STATE OF NEW YORK

DIVISION OF TAX APPEALS

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| In the Matter of the Petition | : | |
| of | : | |
| ANDRE EMMERICH GALLERY, INC. | : | DETERMINATION<br>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 a petition 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.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on May 3, 1993 at 9:15 A.M., with all briefs filed by September 13, 1993. Petitioner was represented by Rosenman & Colin, Esqs. (Eugene L. Vogel, Esq., and Gilbert S. Edelson, Esq., of counsel). The Division of Taxation was represented by William F. Collins, Esq. (Vera R. Johnson, Esq., of counsel).

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 themas receipts from sales of personal property, was due to reasonable cause and not due to willful neglect.

FINDINGS OF FACT

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.

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."

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.

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 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 |

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.

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.

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.

## CONCLUSIONS OF LAW

A. 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 . . . ."

The issue herein devolves to 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.

B. The Tax Appeals Tribunal considered this issue in Matter of Tradearbed, Inc. (Tax Appeals Tribunal, January 12, 1989), where it was called upon to decide if that petitioner's receipts were sales of tangible personal property or services performed. The Tradearbed case involved an importer of steel products which sold products primarily purchased from related companies located abroad. The Division determined that Tradearbed was a mere selling agent of the foreign affiliates and had no sales of its own and maintained a profit margin of only about one percent. The sales receipts were determined to be commissions received as agent and allocated to New York. The Tribunal, relying on the Restatement (Second) of Agency,

cancelled the deficiency because it found no such agency relationship, rather it found an independent buyer-seller relationship, based upon seven factors set forth in the Restatement. The Tribunal found certain factors indicative of an agency relationship which supported a characterization of receipts from the performance of services within the State, while facts indicative of petitioner taking title to property as an independent buyer/seller supported the characterization of receipts from the sale of tangible personal property. The Restatement (Second) of Agency made the following distinction between an agent and an independent buyer/seller:

> "One who receives goods from another for resale to a third person is not thereby the other's agent in the transaction: whether he is an agent for this purpose or is himself a buyer depends upon whether the parties agree that his duty is to act primarily for the benefit of the one delivering the goods to him or is to act primarily for his own benefit" (Restatement [Second] of Agency § 14J [1958]).

The Restatement also sets out various "indicia of sale" to help in making a determination of whether a person is acting as agent or an independent buyer-seller.

However, the instant matter presents a very different and specific genre, i.e., the special relationship between artists and art merchants. In fact, so special is the relationship that the New York State Legislature codified the relationship in Arts and Cultural Affairs Law § 12.01. That statute provides, in pertinent part, as follows:

> "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 or craftsperson, his heirs or personal representatives, delivers or causes to be delivered a work of fine art, craft or a print of his own creation 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 or craftsperson 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;
>
> "(ii) such work is trust property in the hands of the consignee for the benefit of the consignor;
>
> "(iii) any proceeds from the sale of such work are trust funds in the hands of the consignee for the benefit of the consignor;

> "(iv) such work shall remain trust property notwithstanding its purchase by the consignee for his own account until the price is paid in full to the consignor; provided that, if such work is resold to a bona fide third party before the consignor has been paid in full, the resale proceeds are trust funds in the hands of the consignee for the benefit of the consignor to the extent necessary to pay any balance still due to the consignor and such trusteeship shall continue until the fiduciary obligation of the consignee with respect to such transaction is discharged in full; and
>
> "(v) no such trust property or trust funds shall be subject or subordinate to any claims, liens or security interest of any kind or nature whatsoever.
>
> "(b) Waiver of any provision of this section is absolutely void except that a consignor may lawfully waive the provisions of clause (iii) of paragraph (a) of this subdivision, if such waiver is clear, conspicuous, in writing and subscribed by the consignor . . . ."

It is noted that petitioner purportedly had oral contracts with its artists/consignors, the full terms of which were not disclosed in the record.[1] But it seems clear that petitioner was an "art merchant", defined in the Arts and Cultural Affairs Law as follows:

> "2. 'Art merchant' means a person who is in the business of dealing, exclusively or non-exclusively, in works of fine art or multiples, or a person who by his occupation holds himself out as having knowledge or skill peculiar to such works, or to whom such knowledge or skill may be attributed by his employment of an agent or other intermediary who by his occupation holds himself out as having such knowledge or skill. The term 'art merchant' includes an auctioneer who sells such works at public auction, and except in the case of multiples, includes persons, not otherwise defined or treated as art merchants herein, who are consignors or principals of auctioneers" (Arts and Cultural Affairs Law § 11.01[2]).

Further, there is no question that artists placed works with petitioner on consignment, defined as follows:

> "12. 'On consignment' means that no title to, estate in, or right to possession of, the work of fine art or multiple that is superior to that of the consignor vests in the consignee, notwithstanding the consignee's power or authority to transfer or convey all the right, title and interest of the consignor, in and to such work, to a third person" (Arts and Cultural Affairs Law § 11.01[12]).

However, it is important that the Legislature felt compelled to specifically identify the art merchant as the artist's agent with regard to works delivered to it on consignment and that any

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[1]Although petitioner also received works from collectors and others, it submitted no evidence regarding the number of consigned works received from artists, collectors, or others. Therefore, petitioner has not carried its burden of proof and may not allege error by the Division where it has failed to differentiate the source of commissions earned (Tax Law § 1089[e]).

proceeds from the sale of such art work are trust funds in the hands of the consignee for the benefit of the consignor. In the case of a sale to a third party, like the instant matter, the resale proceeds are trust funds in the hands of the consignee until the artist is paid his balance due. Hence, this case is

distinguishable from Tradearbed, where the issue of an agency relationship was not clear on the facts or law.

Here, petitioner was acting as the agent for its consignors, by statutory definition (Arts and Cultural Affairs Law § 12.01). That section 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. This clear and strong statement, to which petitioner has not seriously addressed itself, is presumably common knowledge in the arts community and it is noteworthy that petitioner's actions and conduct of its business are consistent with its terms. Its distinction between commission sales and other sales of tangible personal property for internal purposes (sales journal and financial statements) and disclosure on its Federal and New York State tax returns underscores its acknowledgement of its responsibility as a fiduciary to its consignees.

In Tradearbed, the Tribunal used the characterization of receipts as the primary deciding factor in its determination of the receipts factor. It reasoned that a finding of an agency relationship or the "factors indicative of an agency relationship" would support a finding that the receipts were derived from the performance of services as opposed to a sale of tangible personal property. Since the Arts and Cultural Affairs Law clearly establishes an agency relationship between artist and art merchant, i.e., petitioner and its consignors, "[n]otwithstanding any . . . law, statute, requirement or rule . . . to the contrary", something not present in Tradearbed, and petitioner's bookkeeping and business practices were consistent with said relationship, it is determined that petitioner was acting as an agent for the artists with which it did business and the receipts reflect services performed. Since there was no dispute

that the services were rendered in New York State, the situs of petitioner's offices and all of its employees, the Division properly found the receipts to be services allocated to New York (see, 20 NYCRR 4-4.3[b]).

Petitioner contends that its business is similar to any other retail store that sells on consignment, e.g., book stores and newsstands, and relies heavily upon the Tribunal decision in Matter of Tradearbed, Inc. (supra). But petitioner does not address the Arts and Cultural Affairs Law, except in a footnote to its reply brief, where it tersely stated that it was not helpful herein because the purpose of the law was merely to "[protect] artists from runaway galleries." Petitioner also does not address the explicit language of section 12.01(a)(i) which establishes an agency relationship, the heart of the issue in Tradearbed, the very case it cites as support for its position.

It is determined herein that the nature of the relationship between the artist and art merchant and the special statutory provisions relating thereto distinguish this matter from the circumstances found in Tradearbed and even Northwest Textbook Depository Co. v. Dept. of Revenue (11 Or Tax 280 [1989] [wherein the Oregon Tax Court allocated receipts from the sale of consigned textbooks as sales of tangible personal property rather than services, because it found that the focus of the business activity giving rise to the income was the sale of the product]). In Northwest Textbook Depository, the Oregon tax court held that the textbook depository was engaged in the sale of tangible personal property and that its purchasers were paying for goods not services. The court drew a distinction between a unitary business and a separate business, choosing to view the textbook depository as a separate business entitled to apportion its income based on out-of-state sales of tangible personal property. Perhaps with a statute like the Arts and Cultural Affairs Law and circumstances like those herein, the Oregon tax court would have come to a different conclusion. It is plausible that the agency relationship might have been viewed along the lines of a unitary relationship rather than an independent buyer/seller -- a determination made herein.

However, as stated above, there is a statutory presumption of an agency relationship in

this matter 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.

C. Petitioner requests that penalty be abated because its failure to pay the tax assessed was due to reasonable cause and not due to willful neglect (Tax Law § 1085[a][3]). Petitioner urges that because it reported its taxable income in good faith based upon its incorrect interpretation of substantial statutory authority and case law, penalties should be abated.

However, this argument amounts to a claim that petitioner's good faith, albeit incorrect, legal interpretation amounts to reasonable cause.

It has been held:

> "the failure to pay a tax due to a different legal interpretation of a statute need not be considered 'reasonable cause'. In fact, if it were so considered, [the Commissioner] would rarely if ever be entitled to levy such penalties" (Matter of Auerbach v. State Tax Commn., Sup Ct, Albany County, March 27, 1987, Williams, J., affd 147 AD2d 390, 536 NYS2d 557).

Given all the circumstances of this matter, and the fact that petitioner only advances this one theory as a basis for the abatement of penalties, it is determined that the imposition of penalties herein was warranted and is sustained.

D. The petition of Andre Emmerich Gallery, Inc. is denied and the Notice of Deficiency, dated January 6, 1992, is sustained.

DATED: Troy, New York
February 24, 1994

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE