial or Heller during the audit period.

When Clayton prepared a lease on its own lease forms, the monthly installment payment and the sales tax due on that payment were stated separately. Once the transaction was discounted, the total payment and sales tax due were to be paid directly to the funding source. At least one funding source collected and paid the tax to New York in its own name. Others collected the tax and remitted it directly to Clayton which filed returns and paid the tax in its own name. Still others collected and deposited the tax in a bank account to which Clayton had access for the sole purpose of paying the tax to New York. These arrangements were reflected in Clayton's contracts with the funding sources.

The auditor's workpapers establish that over 10 percent of Clayton's transactions involved Ultra Funding Corporation ("Ultra") as a funding source. A letter dated January 7, 1991, addressed to Mr. Tadler from Bernard Bortnick, president of Ultra, states:

> "Please be advised that any and all lease transactions discounted by Clayton Funding Corporation with Ultra Funding Corporation were serviced by Ultra Funding Corporation and its assignees and with regard to the collection of New York State Sales Taxes were the responsibility of Ultra Funding Corporation or its assignees, and said taxes were remitted directly to New York State."

Chase Commercial Corporation was another of Clayton's major funding sources. A copy of the financial agreement entered into between Chase and Clayton contains the following provision:

> "TAXES. The Bank will have the right, but will not be obligated to segregate the part of each collection made by Bank which constitutes any use or sales tax which may be payable. All such monies will be deposited to the Company's credit in a special non-interest-bearing checking account at the Bank, subject to withdrawal by check payable only to the appropriate taxing authorities. <u>The Company will prepare all sales or use tax returns required to be prepared and filed by the Company and forward the same to the Bank at least seven days prior to the date such returns are due, together with a check payable to the appropriate taxing authority drawn on such special account with an envelope addressed to such taxing authority with first class postage affixed. The Bank will send the tax return and check to the taxing authority as directed by the Company and permit funds from the special account to be withdrawn to pay taxes due but only to the extent that a sufficient credit balance exists in favor of the Company in the account from moneys collected for such purpose</u>. The Bank shall have no obligation to pay any taxes on such collections except from funds supplied by the Company for such purpose.
>
> At the time Obligations are assigned to the Bank, the Company will advise the Bank of the appropriate sales or use tax rate to be applied to any payments. The Company will be solely responsible for the accuracy of the information supplied to the Bank and for keeping it advised of any changes in such information.
>
> This procedure to facilitate the payment of sales or use taxes is solely an accommodation extended by the Bank to the Company and may be discontinued at any time upon five days notice.
>
> The Bank shall have no liability for errors or omissions with respect to segregating or paying any monies collected and the Company specifically agrees that the Company is solely responsible for billing, collecting, reporting and paying all taxes due with respect to the transactions contemplated by this Agreement. The Company further agrees to indemnify and hold the Bank harmless from and against all liabilities to any taxing authority arising out of this Agreement. To the extent collections are made by the Company, it will timely report and pay all sales or use taxes due from funds collected for such purpose. Copies of tax reports with proof of payment of taxes will be sent to the Bank upon request." (Emphasis added.)

Clayton prepared sales tax returns in compliance with the terms of its agreement with Chase.

Petitioner provided information with regard to its arrangements for collecting and remitting sales tax for each of its funding sources. What follows are representative examples of those arrangements.

(a) Barclay's Bank sent Clayton a monthly check representing sales tax collected on monthly lease payments. The checks were made out to the State of New York as payee. Clayton forwarded these checks directly to New York with its sales tax returns. Apparently, the amount of the check was included by Clayton in its statement of its own sales tax liability. The bank did not provide Clayton with a reconciliation of lease payments due, payments collected and sales tax collected.

(b) Tilden Commercial Alliance, Incorporated remitted a monthly check made out to Clayton and a schedule, apparently showing the name of the lessee, lease payments received and sales tax collected.

(c) First National Bank of Long Island remitted checks to Clayton on a quarterly basis. The actual amount remitted during the audit period was $237.76. The schedule relied on by the Division to calculate Clayton's tax liability shows that this bank should have collected and remitted $8,641.92.

Another of Clayton's major funding sources was Bank Leumi. From the beginning of the audit period until the second half of 1983, Bank Leumi collected sales tax at the time it collected the installment payment upon which the tax was due. Upon assignment of the lease by Clayton, Bank Leumi sent the lessee a letter advising him or her of the assignment and instructing the lessee to make all future payments to Bank Leumi. Included with the letter was a document entitled "Highlights of Lease". It showed the original term of the lease, the amount of the monthly payment and sales tax due on the payment.

From September 1981 through February 1984, John J. Hurley was employed by Bank Leumi as the first vice-president in charge of the Installment Loan Department. In the course of his duties, Mr. Hurley reviewed the bank's recordkeeping system with regard to assigned leases and discovered that Bank Leumi had no system for segregating and keeping a record of sales tax collected. Any amounts in excess of the monthly installment payments were being recorded as overpayments, when, in fact, the additional amounts represented sales tax due on the installment. Upon inquiry, Mr. Hurley was advised that the bank's computerized recordkeeping system was inadequate for the purpose of collecting and maintaining records of sales tax so collected. In consultation with the bank's lawyers, Mr. Hurley instituted a new policy requiring all lease assignors (such as Clayton) to collect the sales tax payment separately from the bank's collection of the installment payment.

As of September 1983, Clayton required lessees whose lease was assigned to Bank Leumi to make a separate payment of sales tax. Lessees were required to send a monthly sales tax payment directly to Clayton and to pay by check made payable to N.Y. State Sales Tax. Clayton did not know whether a lessee was making timely payments to Bank Leumi or whether the terms of the lease agreement had been altered because Bank Leumi failed to provide Clayton with timely reports detailing the status of leases assigned to the bank. Bank Leumi did provide lessors with trial balances of each lessee's account. The bank tracked accounts using a numerical identification system rather than the lessee's name. The number assigned to each account was different from the lease number assigned by Clayton. For that reason, reports generated by Bank Leumi could not be used by Clayton to identify the accounts by name without aid from Mr. Hurley and the Bank's collection department.

Clayton's records of sales tax collected by the funding sources and remitted to New York State through Clayton consisted of worksheets attached to Clayton's file copies of the filed sales tax returns.

The arrangements between Clayton and its assignees were different depending on the requirements of the assignee. Generally, Clayton assigned all its rights and remedies under the lease but none of its obligations. The assignee was authorized to collect payments due, compromise or discharge the debt, repossess the equipment and to exercise all other rights, remedies or claims of the assignor.

Clayton never funded a lease transaction using its own funds. In most cases, the bank or funding source issued a check in payment for the equipment directly to the supplier of the equipment.

The Division offered in evidence a series of documents which exemplify a typical transaction involving Clayton.

The first document is an agreement between Clayton and a company named Food Communications ("Food") and is dated January 4, 1983. The agreement states that Food requests Clayton "to extend credit to and to purchase notes, accounts and/or other obligations...from or otherwise to do business with" Food. Food authorized Clayton to obtain a credit report and guaranteed Clayton that it would pay all obligations incurred in its business with Clayton.

The second document is an executed copy of a Clayton lease agreement. Food is identified as lessee, Interconnect Telephone Services ("Interconnect") is identified as the equipment supplier and the equipment is shown as a telephone system. The term of the lease is shown as 36 months. Rental payments were to be $145.39 per month, plus sales tax of $11.99. Food was required to make an advance payment to Clayton of $361.68. The lease is dated February 7, 1983.

The next document is an Interconnect invoice. It is dated February 3, 1983. The invoice provides for billing to Clayton and shipment to Food. The terms of the transaction are shown as "lease". A description of the transaction shows that Interconnect was to furnish and install an ITT Key Telephone System. The amount due is shown as $3,616.80, from which a "10% Prepaid Purchase Option" of $361.68 was subtracted, resulting in a total amount due of $3,255.12.

Clayton assigned the lease to Bank Leumi. The lease assignment document is also dated February 7, 1983.

A letter, bearing the letterhead of Bank Leumi and dated February 7, 1983, advises Food that Clayton has assigned the lease to Bank Leumi. A second document, entitled "Highlights of Lease", provides that 35 payments of $145.39, plus sales tax of $11.99, are to be made by Food to Bank Leumi, beginning on March 8, 1983.

SUMMARY OF THE PARTIES' POSITIONS

Petitioners contend that the notice of determination issued to Clayton should be cancelled in its entirety because the consents to extend the period of time for assessment of sales and use taxes under article 28 of the Tax Law do not cover the full period of the assessment (see Finding of Fact "9").

Petitioners contend that the notice of determination issued to Robert J. Tadler should be cancelled in its entirety since the consents extending the statutory period of limitation for assessment of tax name only Clayton as the vendor, and no consents naming Robert J. Tadler individually were obtained.

Petitioners maintain that Clayton provided the Division with a complete set of books and records which were adequate for purposes of performing a complete audit and that the Division impermissibly estimated the tax due on the basis of a summary report generated for internal corporate purposes rather than conducting a complete audit. They argue on this ground that the notices of determination should be cancelled in their entirety.

Petitioners maintain that they accepted resale and capital improvement certificates in good faith and that the Division erred in holding Clayton liable for collection of tax on those transactions where such a certificate was provided.

It is petitioners' position that the responsibility for collection and remittance of sales tax to the State rested on the funding source in those situations in which Clayton acted merely as a broker (i.e., those transactions involving Beneficial Commercial Corporation and Walter J. Heller). Clayton concedes that it was obligated to collect sales tax on the receipts from the lease payments and purchase options it actually collected; however, it maintains that after a lease was assigned to another party it became that party's obligation to collect and remit sales tax on the lease payments.

Petitioners maintain that detailed information was available at the time of audit showing which of the parties (Clayton or the funding source) was liable for collection of sales tax, which of the parties collected and remitted the sales tax, and in whose name the sales tax was remitted and that this information was never reviewed by the Division.

By their petition, petitioners asserted that Clayton had no responsibility to collect tax on any of the installment payments because the transactions at issue were not true leases or sales but were instead secured transactions.

Petitioners seek abatement of penalties. It is their position that they established through evidence that Clayton maintained an adequate set of books and records and made a good faith effort to ascertain and pay all sales tax due.

Petitioners set forth the following claim in their petition:

> "The Petitioner maintained complete books and records such that the Department was not authorized to estimate taxes due in accordance with Tax Law Section 1138".

The Division denied this claim "to the extent that said paragraph implies that the petitioner's books and records were not used in determining tax due". At hearing, the Division took the position that Clayton's books and records were adequate for audit purposes and that they were, in fact, used in the audit.

The Division asserted in its answer that the agreements entered into by Clayton were true leases and not secured transactions. The Division took the position on audit and at hearing that the funding sources to whom the leases were assigned were not responsible for collection of sales tax because the transactions involving those funding sources were financial arrangements and not sales.

CONCLUSIONS OF LAW

A. Tax Law § 1147(b) imposes a period of limitation for the assessment of sales and use taxes of no more than three years from the date of filing of a return; provided that where no return has been filed as provided by law, the tax may be assessed at any time. Section 1147(c) of the Tax Law provides:

> "Where, before the expiration of the period prescribed herein for the assessment of an additional tax, a taxpayer has consented in writing that such period be extended the amount of such additional tax due may be determined at any time within such extended period. The period so extended may be further extended by subsequent consents in writing made before the expiration of the extended period."

Pursuant to Tax Law § 1147(c), Mr. Tadler consented in writing that the period for assessing tax due from Clayton for the periods September 1, 1980 through February 28, 1982 might be determined at any time before June 20, 1985. The notices of determination were dated September 20, 1985, three months after the date consented to by Mr. Tadler. Petitioners now argue that the notice of determination issued to Clayton must be cancelled in its entirety on the ground that the Division failed to follow its own procedures.

If the notice of determination issued to Clayton was untimely, it was untimely only for the periods September 1, 1980 through May 31, 1982. The auditor's workpapers show that sales tax returns were filed for these periods and taxes remitted to the State; however, they do not show when the returns were filed, and petitioners offered no evidence to establish the dates of filing. In order to prove that the assessment for any quarterly period was made more than three years after a return was filed, it was incumbent upon petitioners to show the date of filing of the sales tax return. As petitioner failed to do so, there is insufficient evidence in the record to support a finding that the assessment for any period was issued beyond the three-year statute of limitations.

Petitioners also contend that the consents to extend the statutory period of limitation for assessment of Clayton are not binding on Mr. Tadler. Since separate consents were not obtained for Mr. Tadler, petitioners argue that the notice of determination issued to him is untimely and must be cancelled in its entirety. The conclusion that petitioners failed to prove that the assessments were untimely applies to the notice issued to Mr. Tadler as well as to that issued to Clayton. In light of the fact that it has not been proven that the assessment issued to Mr. Tadler was untimely, petitioners' argument regarding the applicability of the consent to him is moot. It must be noted however that Mr. Tadler, the sole shareholder and president of Clayton, executed the consents on behalf of Clayton who is named as the "vendor" (cf., Matter of Ronald Rossi, State Tax Commission, September 16, 1983).

B. Section 1131(1) of the Tax Law includes in the definition of "persons required to collect tax" every "vendor" of tangible personal property or services. As material to this discussion, a "vendor" is defined as "[a] person making sales of tangible personal property...the receipts from which are taxed" under article 28 (Tax Law § 1101[b][8][A]). The term "sale", as used in article 28, includes "[a]ny transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume, conditional or otherwise" (Tax Law § 1101[b][5]). 20 NYCRR 526.7(c) provides:

> "(1) The terms rental, lease, license to use refer to all transactions in which there is a transfer of possession of tangible personal property without a transfer of title to the property. Whether a transaction is a 'sale' or a 'rental, lease or license to use' shall be determined in accordance with the provisions of the agreement.
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> (3) A lease which has been entered into merely as a security agreement, but which does not in fact represent a transaction in which there has been a transfer of possession from the lessor to the lessee, is not a 'sale' within the meaning of the Tax Law."

Because the sales tax is a transaction tax, liability for the tax occurs at the time of the transaction; generally, the taxed transaction occurs when there is an exchange of consideration for the transfer of title or possession or both from one person to another (20 NYCRR 525.2[a][2]). In the case of a lease, the tax is on use and possession of the lease property for each rental period as it accrues; accordingly, the tax is imposed on each rental payment at the time paid, regardless of the date of the agreement (<u>Matter of Petrolane N.E. Gas Service v. State Tax Commn.</u>, 79 AD2d 1043, 435 NYS2d 187, 189, <u>lv denied</u> 53 NY2d 601, 438 NYS2d 1027).

C. In order to determine who was responsible for collection of tax in the transactions which occurred here, it is first necessary to determine whether the Clayton transactions were true leases or security agreements. There is a large body of case law in which this issue has been addressed. From the court decisions, it is possible to identify the factors which are to be considered in making such a determination.

The fact that an agreement is entitled a "lease" by the parties and contains language typical of lease agreements, such as "lease", "lessor", "monthly rental" carries little weight. Rather, the court will consider the intentions of the parties and look to factors outside the lease itself as well as to the contents of the lease (<u>Matter of Sherwood Diversified Services</u>, 382 F Supp 1359, 1362 [SD NY 1974]).

Where the lessor was not in the business of leasing the equipment in question, this was considered to be a factor indicating a secured transaction and not a true lease (<u>Leasco Data Processing Equipment Corp. v. Starline Overseas Corp.</u>, 74 Misc 2d 898, 346 NYS2d 288, <u>affd</u>

45 AD2d 992, 360 NYS2d 199, appeal dismissed 35 NY2d 963, 365 NYS2d 179). A provision requiring the lessee to maintain insurance coverage upon leased equipment indicates that the transaction is a secured transaction and not a true lease (International Paper Credit Corporation v. Columbia Wax Products Co., 102 Misc 2d 738, 424 NYS2d 827, 830, revd on other grounds 79 AD2d 700, 434 NYS2d 270, citing In re Tillery, 571 F2d 1361 [5th Cir]). The fact that total rentals exceeded the original purchase price of the equipment by 30 and 46%, respectively, on two leases indicated that the leases were intended as security (National Equipment Rental Ltd. v. Priority Electronics Corp., 435 F Supp 236 [ED NY]). A lease which contains an acceleration clause providing for the sale of the leased property upon default in payments, with the lessee liable for any deficiency, may dictate a conclusion that the transaction was a conditional sale in which the lessor retained a secured interest in the property (International Paper Credit Corporation v. Columbia Wax Products, supra, citing Computer Sciences Corp. v. Sci-Tek Inc., 367 A2d 658 [Del]).

Professors White and Summers have compiled the following factors for determining whether a transaction involves a true lease or security interest:

> "The lessor's status as [professional] financier.... So, too, such factors as whether the lessee is required to insure the goods in favor of the lessor for a value equal to the total rental payments; the risk of loss or damage is on the lessee; the lessee is to pay for taxes, repairs, and maintenance; there are default provisions governing acceleration and resale; a substantial, non-refundable deposit is required; the goods are to be selected from a third party by the lessee; the rental payments are equivalent to the cost of goods plus interest; the lessor lacks facilities to store or retake the goods; the lease is to be discounted with a bank; warranties normally found in a lease are excluded; the goods are fixtures impractical to remove." (J. White & R. Summers, Handbook of the Law Under the Uniform Commercial Code § 22-3, at 882-83 [2d ed 1980].)

One test frequently used by the courts in determining whether a lease is one intended for security is to compare the purchase option price to the total rentals. Section 1-201(37) of the Uniform Commercial Code states in relevant part:

> "Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security." (Emphasis added.)

Thus, in Matter of Crown Cartridge Corp. (220 F Supp 914 [SD NY 1962]), a purchase option of 7.7 percent was found to make the lease one intended for security. The same result was reached with an 8.5 percent purchase option (Matter of Merkel Inc., 45 Misc 2d 753, 258 NYS2d 118, revd on other grounds 25 AD2d 764, 269 NYS2d 190). In Matter of Herold Radio & Electronic Corp., (218 F Supp 284 [SD NY 1963], affd 327 F2d 564 [2d Cir 1964]), a 10% purchase option was held to be nominal. Furthermore, it has been held that a lease can create a security interest even where there is no purchase option (Leasing Service Corp. v. American Nat. Bank & Trust Co., 19 UCC Rep 252 [D. NJ 1976]). That court relied on the fact that the total rental payments exceeded the value of the equipment by 37% as an indication that the leases were conditional sales, and thus the leases were intended as security (see also, Matter of O.P.M. Leasing Services v. Homestead Fabrics, 18 UCC Rep 1342 [Sup Ct NY County 1976]).

The only case considering whether a transaction constituted a true lease or security agreement in the context of New York's sales tax law is Matter of Sherwood Diversified Services (supra). There, the court found that the following factors compelled a conclusion that certain equipment lease transactions were security agreements and that the respondent, Sherwood, was a financing agent and not a seller under article 28: the equipment ordered by the lessees was shipped directly to them by the manufacturers; Sherwood remitted the full sales price plus any applicable sales tax to the manufacturers; the lessees had often placed their orders with the manufacturers before approaching Sherwood for financing; Sherwood did not inspect or select any of the equipment; the lessees were given options to purchase the equipment for nominal sums; U.C.C. financing statements were executed and delivered to the lessees and filed by Sherwood; the agreements were almost always discounted with a bank or other lending institution; the monthly payments were calculated to return to Sherwood the purchase price, sales tax, interest and filing fees; Sherwood did not carry the leased property on its books but rather as accounts receivable; Sherwood did not take any depreciation deductions on the equipment; and Sherwood never took possession of any of the leased equipment at the end of the lease term.

D. Taking into consideration all of the factors outlined by the courts supports the conclusion that the Clayton leases were security agreements and that Clayton acted not as a seller but as a financing agent or a broker. Clayton was approached for financing after the purchaser/lessee selected the equipment from a supplier. The equipment was shipped directly by the supplier to the purchaser/lessee. Clayton did not select or inspect the equipment and the purchaser/lessee had the obligation to install and maintain the equipment. Clayton made no representations or warranties as to the condition, merchantability or fitness for particular purpose of the equipment. The lessee was to supply insurance on the equipment and to assume the risk of loss to the equipment. In case of destruction of the equipment, the stipulated loss value was not the replacement cost of the equipment but the aggregate amount of unpaid total rent for the balance of the lease, less any recovery received by Clayton from insurance. The lease contained an acceleration clause which authorized Clayton, upon the purchaser/lessee's default, to terminate the lease, take possession of the equipment and declare all unpaid rent for the entire lease term immediately due and payable. Under the terms of the agreements, total rentals exceeded the purchase price of the equipment by amounts ranging from approximately 35% to over 60%. Before entering into the lease arrangement, the purchaser/lessee executed a document requesting Clayton to extend credit. The leases were always discounted with a bank or other financial institution. The Clayton brochure indicates that Clayton did not take depreciation deductions on any of the equipment. Clayton never took possession of the equipment either before or during the term of the lease. Whether it took possesion of any of the equipment at the termination of the lease is not known. These factors establish that these transactions were conditional sales and that Clayton's reservation of title to the goods was limited in effect to a reservation of a security interest (UCC § 2-401[2]).

Although the evidence presented with regard to the purchase options was confusing and incomplete, that evidence does not contradict the conclusion reached above. Apparently, purchase options were separately negotiated and not contained in the terms of the lease agreements. Mr. Tadler testified that the purchase option amounts shown on the lease summaries relied on by the Division were merely estimates of the amount he hoped to collect, if and when the lease was reassigned to Clayton. Where those amounts exceeded $1.00, the amount was uniformly estimated to be 10% of the purchase cost of the equipment. Whether it was actually collected or not, that amount must be considered a nominal sum. Where purchase option amounts were collected, those amounts exceeded the original purchase cost of the equipment by approximately 10%, with two exceptions where the amount was approximately 20% of the purchase price. In all cases, the amount of the purchase option collected was nominal. This evidence tends to support the conclusion that the parties intended conditional sales with reserved security interests rather than true leases.

Assuming for the sake of argument that Clayton entered into true leases (and Mr. Tadler testified that this was sometimes the case) the conclusion is inescapable that the agreements maintained their character as leases when they were assigned to banks or other lending institutions. An assignment is a transfer of property, or of some right or interest in property, from one person to another (6 NY Jur 2d, Assignments, § 1). If true leases existed, the banks or other financial institutions must have stood in Clayton's place as lessors. Since the obligation to collect tax would arise at the time each rental payment was made, that obligation would rest with the party collecting the payment.[1]

In accordance with the above discussion, it is found that Clayton was not obligated to collect sales tax on each installment payment as it was made. Inasmuch as the audit proceeded on the theory that Clayton was obligated to collect such payments, the audit method was fundamentally flawed and the results of the audit in error.

E. Petitioners take the position that Clayton's books and records were adequate for the purpose of conducting a complete audit and accurately determining its liability and that the Division impermissibly estimated the tax due based upon an external index. It is beyond

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[1]In fact, the assignments themselves, in which Clayton assigned its "rights" but not its "obligations", are another indication that the agreements were financing arrangements and not true leases (UCC § 2-210[4]).

question that where the taxpayer maintains a complete set of books and records the Division's audit is restricted to those books and records to determine the taxpayer's ultimate tax liability (see, Matter of Chartair v. State Tax Commn., 65 AD2d 44, 411 NYS2d 41, 43; Matter of Cafe Europa, Tax Appeals Tribunal, July 13, 1989). In this case, the Division concedes that Clayton's records were complete and adequate for the purpose of verifying its tax liability.

It maintains, however, that it did not estimate the tax due but used Clayton's records to determine its exact tax liability.

The Division's position is problematic for several reasons. If, as the Division contends, Clayton was obligated to collect sales tax on each and every installment payment, it was also obligated to keep a record of every installment payment made and the tax due on that payment (Tax Law § 1135[a][1]). After assignment of the so-called leases, Clayton did not know whether installment payments were made or not and whether tax was collected or not; therefore, it could not have kept the required records, and its records of sales tax collected could not have been adequate for the purpose of verifying its tax liability.

If either Clayton or the equipment supplier was obligated to collect sales tax at the time possession of the property was transferred to the purchaser/lessee, Clayton's records, especially its leases, invoices from suppliers and cash receipts journal, might have provided a basis for determining the exact amount of tax due. As the audit did not proceed on that basis, those records were not used by the Division to determine Clayton's tax liability. If the banks and other financial institutions were obligated to collect tax due after the assignments took place, Clayton's records would have been adequate for the purpose of determining Clayton's individual liability on amounts it actually collected, but again, the records were not used in this fashion.

The one record which was used by the Division was a computer generated summary of each lease and assignment.[2] The lease summaries were not the source documents required to be

[2]It may be inferred from the record as a whole that the summaries contained information taken from various documents, the leases, assignment documents, invoices, etc., and not only from the leases themselves.

kept as a true record of sales (Tax Law § 1135[a][1]), and, by themselves, the summaries did not constitute adequate books and records. The summaries may have been accurate records of amounts due and owing under each agreement, but they were not accurate records of the amounts actually collected on each transaction and were not prepared or maintained by Clayton as a record of sales. Moreover, while the Division's auditor repeatedly asserted that Clayton's tax liability was not estimated or based upon a projection, the record as a whole establishes that Clayton's taxable sales were projected based upon the summary. Where the taxpayer maintains complete records, Article 28 requires more than the "use" of one individual record to estimate the taxpayer's liability. A test period audit "uses" the taxpayer's records to project the taxpayer's tax liability for an entire audit period; however, such a methodology is unacceptable where complete records are available (Matter of Chartair, supra). If it is assumed that Clayton was obligated to collect tax on each installment payment made under the terms of the leases and that Clayton maintained adequate books and records (these are the premises upon which this audit rests), it must be concluded that the audit impermissably estimated the tax due.

F. In light of Conclusions of Law "D" and "E", other issues raised by petitioners are rendered moot.

G. The petitions of Clayton Funding Corporation and Robert J. Tadler, as officer, are granted, and the notices of determination and demands for payment of sales and use taxes due issued on September 20, 1985 are cancelled.

DATED: Troy, New York

ADMINISTRATIVE LAW JUDGE