STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions of **RAFFOLER LTD. D/B/A TRENDS AND RBM LTD.** for Revision of Determinations or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the period March 1, 1988 through August 31, 1991.	:	DETERMINATION DTA NOS. 815435, 815436, 815437, 815438, 815439 AND 815440
In the Matter of the Petitions of **JERRY WILLIAMS, OFFICER OF RAFFOLER LTD. D/B/A TRENDS AND RBM, LTD. AND STEPHEN BROWN, OFFICER OF RAFFOLER LTD. D/B/A TRENDS AND RBM, LTD**. for Revision of Determinations or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the period June 1, 1990 through August 31, 1991.	:	

Petitioners Raffoler Ltd. d/b/a Trends and RBM, Ltd. 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 March 1, 1988 through August 31, 1991.

Petitioners Jerry Williams, officer of Raffoler Ltd. d/b/a Trends and RBM, Ltd., and Stephen Brown, officer of Raffoler Ltd. d/b/a Trends and RBM, Ltd., 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 June 1, 1990 through August 31, 1991.[1] A hearing was held before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on September 16, 1997, at 10:15 A.M., and continued to its conclusion on November 14, 1997, at 10:00 A.M., with all briefs to be submitted by July 30, 1998, which date began the six-month period for the issuance of this determination. Petitioners appeared by Morrison & Foerster, LLP (Irwin M. Slomka, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Marvis Warren and James DellaPorta, Esqs., of counsel).

ISSUES

I. Whether petitioners, as vendors, may exclude charges to ship merchandise to customers from their taxable receipts subject to New York State and City sales tax.

II. Alternatively, if petitioners are not entitled to exclude the full amount of their shipping charges from taxable sales, whether petitioners are entitled to exclude their actual transportation costs from their taxable receipts.

III. Whether petitioners have established reasonable cause and the absence of willful neglect for abatement of penalties imposed in this case.

FINDINGS OF FACT

1. Raffoler Ltd. d/b/a Trends ("Raffoler"), incorporated in New York in 1982, conducted the business of selling low-priced merchandise by mail through direct mail consumer solicitation. RBM Ltd. ("RBM"), incorporated in New York in 1986, marketed similar merchandise through

[1]The Division conceded that the officers of Raffoler and RBM, Jerry Williams and Stephen Brown, are not being held responsible for the first nine quarters of the audit period, which in its entirety covered the period from March 1, 1988 to August 31, 1991, since they were not assessed within the statute of limitations. Thus, the period for which the officers may be held responsible encompasses June 1, 1990 to August 31, 1991.

space advertisements in newspapers and magazines throughout the country. Raffoler and RBM maintained their corporate headquarters in Westbury, New York, and shared warehouse facilities in Farmingdale, New York.

Raffoler and RBM sold a general line of merchandise that included toys, household products and clothing. They did not manufacture the products they sold, but rather purchased them directly from manufacturers or through intermediaries, such as importers and overseas vendors.

The marketing strategies of the two companies focused on being highly promotional and price sensitive. Many items sold occupied a price range between $5.00 and $20.00. For marketing purposes, Raffoler and RBM used trade names in their promotion of products. The trade names included Trends, CVP, National Historic MINT and GHR.

2. Raffoler, using direct-mail solicitation, reached potential customers by the mailing of promotional materials, such as sweepstakes offerings, with solicitation for Raffoler's products, along with an order form. The order form provided a place for the customer to separately state the sales price of the merchandise on one line and to insert on a separate line, marked "shipping" or "shipping charge," the separate additional charge for Raffoler to ship the merchandise to the customer. RBM created advertisements that ran in various newspapers and magazines throughout the country, such as the freestanding inserts that appear in Sunday newspapers. RBM advertised in such publications as TV Guide, The New York Post, The National Enquirer, and American Legion. Along with the ad RBM included a coupon to fit the order or instructions on how and where to place the order. The coupon provided a place for the customer to separately state the sales price of the merchandise on one line and to insert on a separate line, marked

"shipping" or "shipping charge," the separate additional charge for RBM to ship the merchandise to the customer.

On orders placed with both Raffoler and RBM, actual shipping charges were sometimes fixed, i.e., they did not vary with the size of the order, and at other times varied based on the size of the order. When establishing shipping charges, although Raffoler and RBM sometimes considered the anticipated weight of the item, the companies' primary concerns were with regard to marketing conditions and what was acceptable in the industry and to the consumer.

3. Both Raffoler and RBM shipped the ordered merchandise directly to a customer's home or business, and Raffoler and RBM charged their customers for this service. The customer was provided shipping information so that at the time of order placement, the customer knew the amount of the shipping fee. The shipping fee was separated from the price of the goods on the direct mail order forms and in the space ads. The fee was intended to cover the cost incurred by Raffoler and RBM to send the goods from the Farmingdale warehouse by carriers such as the United States Postal Service ("USPS") or UPS, to the home or business of the consumer.

4. The shipping fees that Raffoler received from customers were generally in excess of the actual shipping costs that it incurred to ship the goods by, for example, UPS or the USPS, to the customer. Jerry Williams, who provided testimony on behalf of Raffoler and RBM in this matter, indicated that one of the problems with trying to set forth the actual cost of shipping on order forms is that the direct mail solicitations are being made throughout the 50 states and the cost to ship the merchandise will vary in accordance with the destination of the product.

5. Gross sales of Raffoler and RBM for the audit period as set forth in the Division's Field Audit Reports were $403,991,522.00 and $110,578,633.00, respectively. For the periods in issue, the actual shipping costs incurred by Raffoler and RBM amounted to $43,131,199.00, as

compared to petitioners' claimed shipping receipts for the same period of nearly $92 million, comprised of $75,681,933.00 reported by Raffoler, and $16,168,179 reported by RBM.

6. When customers placed orders with Raffoler and RBM, the total of the check or the credit sale was recorded as a "sale" on the books of Raffoler and RBM, though such amount included components for shipping and sales tax. The orders were retained for only about three to six weeks because they were received in such volume and took up so much space to store. During the year, the volume of orders ranged from approximately 25,000 to 70,000 each day.

7. Although Raffoler and RBM were separate corporations, RBM did not maintain any separate records of its costs or expenses, including transportation costs. Petitioners did not submit records as to how transportation costs recorded on Raffoler's books should be allocated between it and RBM, but suggested in their brief, after the allocation issue was raised by the Division that such allocation of actual cost could reasonably be made based on reported gross receipts of each company to total receipts of both companies.

8. During an audit of Raffoler and RBM, conducted for the period September 1, 1985 through February 28, 1988 ("the prior audit"), the taxability of Raffoler and RBM's shipping charges first arose. An analysis of incoming orders revealed that Raffoler and RBM had been overreporting sales by not recording an amount for the Tax Law former § 1103(b)(3) exclusion for shipping receipts which petitioners approximated at 20% of total receipts. Beginning March 1, 1988, Raffoler and RBM did not include in their taxable receipts reported on their New York State sales and use tax returns an amount equal to 20% of gross receipts, believing such amounts represented nontaxable shipping charges.

The prior audit was settled by the parties at a conciliation conference in 1990. Under the terms of a settlement, the Division permitted Raffoler and RBM to exclude from its receipts, as

exempt from sales tax, an amount equal to 13% (not the 20%) of its gross receipts, which more closely represented petitioners' costs of shipping, a fact determined based on petitioners' records during the prior audit. Beginning June 1, 1990, petitioners reduced the exclusion for shipping charges reflected on their sales tax returns from 20% to 13% of their gross receipts. Petitioners never collected sales tax from customers on the shipping charges during either of the two audit periods.

The questions of what policy the Division was upholding in relation to the settlement of the prior audit, and what the parties discussed with respect to the Division's advice to petitioners was described in testimony by both Marsha Eisner, the Division's team leader for this audit, and David Welder, a former chief financial officer of Raffoler and RBM. The testimony by both was contentious and both failed to answer directly some pertinent questions posed to them.

9. Jerry Williams, chief executive officer of Raffoler and RBM, testified as to his duties and responsibilities with respect to the companies, their sales philosophies and marketing techniques. Mr. Williams followed the sales tax advice of the companies' then tax advisor, Arthur Gelber, who represented Raffoler and RBM in the prior audit.

10. In July 1989, while the Division was conducting the prior audit, the Tax Appeals Tribunal rendered its decision in ***Matter of Spencer Gifts, Inc.*** (Tax Appeals Tribunal, July 27, 1989). In response to ***Spencer Gifts***, the Division issued audit guideline DOS-90-7, dated July 20, 1990, to its Central Office and District Office Sales Tax Personnel, which was "to be used as a guideline when auditing charges billed as postage, handling, shipping or other designation which represents the cost of transportation between a vendor and retail purchaser." Besides setting forth the provisions of 20 NYCRR 526.5(g), the audit guideline stated the following:

> The Tax Appeals Tribunal in the Matter of Spencer Gifts, Inc. concluded that charges designated as postage and handling on billings to retail purchasers were in fact charges for exempt transportation. This opinion was based on the following:
>
> (1) The petitioner offered uncontroverted testimony that the term "postage and handling" as used on its mail order form denoted a charge for delivery of merchandise from petitioner's warehouse to the purchaser.
>
> (2) This charge for "postage and handling" did not cover costs for handling.
>
> (3) The charges for "postage and handling" were more or less than the actual cost to petitioner for mailing and shipping; however, in the aggregate, the amounts collected by petitioner for postage and handling were less than its overall postage and shipping costs.
>
> As a result, it will now be Audit Policy to exempt charges billed as postage, handling, shipping or other designation if the aggregate receipts for the audit period are equal to or less than the vendor's actual cost of transportation. If the aggregate receipts for the audit period are more than the vendor's actual cost of transportation and charges are not separately stated in accordance with Regulation Section 526.5(g), the entire charge will be taxable.
>
> The actual cost of transportation to the vendor will be the actual out of pocket expense. For example, if the vendor obtains rebates from the transportation company, the rebates will be deducted from the amounts previously paid and the balance will be the actual cost of transportation.

11. Petitioners submitted as part of their evidence a binder of documents entitled "Comparison of Shipping Charges v. Industry," which petitioners compiled to compare petitioners' shipping charges against the shipping charges of other mail order vendors, whom petitioners identify as their competitors, during the tax periods in issue. Petitioners submitted 60 of what they identified as their actual order forms used during the tax periods in issue. Many of the forms indicate a printing date in one corner. Numerous forms contain the date 1988 or 1989. The form itself does not indicate in each case what year it was used. However, Charles Endy, petitioners' comptroller during the period in issue, established that the reference numbers on the order forms correspond to a particular mailing during a certain time frame. In addition to being

able to place the mailing during a particular time frame, Raffoler and RBM were also able to measure the success or failure of a mailing by such reference code.

Also included in the binder were order forms of 12 other mail order vendors, identified as the following: Hanover House, Chef's Catalog, Gold Metal Products, Frederick's of Hollywood, Domestications, Hold Everything, Nature Company, Sturbridge Yankee Workshop, Tapestry, Williams Sonoma, Pottery Barn, and Nino's. These were the vendors petitioners identified as their competitors. Only one form contained a date, other than handwritten designations, to identify during what period the forms were in use. However, Charles Endy also established that the order forms of other mail order vendors chosen for comparison purposes were those that were in existence during the period in issue. No information other than the order form from the mail order catalogs of the competitor vendors was provided.

12. Concerning industry rates, petitioner also submitted a schedule that summarized the comparison of shipping fees within the industry. Petitioners' average shipping fee for the orders it selected for the comparison was $3.46. This was contrasted with the $4.27 industry average cost of 12 companies that petitioners identify as competitors, for orders of the same dollar amount.

13. Ms. Eisner, the team leader of the audit, who testified for the Division with respect to the audit, stated that the Division never established what it considered reasonable rates for the mail order industry, and did not attempt to reduce petitioners' exclusion from approximately $92 million to its actual costs of approximately $43 million, which was established by petitioners during the hearing and accepted as valid by the Division.

14. Petitioners submitted as evidence two sales tax newsletters they received from the Division, dated September 1985 and March 1990, which outlined the sales tax rules for "postage and handling" charges. Both bulletins stated, in pertinent part:

> The charge for transportation of tangible personal property sold at retail is not subject to sales tax when:
>
> 1) the transportation costs are for delivery to either the purchaser or the purchaser's designee, and
>
> 2) the charges are separately stated in any written contract and on the bill given to the purchaser.
>
> Charges are deemed to be separately stated if they can be computed from information appearing on the bill.
>
> To qualify for the exclusion, transportation costs must be for the delivery of the tangible personal property to the purchaser or the purchaser's designee. Any charge made to a retail purchaser which represents the cost of transportation between a supplier, manufacturer, warehouse, catalogue or other distribution point and the seller's place of business is part of the receipt subject to tax, no matter what such cost is labeled.
>
> Postage, shipping or freight charges are all charges for transportation, and are not included in the receipts subject to sales tax when they meet the requirements stated above.
>
> Handling charges are costs which a supplier adds for servicing tangible personal property in preparing such property for shipping and mailing, and are subject to tax.
>
> If handling and transportation charges are combined and billed as one amount, the entire charge is subject to sales tax.

15. Raffoler and RBM separately filed New York state sales and use tax returns on a monthly or quarterly basis, as required, for the audit period, March 1, 1988 through August 31, 1991.

16. The Division issued notices of determination bearing the following dates and amounts, which relate to the Division's inclusion of Raffoler and RBM's shipping charges in taxable receipts:

Petitioner	Date of Notice	Tax	Interest	Penalty	Total
Raffoler	8/30/93	$364,586.80	$220,396.47	$109,376.03	$694,359.30
RBM	8/30/93	73,664.21	41,413.52	22,099.23	137,176.96
Williams, officer of Raffoler	9/9/93	364,586.80	222,322.57	109,376.03	696,285.40
Williams, officer of RBM	9/9/93	73,664.21	41,792.39	22,099.23	137,555.83
Brown, officer of Raffoler	9/9/93	364,586.80	222,322.57	109,376.03	696,285.40
Brown, officer of RBM	9/9/93	73,664.21	41,792.39	22,099.23	137,555.83

The additional tax due was calculated from petitioners' claimed shipping receipts as reported on the sales and use tax returns. The reported shipping receipts were multiplied by a New York State ratio to arrive at additional taxable sales, to which the effective sales tax rate was applied.

17. A conciliation conference was held on October 20, 1994 and conciliation orders were issued dated August 2, 1996 to Raffoler, RBM and Jerry Williams sustaining the notices of determination. Although it appears that a conciliation order was not issued for Stephen Brown, as officer of Raffoler and RBM, he was permitted to join the other petitioners in filing timely petitions. Petitioners Jerry Williams and Stephen Brown do not contest their personal liability as officers of Raffoler and RBM for any deficiency determined herein to be due, except as to the assessments for the periods that the Division has agreed are time-barred (***see,*** Footnote 1). The

only issue that remains unresolved between the parties is that of the taxability of petitioners' shipping charges.

SUMMARY OF THE PARTIES' POSITIONS

18. Petitioners maintain that since their shipping charges were reasonable and separately stated, they should not be included in petitioners' taxable receipts, and should be excluded from receipts subject to sales tax. Alternatively, however, petitioners argue that they should at least be permitted to exclude from sales tax their actual costs of shipping totaling approximately $43 million. Lastly, petitioners assert that since their treatment of shipping charges was based upon reasonable cause, not willful neglect, inasmuch as compliance with the Division's regulations was attempted, penalties assessed by the Division should be abated.

19. The Division takes the position that shipping charges are excludable from sales tax if separately stated from the merchandise costs, and are less than or approximately equal to the actual cost of shipping the merchandise to customers. The Division does not believe that petitioners are entitled to an exclusion for their costs of transportation, since their shipping charges as reported are substantially greater than their actual costs of transportation. The Division believes that the entire amount of shipping charges is subject to sales tax because taxable (amounts received beyond actual transportation costs) and nontaxable (actual transportation costs) components were mixed together in a single charge.

If it is determined, however, that an exclusion to the extent of actual costs is permissible, the Division maintains that no such adjustment is warranted in this case because petitioners have not identified what the actual transportation costs are for each of the corporate petitioners.

In addition, the Division argues that petitioners have not established reasonable cause for the abatement of penalties, since the record established that petitioners' underreporting of tax due was attributable to willful neglect.

CONCLUSIONS OF LAW

A. Tax Law § 1105(a) provides for a tax upon "the receipts from every retail sale of tangible personal property, except as otherwise provided in this article."

The term "receipt" is defined in relevant part by Tax Law former § 1101(b)(3) as:

> The amount of the sale price of any property . . . excluding the cost of transportation of tangible personal property sold at retail where such cost is separately stated in the written contract, if any, and on the bill rendered to the purchaser.

The regulations which addressed the transportation exclusion, 20 NYCRR former 526.5(g), adopted by the Division of Taxation provided:

> (1) The cost of transportation of tangible personal property, sold at retail, which is separately stated in the written contract, if any, and on the bill rendered to the purchaser is excluded from the receipts subject to the tax.
>
> (2) To qualify for the exclusion transportation costs must be for the delivery of the tangible personal property to the purchaser. Any charge made to a retail purchaser, whether labeled transportation, handling or some other designation, which represents the cost of transportation between a supplier, manufacturer, warehouse, or catalog vendor's place of business constitutes part of the receipt subject to tax.
>
> (3) Transportation charges shall be deemed to be separately stated if they can be computed from information appearing on the bill.
>
> (4) To qualify for the exclusion, transportation charges must be reasonable in relation to prevailing established rates. The bureau may establish reasonable charges for an industry, and reduce the exclusion for excessive transportation charges.
>
> *Example 1:* A vendor charges his customer $5 for transportation of the purchases. The purchases are transported from the vendor's place of business to the customer's home. The customer is billed as follows:

Purchase	$100
Transportation charge	5
Total Due	$105

Receipt subject to tax is $100.

Example 2: A vendor charges his customer $5 for transportation of the purchases. The purchases are dropped-shipped from the manufacturer to the purchaser. The customer is billed as follows:

Purchase	$100
Transportation charge	5
Total due	$105

Receipt subject to tax is $100.

Example 3: A vendor charges his customer $5 for transportation of purchases from a warehouse to the retail outlet. The purchaser picks up the merchandise at the retail outlet. The customer is billed as follows:

Purchase	$100
Transportation charge	5
Total due	$105

Receipt subject to tax is $105.

Example 4: A vendor is charged $5 by a supplier for the transportation of merchandise from a warehouse to the vendor's place of business. Upon the sale of the merchandise the vendor bills the purchaser for the $5 transportation charge. The customer is billed as follows:

Purchase	$100
Transportation charge	5
Total due	$105

Receipt subject to tax is $105.

Example 5: A contractor purchases lumber from a broker. The contract provides that the lumber will be drop-shipped from a producer's mill in Washington to the job site and prepaid transportation charges will be included. The contractor is billed as follows:

1,000 bd. ft. 2 x 4	$1,050
(Incl. $50 prepaid freight)	

Receipt subject to tax is $1,000.

Example 6: A building contractor purchases six cubic yards of ready-mix concrete. The producer charges $26 per cubic yard for the concrete and $5 per cubic yard for delivery. The building contractor is billed as follows:

6 cubic yards mix @ $26	$156
$5 delivery per cubic yard	30
Total due	$186

Receipt subject to tax is $156.

B. The Division challenges petitioners' qualification for the transportation exclusion on the broad ground that the phrase "cost of transportation" as it appears in Tax Law former § 1101(b)(3) and 20 NYCRR former 526.5(g) refers to the *actual* cost incurred for transportation of tangible personal property. The Division then reasons that since petitioners' invoices to customers include shipping charges in excess of actual transportation costs, the requirement that actual cost be separately stated on the customer's bill is not met (20 NYCRR former 526.5[g][1]). Though not clearly argued, the Division seems to extend its reasoning to assert that since the charges on the invoice are greater than actual cost, that the transportation costs are for something besides delivery, i.e., a profit center in this case, and therefore, do not meet the requirements of 20 NYCRR former 526.5(g)(2) (an argument that the Division similarly made in ***Matter of Spencer Gifts, Inc., supra***). The Division does not find 20 NYCRR 526.5(g)(4), referring to the requirement that "transportation *charges* must be reasonable in relation to prevailing established rates," as having any bearing on its interpretation of the term "cost." The Division claims this provision was intended to address the situation where a vendor does not use a third party to transport goods, and has indirect costs of its own that it needs to allocate reasonably in order to meet the regulation. The Division suggests, in summary, that "the only way subdivision 4 of 526.5(g) can be reconciled with Tax Law section 1101(a)(3) and subdivisions 1 and 2 of the regulation is if prevailing rate language of subdivision [sic] only

applies where transportation costs are difficult to ascertain." The Division provides no authority for its rationale and this explanation of 20 NYCRR former 526.5(g)(4).

C. The prevailing statute and regulations that must be applied use the term "cost" which is not defined by either source. According to Webster's Ninth New Collegiate Dictionary, "cost" is defined as "the amount or equivalent paid or charged for something." This definition would permit either the Division's interpretation of actual cost, or petitioners' reading as the amount charged. However, the definition must be considered in conjunction with the other facts of this case. The regulations also use the term "transportation charges" in 20 NYCRR former 526.5(g)(4) and all of its examples. The examples refer to the amounted *charged* by the vendor, when they could have referred to the amount paid by the vendor (which cost was passed on to the customer). Neither the statute nor the regulations confine transportation costs to the actual costs paid by a vendor. The regulation at former subdivision four provides that the Division may establish reasonable charges for an industry, and reduce an exclusion for excessive transportation charges. If actual cost were the anticipated measuring rod, there would be no need to permit the Division to make such adjustment. Given all of the facts stated above, the Division's assertion that the phrase "cost of transportation" refers to petitioners' actual cost is rejected. Accordingly, the phrase "cost of transportation" as set forth in the statute and regulations at issue herein will be interpreted to mean the amount Raffoler and RBM charged their customers, i.e., the shipping charges which appeared on Raffoler and RBM's order forms.

The same argument pertaining to the term "cost" was also made by the Division in ***Matter Spencer Gifts, Inc.*** (Division of Tax Appeals, September 15, 1988) and was rejected by the Administrative Law Judge. The determination of the Administrative Law Judge was affirmed unanimously by the Tax Appeals Tribunal (***supra***), without further comment on this point.

D. Having determined the interpretation of the term "cost," there is no dispute as to the fact that the cost of transportation as it appeared on the invoice to the customer was separately stated. Petitioners' order forms and coupons clearly provide a place for such costs to appear apart from the costs of merchandise ordered. Thus, the criteria of 20 NYCRR former 526.5(g)(1) are met.

It is clear from the record that the amounts charged by Raffoler and RBM were for the delivery of the merchandise to the customers of Raffoler and RBM. There is no assertion that the customer is paying for a service other than delivery; however, the Division maintains that the transportation costs include something other than delivery, and in this case that is a large profit. Inasmuch as the statute and regulations do not prohibit a company from making a profit on its delivery charges, this factor does not preclude petitioners from satisfying 20 NYCRR former 526.5(g)(2). Thus, it is deemed to be met.

As to the criteria set forth in 20 NYCRR former 526.5(g)(4), the requirement that transportation charges be reasonable in relation to prevailing established rates, the Division asserts that its audit policy during the period in question was that shipping charges greater than actual transportation costs are receipts subject to sales tax. The Division claims this policy to have been reaffirmed in the audit guideline pronouncement of DOS-90-7 after the Tribunal decision in ***Spencer Gifts***.

The first problem with the Division's argument is that the audit guideline memorandum DOS-90-7, dated July 20, 1990, made a policy pronouncement that provided a clear indication that whatever the Division's policy was before such guideline, was not the same as contained therein. Thus, DOS-90-7 was not a reaffirmation of audit policy, but at best, the creation of what it wanted its current policy to be. Given that fact, questions remain as to the force and effect, if

any, that the audit guideline has on petitioners, and whether and when such policy was effectively communicated to petitioners. The policy was declared in DOS-90-7 during July 1990, according to the date on the document, after the settlement of the prior audit of Raffoler and RBM. There is substantial conflict of testimony between what the Division claims to have told petitioners and what petitioners claim to have been told, leaving the substance of communication between the Division and petitioners very unclear. I do not find the testimony by either party convincing on this point, thus, the determination made herein is based on facts separate and apart from such testimony.

The Division argues its policy position is directly supported by the Tribunal's decision in ***Spencer Gifts*** (***supra***), which merits some discussion. ***Spencer Gifts*** involved the operator of a retail sales business with a mail order division that used order forms with its mail orders that imposed charges in addition to its merchandise costs, referred to as "postage and handling." The primary question in the case before the Administrative Law Judge was "whether the charge denominated by petitioner as 'postage and handling' was a charge *for delivery of merchandise*, excluded from the definition of receipt, or whether it was an incidental charge properly included within the definition of a receipt." (Italics supplied.) The Administrative Law Judge determined that there was uncontroverted testimony that the term used on its mail order form was a charge for the delivery of merchandise from petitioner's warehouse to the purchaser; that the charges did not cover costs for "handling"; that the charges for postage and handling for an individual order might be more or less than the actual cost to petitioner of mailing or shipping; and in the aggregate, amounts collected by petitioner for postage and handling were less than its overall actual costs for postage and shipping. The Division argued that the shipping charges were not identical to the amounts of petitioner's actual costs, and therefore, there were also costs involved

which existed for something other than delivery. The Division predicated its rationale upon its general position that the term "cost of transportation" as used in Tax Law former § 1103(b)(3) is confined to the actual costs of postage, shipping and freight charges. The Administrative Law Judge rejected the Division's arguments on the basis that the statute and regulations do not confine the costs to *actual* costs, and referred to the 20 NYCRR former 526.5(g)(4) requirement that the charges must be reasonable in relation to prevailing rates (which petitioners in that case had established by reference to competing mail order houses, though the details of the proof are unknown). The Tax Appeals Tribunal reviewed the matter, and key to their affirmance of the lower determination on the delivery issue is that the Tribunal found persuasive the fact that the charges in that matter did not even cover the costs of shipping borne by Spencer. In other words, there could not have been a handling component, when, in fact, Spencer had not even covered its own costs of shipping. The Tribunal did not say that charges in excess of actual costs would not qualify for the exclusion. It essentially stated that charges that differ from actual costs will not necessarily be deemed something in addition to transportation, where the facts support that the charges are only for transportation. For the Division then to develop an audit policy that exempts charges billed as postage, handling, shipping or something else only if the aggregate receipts for the audit period are equal to or less than the vendor's actual cost of transportation impermissibly extends the Tribunal reasoning.

The Division publishes audit guidelines which are detailed manuals, unpublished to the public, describing Department policy and interpretations, regarding substantive and procedural issues likely to arise during the conduct of an audit of a taxpayer (***Matter of Rawl***, Tax Appeals Tribunal, June 2, 1997). No one questions the authority of the Division to issue appropriate implementing guidelines, and, as the Court noted in ***Unimax Corp. v. Tax Appeals Tribunal*** (79

NY2d 139, 581 NYS2d 135, 137), the Department's methodology is entitled to deference, provided it is not irrational or unreasonable, and does not contravene or impede the specific legislative intent of the governing statute. It is well established that audit guidelines do not have the force and effect of law (***Matter of Unimax Corporation***, Tax Appeals Tribunal, November 22, 1989). In this case, the statute and regulations must be read together for proper application of the governing rules. However, where a statute or regulations do not provide the authority for some aspect of a matter, or audit guidelines can be utilized as an interpretive aid (***Matter of Tweed***, Tax Appeals Tribunal, May 23, 1996), such guidelines may be quite useful. I do not find that to be the case here. In addition, I believe the audit guideline is in contravention of the existing regulations. The audit guideline requires that the aggregate shipping receipts for the audit period must be less than or equal to the vendor's actual cost of transportation and be separately stated on the order form for the charge to be exempt. As to the statute, this guideline adds a requirement that clearly does not exist. With respect to the application of the statute and regulations together, I believe the audit guideline is in direct conflict with 20 NYCRR former 526.5(g)(4) permitting reasonable charges, and the opportunity to prove that such charges are reasonable. Although the Division made a brief argument that it was equating its interpretation of "reasonable" with a vendor's actual cost, the Division was not applying such interpretation in that manner in this case, since its obvious next step would have been to reduce petitioners' exclusion for what it deemed to be excessive charges, i.e., those above actual cost. This suggested course of action was rejected by the Division (***see***, Finding of Fact "19").

The statute and regulations provide authority for an exclusion from receipts, and present what must be shown to accomplish the same. The rules are quite clear. The audit guideline is

not merely an interpretive aid in this case, it changes the rules in contravention of the statute and regulations. Accordingly, it cannot be enforced as though it supercedes the regulatory provisions.

E. The remaining issue with respect to whether petitioners are entitled to the exclusion for transportation charges, is whether petitioners have met their burden of proving that the charges are reasonable in relation to prevailing established rates (20 NYCRR former 526.5[g][4]). The Division is permitted to establish rates for an industry, and make an adjustment if it finds that a vendor's transportation charges are comparatively excessive (***id***). However, the Division did not establish rates for mail order companies or attempt any adjustment in petitioners' charges. In support of their position that the rates charged by Raffoler and RBM were reasonable in relation to others in the mail order industry, petitioners introduced a comparison of order forms used by Raffoler and RBM during the audit period and order forms of 12 companies petitioners identified as their competitors. A summary matrix showed that petitioners' average shipping fee for orders of a particular dollar value was $3.46. This amount was contrasted with the amount of $4.27 representing the average industry charge for orders of the same dollar value, using the ordering forms for the audit period from the 12 competitor companies. However, petitioners blindly identified the comparative companies as their competitors. No information was presented to show that, in fact, such comparative companies were indeed competitors. The companies' product lines were not disclosed. The companies' sales or other comparative financial data were not presented. Although it appears that each of the companies provided a means to order merchandise by mail order, that characteristic is the only apparent similarity between Raffoler and RBM and such companies. Even if petitioners conclusively established that each of these companies were mail order companies, the type of merchandise sold has a direct bearing on not only comparability, but also a direct effect on the key issue, the comparability of the shipping

rates. No more than one would consider all retail companies, all manufacturers, or all sellers of food products comparable to one in the same category without additional information, to deem all mail order vendors comparable to each other would be an error. Accordingly, it is determined that petitioners did not meet their burden of proving that their transportation charges were reasonable in relation to prevailing established rates. Thus, petitioners are not entitled to the sales tax exclusion for the transportation charges of nearly $92 million collected during the audit period.

F. The statute permits an exclusion for the cost of transportation of tangible personal property sold at retail where the cost is separately stated. The regulations expand upon what is required to qualify for such exclusion, and, but for petitioners' failure to prove the reasonableness of its rates, such charges otherwise qualify. The Division has the discretion to reduce the exclusion for what it determines to be excessive transportation charges. In accordance with the legislative and regulatory intent surrounding the exclusion, the Division acted improperly by refusing to exercise such power, in what appeared to be a punitive decision. The Division did not claim inability to exercise its discretion, nor did the Division argue that it chose not to make such a reduction for any other reason. Rather the Division claims that petitioners are not entitled to the same because it was not provided a breakdown of actual transportation costs incurred by each of the companies, Raffoler and RBM. The first time the Division raised this argument is in its brief after the close of the hearing.

Although the Division assessed Raffoler and RBM separately, during the hearing, the Division treated the two companies as one for purposes of establishing their qualification for the exclusion. Many questions were addressed to and answered for the companies in a joint manner. Although it was established at the hearing that petitioners' records did not reflect a separation of

actual transportation expenses between Raffoler and RBM, the fact that petitioners would be denied the exclusion if such costs could not be separated was never asserted. The Division maintains that the record does not contain any reasonable method of allocating transportation costs between Raffoler and RBM, and thus denies any opportunity for allocation. On the contrary, the record contains sufficient information to allocate the actual expenses of $43 million reasonably, which were accepted by the Division as representative of petitioners' actual transportation costs. The shipping charges as reported by Raffoler and RBM were $75,681,933 and $16,168,179, respectively. A pro-rata allocation based on shipping receipts, would result in 82% and 18% of actual transportation costs permitted as an exclusion to Raffoler and RBM, respectively. Petitioners also suggested, in response to the Division's assertion that the record did not contain the information necessary to allocate the costs, that the actual costs of shipping ($43,139,199) be allocated between Raffoler and RBM by their respective ratios of gross sales of each to total sales of both entities combined. This computation resulted in allocations of approximately 78.5% and 21.5% to Raffoler and RBM, respectively. Given the fact that there is support for pro-rata allocation in tax matters (***see, Matter of Shorter,*** Tax Appeals Tribunal, July 31, 1997; ***Matter of Golden v. State Tax Commission***, 90 AD2d 941, 457 NYS2d 905 [where the Court held that for purposes of computing the subtraction modification pursuant to Tax Law § 615(c)(3), the Division properly allocated investment expenses to exempt income in the same proportion as the exempt income bears to total income]) and that the allocation on the basis of two sets of financial data contained in the record can be made, with significantly similar results, petitioners' proposed method of allocation is accepted. Accordingly, the assessment should be reduced by pro-rata amounts attributable to each corporation, to result in the allowance of an exclusion equal to actual total transportation costs of $43,139,199.00.

G. Tax Law § 1145(a)(1)(i) imposes a penalty upon persons who fail to timely file a return or timely pay the tax imposed by Articles 28 and 29 of the Tax Law. The penalty may be waived if "such failure or delay was due to reasonable cause and not due to willful neglect" (Tax Law § 1145[a][1][iii]). 777 The taxpayer bears the burden of establishing that its actions were based on reasonable cause and not willful neglect (***see***, ***Matter of Philip Morris, Inc.***, Tax Appeals Tribunal, April 29, 1993; ***Matter of MCI Telecommunications Corp.***, Tax Appeals Tribunal, January 16, 1992, ***confirmed*** 193 AD2d 978, 598 NYS2d 360).

The regulations at 20 NYCRR 536.5(c)(5) provide that the following constitutes grounds for reasonable cause for the failure to pay tax when due:

> Any other cause for delinquency which would appear to a person of ordinary prudence and intelligence as a reasonable cause for delay and which clearly indicates an absence of willful neglect may be determined to be reasonable cause. Ignorance of the law, however, will not be considered as a basis for reasonable cause.

H. A finding that the taxpayer acted in good faith is a prerequisite to the conclusion that the failure or delay was due to reasonable cause and not willful neglect (20 NYCRR 536.5[d][1]). The most important factor in determining whether reasonable cause and good faith exist is the extent of the taxpayer's efforts to ascertain the proper tax liability (***Matter of Kal Assoc.***, Tax Appeals Tribunal, October 17, 1991; ***see***, ***Matter of Philip Morris, Inc.***, ***supra***).

Judged by the foregoing standards, petitioners have not shown that their failure to pay was due to reasonable cause and not due to willful neglect. According to the testimony provided at the hearing, in early 1988 petitioners began excluding from taxable receipts an amount equal to approximately 20% of such receipts, which represented what petitioners believed to be nontaxable shipping charges. This amount was calculated by an analysis of

orders during the prior audit when it was determined that petitioner had not been excluding from gross receipts amounts for shipping charges. Petitioners continued to exclude the same 20% between March 1, 1988 and mid-1990, when that audit was actually settled. As a part the settlement of the prior audit, petitioners were permitted to exclude 13% of gross receipts, a reduction from petitioners' calculated 20% amount. The exclusion was permitted as a percentage of gross receipts in this amount as a means to settle the prior audit. It is clear from the record that everyone involved was aware of such fact. There was no authorization for petitioners to exclude a percentage of gross receipts, rather than its actual shipping receipts, but for such settlement. Mr. Williams, Mr. Welder and Mr. Endy were all involved in some phase of the prior audit, and the testimony of each demonstrated sufficient business acumen to suggest that they were or should have been aware that the method they were using to exclude shipping receipts was not in accordance with the law, but rather was offered as a compromise to conclude the audit in a reasonable manner. Once the exclusion was permitted, petitioners should have acted in a manner to preserve their ability to attain the exclusion, i.e., maintain the records required to keep the shipping receipts separate from sales as they were collected with the order forms, which petitioners failed to do. The failure to record such amounts in a careful manner which would be more likely to insure the availability of the exclusion to them is a clear indication that petitioners did not make a serious effort to ascertain an accurate tax liability. Likewise, if petitioners were truly confused about the law or the Division's policy, making further inquiry was incumbent upon Raffoler and RBM. Accordingly, petitioners have failed to show there was a lack of willful neglect sufficient to warrant abatement of the penalties.

I. The petitions of Raffoler Ltd. d/b/a Trends, RBM Ltd., Jerry Williams, as officer of Raffoler and RBM, and Stephen Brown, as officer of Raffoler and RBM are granted to the extent determined in Conclusion of Law "F," but otherwise denied. The notices of determination dated August 30, 1993 and September 9, 1993 are to be adjusted in accordance with Conclusion of Law "F" and Footnote "1", and as adjusted, are sustained together with such interest and penalties as may be lawfully due.

DATED: Troy, New York
January 28, 1999

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE