STATE OF NEW YORK

DIVISION OF TAX APPEALS

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| In the Matter of the Petition | : | |
| of | : | |
| **MICHAEL D. BUTTON AND JAMES F. BUTTON** | : | DETERMINATION |
| | : | DTA NO. 817034 |
| for Revision of a Determination or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period October 7, 1997 through November 8, 1997. | : | |
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Petitioners, Michael D. Button and James F. Button, 2 Button Lane, Frankfort, New York 13340, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period October 7, 1997 through November 8, 1997.

A hearing was commenced before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on November 17, 1999 at 10:30 A.M. and continued to completion on November 18, 1999. Petitioners' reply brief was filed on April 28, 2000, which date began the six-month period for the issuance of this determination. Petitioner appeared by Thomas G. Jackson, Esq. The Division of Taxation appeared by Barbara Billett, Esq. (John E. Matthews, Esq., of counsel).

## *ISSUES*

I. Whether notices of determination issued to petitioners as officers of a corporation which failed to pay the prepaid sales tax on cigarettes must be deemed to be null and void because each notice assessed tax, penalty and interest pursuant to Tax Law §§ 1131(1), 1133(a) and 1138, rather than a penalty equal to the tax not paid as required by Tax Law § 1145(e).

II. Whether, if the notices of determination are deemed to be valid, the assessments must be canceled because the Division of Taxation issued conciliation orders canceling all penalties assessed against petitioners.

III. Whether petitioners were prevented from exercising their authority as corporate officers by the actions of Marine Midland Bank such that they cannot be held liable for the taxes owed by the corporation for the period in issue.

IV. Whether, if petitioners had the authority to pay the taxes due from the corporation, their failure to pay those taxes was due to reasonable cause and not to willful neglect.

V. Whether the corporation's liability for prepaid sales taxes on cigarettes should have been recovered from the corporation's creditor, Marine Midland Bank, which took possession of the affixed and unaffixed tax stamps.

## *FINDINGS OF FACT*

1. Petitioner Michael D. Button is the former president of Herkimer Wholesale Company, Inc. ("Herkimer"), a wholesale supplier of groceries, candy, cigarettes and other sundries. His brother, James F. Button, is the former vice-president of Herkimer. The Button family purchased Herkimer in 1968 and operated the business for almost 30 years from its main office in Utica, New York.

2. Herkimer was licensed as a cigarette agent by the Division of Taxation ("Division"). In this capacity, Herkimer was required to advance and pay the cigarette tax imposed under Tax Law § 471. As of September 1, 1995, Herkimer was also required to prepay on account of sales taxes imposed by articles 28 and 29 of the Tax Law. Herkimer advanced and prepaid the cigarette and sales taxes by purchase of cigarette tax stamps from Fleet Bank acting as an agent

of New York State. The tax stamps were affixed to packages of cigarettes sold by Herkimer in New York State as evidence that the taxes had been paid.

3. Herkimer filed a credit bond with the Division and was permitted to purchase tax stamps on credit and to pay for them 30 days later. By late 1997, the amount of Herkimer's credit bond was $2.2 million. The surety was National Union Fire Insurance Company of Pittsburgh, Pennsylvania.

4. To pay for the tax stamps purchased on 30-day credit, Herkimer filed an authorization for Automatic Clearing House ("ACH") debits which authorized Fleet Bank to use ACH procedures to debit a designated account that Herkimer maintained with a branch of Marine Midland Bank ("Marine") in Utica, New York for the amount of tax owed.

5. During the entire time that it was owned by members of the Button family, Herkimer's sole banking relationship was with Marine where it maintained checking accounts and received mortgages, demand loans and installment loans. Herkimer's receipts grew from $2 million per year in 1968 to almost $125 million per year in 1996. During that time, Herkimer's borrowings from Marine also grew to almost $12 million.

6. By arrangement with Marine, all of Herkimer's receipts were deposited daily into operating accounts maintained at Marine. Overdrafts on Herkimer's checking accounts routinely occurred in the course of Herkimer's business. Since large deposits of cash were being made by Herkimer on a daily basis, Marine permitted the overdrafts which were repaid on days when Herkimer had deposits in amounts large enough to cover them, and Marine charged Herkimer interest on the daily average outstanding amount.

7. From the beginning of its relationship with Marine, Herkimer had never been late in making payments on any mortgage, note or interest expense. However, its total indebtedness to Marine grew.

8. On Friday, September 24, 1996, representatives of Marine required Herkimer's officers to attend a meeting at Marine's offices. At that meeting, Herkimer was informed that Marine was altering its methodology for computing Herkimer's borrowing base (i.e., the amount of collateral maintained by Herkimer to support its loans). From that date forward, Marine eliminated the value of affixed and unaffixed tax stamps, cigarette coupons, cigarette coupon receivables and manufacturer's receivables to determine the loan amounts for which Herkimer qualified. As a result of this change, Herkimer was placed in default of its collateral obligations under the Marine loans.

9. On October 25, 1996, Herkimer and Marine entered into a Loan and Security Agreement (the "Loan Agreement") which consolidated and restructured certain of Herkimer's pre-existing debt to Marine. As pertinent here, Marine agreed to make available $250,000.00 to cover short term overdrafts in Herkimer's operating accounts with advances being repaid within five business days provided that the sum of the aggregate principal not exceed $8,850,000.00.

10. Herkimer's financial condition at the end of 1996 is summarized in an independent auditor's report issued by Pasquale & Bowers, Certified Public Accountants, on April 24, 1997.

> [Herkimer] incurred a substantial net loss for the period ended December 31, 1996. In addition, at December 31, 1996, [Herkimer] has a working capital deficit of approximately $4,400,000 and total liabilities exceed total assets by approximately $4,600,000. The loss included approximately $3,800,000 in trade and nontrade receivable allowances and write-offs and other significant increases in operating costs that management has deemed to be nonrecurring. These factors raise substantial doubt about [Herkimer's] ability to continue as a going concern. [Herkimer's] ability to establish favorable bank terms and maintain bonding and account drafting arrangements with cigarette manufacturers factor heavily into its ability to continue as a going concern. Management has met with representatives

> from its bank in an attempt to restructure debt and secure the bank's continuing support. The bank previously amended its loan agreement and provided an extension of the line through June 30, 1997.
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> During the last quarter of calendar 1996, management retained a group of industry consultants to assist in restructuring [Herkimer's] operations. . . . The new management team has analyzed operations and is focusing on increasing efficiency, profitability and cash flow through inventory management and reduced operating costs. Management is confident it is taking the steps necessary to enable [Herkimer] to return to profitability.
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> It is not possible, however, to predict at this time the success of management's efforts. The financial statements do not include any adjustments relating to the recoverability and classification of recorded assets, or the amounts and classification of liabilities that might be necessary in the event [Herkimer] cannot continue in existence.

11. As a condition of extending Herkimer's loans, Marine required Herkimer to seek a buyer for its business. Herkimer's principals entered negotiations with another New York State cigarette agent, A.D. Bedell, about the possibility of that agent's purchasing Herkimer's assets and inventory and assuming some of Herkimer's debt. The negotiations between Herkimer and the potential buyer broke down on November 5, 1997, and Bedell withdrew from further negotiations.

12. On Thursday, November 6, 1997, Herkimer received faxed copies of two letters from Marine's attorneys, Hancock & Estabrook, each dated November 6, 1997. The first letter notified Herkimer of Marine's demand for immediate repayment of all indebtedness owing under the Loan Agreement and for overdrafts existing in Herkimer's operating accounts plus interest, costs and expenses. In addition, Marine demanded all inventory, equipment, accounts, general intangibles and chattel paper of Herkimer and of a related company (Button Leasing Co.). Marine also demanded that Herkimer "hold in trust for the benefit of, and immediately turnover to Marine any proceeds of any of the Collateral now or hereafter in possession of the Borrower." Herkimer was warned that failure to turn over any proceeds might be deemed a criminal

conversion. Finally, Herkimer was informed that Marine would be returning all items submitted for payment to it, adding: "Borrowers' accounts are, as you are aware, currently overdrawn." The second letter dated November 6, 1997 corrected several amounts stated in the first letter. According to the letters, Herkimer's indebtedness under the Loan Agreement amounted to $9,750,000.00, and, Herkimer's overdrafts amounted to $1,234,495.04.

13. On the morning of Friday, November 7, 1997, Herkimer's principals learned that its operating accounts had been frozen as of November 5, 1997, and all monies in Herkimer's payroll account and operating account had been used by Marine to reduce Herkimer's debt. This included deposits of $148,897.66 made directly into a Marine account by Herkimer's sales personnel. As a result, an ACH debit submitted by Fleet Bank on November 5, 1997 for cigarette stamps purchased 30 days earlier was returned by Marine for insufficient funds.

14. At approximately 5:00 P.M. on November 7, 1997, Marine served Herkimer with a restraining order issued by the New York State Supreme Court of Onondoga County which prevented Herkimer from using or transferring any of the collateral (essentially all cash and assets owned by Herkimer and related corporations wherever located). This effectively prevented Herkimer from doing business.

15. On Monday, November 10, 1997, an involuntary petition under Chapter 7 of the Bankruptcy Code was filed against Herkimer in the United States Bankruptcy Court, Northern District of New York (the "Bankruptcy Court") and served on Herkimer on the same day. The petitioners were Geri Button, a sister of petitioners, A.E. Austin-Brown Associates, Inc. and Scott Brown & Co. The total amount of the petitioners' claims was $107,100.00.

16. On November 12, 1997, Marine moved in the Bankruptcy Court for an injunction enjoining Herkimer from using or otherwise disposing of certain collateral and cash collateral

described in the affidavit of Steven F. Ricca, a vice-president of Marine, and for an order prohibiting Herkimer's continued use of Marine's cash collateral during the pendency of the bankruptcy proceeding, among other things. In his affidavit, Mr. Ricca asserted that Herkimer's daily deposits ranged between $70,000.00 and $900,000.00 and that its deposits for the seven business days beginning November 6, 1997 through November 14, 1997 should have amounted to $2,175,000.00. Marine accused Herkimer of diverting this collateral since no deposits had been made into Marine accounts after November 6, 1997.

17. Honorable Stephen D. Gerling, Chief Judge of the Bankruptcy Court, issued an Order to Show Cause and Temporary Restraining Order on November 12, 1997 which, as pertinent here, states:

> **ORDERED,** that pursuant to § 303(f)[1] and pending the hearing and determination of the subject motion, the Debtor be and hereby is enjoined and restrained from using, transferring, selling, pledging, assigning, hypothecating or otherwise disposing of subject collateral other than in the usual and ordinary course of its business, and shall deposit any and all proceeds of the collateral collected since November 5, 1997 in a separate checking account to be established at Marine, except for the sum of $100,000 or such other amount as may be agreed to by the parties, currently on deposit at Albank, in order to cover payroll obligations for the weeks of Nov. 3rd and Nov. 16, 1997, pursuant to Rule 7065 of the Federal Bankruptcy Rules of Procedure, Rule 65(b) of the Federal Rules of Civil Procedure and Local Rule 913,2; and it is further
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> **ORDERED**, that at least one business day prior to said hearing, the Debtor shall provide Marine and its counsel with a detailed accounting with respect to the Debtor and its affiliates conduct with respect to the disposition of the collateral since November 5, 1997; along with copies of invoices and receivables listings reflecting all outstanding receivables as of November 12, 1997.

18. On November 26, 1997, Judge Gerling issued an order granting Herkimer's motion to convert the case to a Chapter 11 proceeding, and on December 10, 1997, Herkimer and Marine

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[1] Subsection (f) permits the debtor to continue to operate any business of the debtor and to dispose of property the same as if the case had not been commenced. However, the court is permitted to control the debtor's powers to prevent the debtor from disposing of assets to the detriment of the creditors. Judge Gerling did just this.

entered into a cash collateral stipulation, approved by the Bankruptcy Court, that allowed Herkimer access to the cash collateral subject to the terms of the stipulation. The stipulation was placed on the record of the hearing held on December 10, 1997. Stephen A. Donato, Esq., and James Canfield, Esq., appeared on behalf of Marine. The pertinent portions of the stipulation are as follows:

> Mr. Canfield: The debtor's use of cash in the cash collateral account on a given day is going to be limited to the extent that the inventory borrowing basis and receivable borrowing basis, and those are calculated per the October 25, 1996 Loan and Security Agreement, and collected funds in the cash collateral account exceed, then we have the following provisions: One is $6,552,900 as of December 11, 1997. That's defined as the base. That base is increased by $50,000 each day on Friday, December 12, Monday, December 15th, Tuesday, December 16th, Wednesday, December 17th and for Thursday, December 18th. That bases or the floor, as I call it, must be $6,758,000. That is essentially what Marine's collateral position was as of the date of the Petition.
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> In determining the borrowing bases, we are going to allow the debtor to include pre-paid inventory, which is in transit in the formula in determining those bases.
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> * * *
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> Mr. Donato: The debtor shall and has already opened up a debtor-in-possession account at Marine Midland Bank. During the terms of the stipulation the debtor shall comply with all terms and conditions of the Loan Agreement, except as modified herein, excluding known defaults as of today. *This includes compliance with Section 7 of the Loan Agreement requiring the deposit of all cash collateral and proceeds in the same medium in which received within 24 hours of receipt into the bank account at Marine Midland.*
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> *The debtor shall not engage in any transactions outside the ordinary course of business. The bank's collateral shall only be used in the ordinary course of the debtor's business. No other sale or disposition of the collateral shall be made by the debtor without further order of the Court.*
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> The cash collateral account shall be held under the joint control of the debtor, subject to the lien of the bank. *The debtor will not attempt to draw any checks against or initiate any wire transfer from the cash collateral account and hereby authorizes the bank to place a hold on the cash collateral account to ensure the prevention of same.*

> The debtor intends to use the cash collateral on a daily basis in varying amounts . . . on each day of the week in which the stipulation is in effect. And after receipt by the bank of a duly completed and verified cash collateral certificate for each particular date, . . . the bank shall transfer, from the debtor's cash collateral account to the [debtor-in-possession] account, the amount authorized in the cash collateral account, and to the extent of such funds, the debtor may use such funds in the ordinary course of business.
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> * * *
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> Mr. Donato: The bank will have no obligation to make any transfer from the cash collateral account to the debtor's [debtor-in-possession] account at the bank if the debtor is in default of any term or provision of this stipulation or any other loan document, except for known defaults as of today.
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> *Further, any transfers by the bank from the cash collateral account to the [debtor-in-possession] account, other than authorized by this agreement, will be subject to the bank's sole and absolute discretion.*

The collateral stipulation was approved by Order of the Bankruptcy Court.

19. When the ACH debit submitted by Fleet Bank was returned for insufficient funds, a representative of Fleet Bank notified Christine Bowen, a Tax Technician in the Division's Commodities Audit Unit. She was able to speak with Michael Button after making several phone calls to Herkimer over a period of a few days. He informed her of the bankruptcy proceeding and asked if Herkimer would be allowed to continue purchasing stamps. Ms. Bowen initially told Mr. Button that Herkimer would not be able to purchase stamps until Herkimer satisfied the outstanding balance of tax due on the prior purchases. After receiving the bankruptcy documents she had requested and discussing the matter with her supervisors, Ms. Bowen informed Mr. Button that Herkimer would be allowed to continue purchasing stamps; however, Herkimer was required to wire transfer payment for all stamps at the time they were ordered.

20. On December 8, 1997, the Division issued to Herkimer a Notice and Demand for payment of sales and use taxes due for the period ended November 8, 1997 in the amount of

$427,560.00 plus interest of $6,490.38 and penalty of $46,963.80 for a total due of $481,014.18 (assessment number L-014466172-5). The prepaid sales tax liability relates to stamps ordered by Herkimer in the period October 6, 1997 through November 7, 1997. Under the terms of the 30-day credit agreement, payments for those stamps would have come due from November 5, 1997 through December 7, 1997. ACH transactions were initiated by Fleet Bank on November 5, 1997, November 6, 1997, November 7, 1997, November 13, 1997 and November 14, 1997. These were returned by Marine for insufficient funds or because the operating account was frozen. When these ACH debits were returned by Marine, the Division accelerated the remaining payments due; thus, the Notice and Demand is for the period ended November 8, 1997, the last date of stamp purchase rather than the date the last payment was due, December 5, 1997. The Division filed a Proof of Claim in the bankruptcy proceeding on December 19, 1997 listing the December 8, 1997 sales tax assessment as well as claims for cigarette tax and highway use tax.

21. On January 26, 1998, the Division issued identical notices of determination to petitioners, assessing sales tax of $427,560.00 plus penalty and interest for the period October 7, 1997 through November 8, 1997. The notices state: "This notice is issued because you are liable as an Officer/Responsible Person for taxes determined to be due in accordance with sections 1138(a), 1131(1), and 1133 of the New York State Tax Law." The parties agree that the assessments were improperly drawn and should have been issued as a penalty equal to the tax due from Herkimer plus penalty and interest pursuant to Tax Law § 1145(e).

22. From December 10, 1997 through February 24, 1998, Herkimer continued to do business as a wholesale supplier of cigarettes and other products. During that time, it was able to purchase limited amounts of inventory and to make payroll payments to a small number of

employees. It continued to purchase tax stamps but was required to directly wire transfer payment for the stamps. On February 24, 1998, Herkimer ceased all operations, and the Bankruptcy Court issued an order permitting Marine to enforce the terms of the Stipulation and foreclose on all of the collateral securing Herkimer's indebtedness to Marine.

23. By letter dated February 25, 1998, R. John Clark, as the attorney for Marine, informed the Division that Herkimer, a licensed cigarette agent had surrendered possession of all of its inventory to Marine as a secured creditor and that Marine intended to sell the cigarettes and other tobacco product to a licensed wholesaler or wholesalers. The letter goes on to state:

> We are assuming that Marine's taking possession of the inventory of the Licensee and subsequent sale as the secured creditor to a licensed dealer would be deemed an "isolated circumstance" and that your Department would allow Marine to do such without obtaining an agent's license pursuant to Section 331.1(a)(5) and 332.1(a)(3) of the Regulations adopted under Article 20 of the New York State Tax Law.
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> Assuming such is the case, we would request written confirmation from your Department that Marine is authorized to act in the capacity of an agent without obtaining an agent's license for the purpose of liquidating the inventory of Licensee. If Marine intends to dispose of any of the tobacco inventory other than to a licensed wholesaler, Marine will advise you accordingly.

24. Peter Spitzer who was then an auditor in the Division's Registration and Bond Unit responded with a letter to Robert Markowski in Marine's Syracuse office, dated March 3, 1998. In that letter, the Division granted Marine authorization to act in the capacity of a cigarette agent and wholesale dealer, subject to certain conditions: (1) within three days after authorization was granted, and prior to any sales, the Division was to be allowed access to the premises to conduct an inventory of all cigarettes and tobacco products and any unaffixed New York State cigarette stamps; (2) all unaffixed tax stamps were to be returned to the Division at the time the inventory was conducted and "upon receipt of a properly completed Claim for Redemption/Refund of Cigarette Tax Stamps and Prepaid Sales Tax (CG-114), the refund claim will be processed and

paid pursuant to law;" all stamped cigarettes were to be sold only to licensed agents, wholesale dealers or retailers; (4) cigarettes were to be sold in accordance with the Cigarette Marketing Standards Act; tobacco products were to be sold tax free to a licensed distributor who would then be responsible for remitting the tax due; and (5) Marine was to submit a separate accounting of all cigarette and tobacco product sales providing the following information for each transaction entered into: customer name, address, license number, product type, brand, quantity sold, denomination of affixed tax stamps, selling price per unit without tax and total selling price per unit including tax if any.

25. On March 6, 1998, Mr. Spitzer received a second letter from Marine's attorneys referring to a conversation had the preceding day between Mr. Spitzer and one of Marine's attorneys, Mr. Clark. The letter asks Mr. Spitzer to state whether the Division would authorize a check to be issued payable directly to Marine or a two-party check to Marine and Herkimer in payment of a refund for unaffixed tax stamps in Herkimer's inventory. There is no evidence that Mr. Spitzer replied to the letter, nor is there evidence that Marine ever filed a claim for refund for tax stamps purchased by Herkimer.

26. Employees from the Division's Syracuse District Office conducted an audit of the Herkimer inventory which was completed on or before April 1, 1998. These employees removed unaffixed New York State tax stamps and tax stamps from other jurisdictions from the premises at this time.

27. Marine Midland retained American Industrial Auctioneering Co. of Buffalo, New York (the "Auctioneer") to dispose of Herkimer's inventory. Much of the cigarette inventory consisted of stale or otherwise unsalable cigarettes with tax stamps affixed. The entire Herkimer inventory was transferred to Tripifoods, Inc., a Buffalo cigarette agent, which tendered the best

offer in response to an offer to bid on the inventory. The inventory purchased by Tripifoods, included both stamped and unstamped cigarettes and sellable and unsaleable cigarettes.

28. The Bureau of Conciliation and Mediation Services issued identical conciliation orders to petitioners, each dated March 5, 1999. In those orders, the Division sustained the amount of tax assessed in the notices of determination but canceled the penalties assessed and ordered that the interest be recomputed at the applicable rate.

***SUMMARY OF THE PARTIES' POSITIONS***

29. Petitioners claim that they were effectively precluded from carrying out their obligation to pay the prepaid sales tax on cigarettes by Marine's actions in freezing Herkimer's operating accounts and obtaining court orders that denied petitioners control over the financial affairs of Herkimer. They argue that they cannot be held personally liable for prepaid sales taxes due from Herkimer because they were denied the authority to pay those taxes.

30. The Division alleges that petitioners had sufficient control over the financial affairs of Herkimer to satisfy the tax liabilities and chose not to do so. The Division alleges that Herkimer deposited in excess of $380,000.00 in an Albank account between November 5, 1997 and November 7, 1997. These funds, the Division alleges, were under petitioners' control and could have been used to satisfy the amounts which came due during that three-day period. The actual amount alleged is taken from the affidavit of Steven F. Ricca, a Marine vice-president, which was filed in the bankruptcy proceeding. His assertion is based on projections of daily receipts provided by Herkimer to Marine to support Herkimer's loan extension requests. Based on this evidence, the Division argues that petitioners were in a position to pay the $96,780.00 in prepaid sales tax liability which had accumulated by November 7, 1997. The Division insists that petitioners were not restrained by court order from expending Herkimer's capital until, at the

earliest, November 12, 1997, when Marine obtained a restraining order from the Bankruptcy Court.

The Division alleges that the payments for the remaining stamp purchases were due on dates between November 13, 1997 and December 5, 1997. Since Herkimer was operating as a debtor-in-possession as of December 5, 1997, the Division claims that petitioners had the authority to pay Herkimer's tax debts when they came due.

31. In ***Lincoln First Commercial Corp. v. New York State Tax Commn.*** (136 Misc 2d 478, 518 NYS 2d 904), a commercial lending corporation claimed that since tax stamps are permanently affixed to cigarette packages and since cigarettes cannot be sold without the stamps, the proceeds from the stamps (which were in an escrow account) were included in the corporation's prior perfected security interest in the property of the debtor, a cigarette agent. The court disagreed based on the position of the Division. It held that a cigarette agent cannot possess the type of rights in tax stamps which would permit it to pledge the stamps as collateral to a third party. By letter dated December 11, 1997, Herkimer's attorney, Karl E. Manne, asked the Division's Office of Counsel for an opinion concerning the interest of a secured party (Marine) in the cigarettes tax stamps of Herkimer. At Mr. Manne's request, the Division responded directly to Marine, in care of Hancock & Estabrook. The Division's letter, dated December 19, 1997, states, in relevant part:

> Licensed agents such as Herkimer are, by law, agents of the State for the administration of tax imposed by Article 20 of the Tax Law. Such agents are fiduciaries and must account to the State for any unused or unpaid for stamps. (Tax Law §§ 472.1, 473; 20 NYCRR Parts 331 and 337). Cigarette tax stamps are only and essentially tangible evidence of the payment of the cigarette tax, and cannot be pledged by an agent (*Lincoln First Commercial Corp. v. New York State Tax Commn.***,** 136 Misc 2d 478). Accordingly, Marine can never acquire a secured interest in cigarette tax stamps whether affixed to cigarettes or not. No private individual can obtain a lien on a sovereign State's taxing powers.

Based upon the opinion in ***Lincoln First Commercial*** and the Opinion of Counsel, petitioners argue that the Division had a duty to recover the proceeds of the unpaid tax stamps from Marine. The Division granted Marine permission to act as a cigarette agent to dispose of the cigarette inventory. According to petitioners, Marine also acquired a duty to account for any unused or unpaid for tax stamps in its possession. In petitioners' view, the Division treated Marine as if it had a lien on the tax stamps by permitting Marine to act as a cigarette agent and allowing Marine to transfer affixed tax stamps for which tax had not been paid. Since Marine did not and could not have a secured interest in the tax stamps, the Division should have sought payment for the tax stamps from Marine or repossessed the tax stamps not paid for, before granting Marine authority to act as a cigarette agent.

32. The Division contends that it was not required to seek collection of the prepaid sales tax from Marine. Since cigarette tax stamps evidence the payment of the cigarette and prepaid sales taxes, each stamp, according to the Division, serves as certification that another party (higher in the chain of distribution) has paid, or has assumed liability for the tax required to be paid. The Division, stating that there are no regulations with respect to certification for prepaid sales tax on cigarettes, draws an analogy to the prepaid sales tax on motor fuel and cites to the motor fuel tax regulations which state: "[I]f a properly completed certification is furnished to a purchaser by his seller and if such certification is accepted in good faith, the purchaser is relieved of any liability for the taxes" (20 NYCRR 561.5[c]). [2] According to the Division,

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[2] Petitioners note that Tax Law § 1132(k) (added by L 1995, c 2, § 56) does refer to certification. Section 1132 (k)(1)(I) provides that no person, other than one purchasing at retail, shall purchase cigarettes unless the prepaid sales has been paid by an agent and passed through by the agent or a wholesaler or retail dealer in accordance with a certification under Tax Law § 1132 (k)(1)(iii) or paid by the agent, wholesaler or retail dealer and passed on to the purchaser. Tax Law § 1132(k)(1)(iii) provides that upon the sale of cigarettes, other than at retail, the seller must give to the purchaser a certification. If the seller is an agent, the certification must state that the agent has paid the tax and is passing through the amount paid (Tax Law § 1132 [k][1][iii]) . Otherwise, the seller must state that it is passing through an amount assumed or paid by a previous agent, identified on the certification,

Marine, when it seized the cigarette inventory of Herkimer, was placed in the position of a purchaser of those cigarettes. Thus, the Division argues, the affixed tax stamps acted as certification from Herkimer to Marine that Herkimer had paid the prepaid sales tax or accepted liability for the prepaid sales tax, and Marine accepted that certification in "good faith." If it is found that Marine did not accept this certification in good faith, then, the Division argues, Marine would be jointly and severally liable with Herkimer for the taxes at issue. The Division contends that it is not required to seek payment of tax from each party liable for the tax, so petitioners are not relieved of liability even if Marine is found to be responsible also. Finally, the Division makes the following argument:

> Similarly, the Tax Law does not require the Division to seek recovery from Marine Midland for any funds it seized that were partially comprised of collected taxes. Even if the Division were so required, it could not collect from Marine Midland because there would be no way to determine what portion of such funds did, in fact, represent collected taxes. *Had Petitioners set up a tax accrual account to receive both the cigarette tax and the pre-paid sales tax that was routinely collected from its customers*[3], the Division would have had some basis to attempt collection from Marine Midland. However, even had those accounts been established, the Division would not have been *required* to pursue collection from Marine Midland (Division's brief, p. 11, citation omitted; first emphasis added, second emphasis in original).

Petitioners counter the Division's arguments by noting (1) that Marine took possession of the cigarettes in its capacity as a secured creditor and was not a purchaser of the cigarettes; (2) that under the circumstances there was no sale of cigarettes and Herkimer was not required to provide the certification provided for in Tax Law § 1132 (k)(1); (3) if, as the Division contends,

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which was previously passed on to the seller (Tax Law § 1132 [k][1][iii]). If the certification has been furnished to the purchaser and accepted in good faith, the burden is on the seller to show that tax was assumed or paid by a licensed agent and passed through to the purchaser (Tax Law § 1132 [k][1][iv]). If the certification is not furnished by the seller to the purchaser, it shall be presumed that the tax was not paid, and the purchaser will be jointly and severally liable for the prepaid sales tax (Tax Law § 1132 [k][1][v]).

[3] Herkimer did not routinely collect tax. It prepaid the sales tax imposed on consumers under Tax Law § 1105(a) and passed the amount through to its customers.

Marine was placed in the position of a purchaser, then in the absence of a certification the statutory presumption is that no amount of tax has been prepaid and Marine could not have accepted in good faith that the prepaid sales tax had been paid. In addition, since Marine was fully aware that the tax was not paid when demand was made through an ACH debit, it could not rely on good faith acceptance of any certification. Since the Division and Marine were aware of the outstanding sales tax liability, Marine should not have been allowed to transfer cigarettes with tax stamps affixed until the liability was satisfied.

33. Petitioners argue that the liabilities asserted against them should be reduced to the extent of the value of tax stamps returned to the Division for refund by Tripifoods and unaffixed stamps seized by the Division. According to Trippifoods' records, 17,467 cartons of cigarettes with tax stamps affixed were purchased by Trippifoods from Marine. The value of prepaid sales tax would have been $24,453.80. Petitioners calculated the value of prepaid sales tax related to the unaffixed tax stamps removed by the Division based on a two-page handwritten schedule prepared by Division employees and an internal Division memorandum. Petitioners also calculate that the Division removed 7,334 tax stamps which had a prepaid sales tax value of $1,026.76. The Division requested that the notices be sustained in full, and no adjustments be made for tax stamps removed by the Division from Herkimer's premises or tax stamps transferred to Trippifoods.

34. The final issue raised by petitioners relates to the form of the notice issued to petitioners. The Division acknowledges that the notices were incorrectly issued in the form of an assessment of tax, penalty and interest, rather than as an assessment of penalty equal to the amount of tax not paid, plus penalties and interest. Petitioners argue that if the notices are deemed valid, then they must also be deemed to be in the correct form, i.e., in the form of a

penalty equal to the amount of tax due, plus penalty and interest (a proposition also accepted by the Division). Since the Division issued a conciliation order canceling all penalty, the assessments, according to petitioners, are canceled in full. Petitioners also argue that the conferee must have found reasonable cause to cancel the penalties in order to reach the result he did.

35. The Division argues that despite facial defects on the face of the notice, the notices issued were nonetheless valid, and the defects have no consequence. It also contends that the conciliation orders canceled the section 1145(e) penalty assessed against the corporation and not the penalty equal to the amount of tax due assessed against petitioners. The Division contends that petitioners have not established reasonable cause for abatement of penalties. The Division claims that since petitioners were aware that Herkimer was in a precarious financial position, they should have established a cigarette tax and prepaid sales tax accrual account with Marine. According to the Division, these funds, if properly segregated, would not have been subject to Marine's control through its financing arrangements. Since petitioners did not take such steps to preserve the State's tax funds, they have not, in the Division's view, established reasonable cause.

The Division also takes the position that petitioners could have requested permission of the Bankruptcy Court to pay the taxes owed from its daily receipts and that their failure to do so shows that they did not have reasonable cause for failing to pay the taxes due.

## ***CONCLUSIONS OF LAW***

A. A valid assessment document is a prerequisite to the jurisdiction of the Division of Tax Appeals (***Matter of Negat,*** Tax Appeals Tribunal, April 9, 1992). The parties agree that the notices of determination issued to petitioners were incorrectly drawn as responsible officer

assessments pursuant to Tax Law §§ 1131(1), 1133(a) and 1138(a). A brief explanation is in order. Tax Law § 1131(1) defines "persons required to collect [sales] tax" as follows:

> [E]very vendor of tangible personal property or services; every recipient of amusement charges; and every operator of a hotel. Said terms shall also include any *officer*, director or employee of a corporation or of a dissolved corporation, any employee of a partnership or any employee of an individual proprietorship *who as such officer*, director or employee *is under a duty to act for such corporation*, partnership or individual proprietorship in complying with any requirement of this article; and any member of a partnership (emphasis added).

As Herkimer's president and vice-president, respectively, petitioners were under a duty to act for Herkimer in complying with all requirements of article 28. This includes Herkimer's obligation to pay the prepaid sales tax imposed on cigarettes under Tax Law § 1103. Therefore, although prepaid sales tax is not directly collected from the consumer, petitioners are "person[s] required to collect tax" according to the statutory definition. Tax Law § 1133(a) states that "every person required to collect tax" shall be personally liable for "the tax imposed, collected or required to be collected" pursuant to article 28. It would appear then that petitioners might properly be assessed pursuant to these provisions. However, the Division and petitioner assert, without explanation or discussion, that the notices were not properly issued.

B. Tax Law § 1103(a)(1) provides, in relevant part, as follows:

> Every cigarette agent shall pay, as a prepayment on account of the taxes imposed by [the Sales and Use Taxes article] . . . , a tax on cigarettes possessed for sale or use in this state and to which an agent is required to affix cigarette tax stamps under article twenty of this chapter, at the time that the agent is required to purchase and affix such stamps . . . and the provisions of such article twenty in relation to the use of stamps to evidence payment of the [cigarette] tax . . . shall be applicable to the prepayment imposed by this section . . . .

Tax Law § 1145(e) provides that any officer or employee of a corporation under a duty to act for such corporation "which fails to pay the tax required to be prepaid by . . . [Tax Law §

1103, Prepayment of sales tax on cigarettes, is] liable for a penalty equal to the total amount of the tax not paid, plus penalties and interest." Placing personal liability for the prepaid sales tax on corporate officers under Tax Law § 1133(a) would cause them to be liable, not only for tax, penalty and interest imposed against the corporation, but also for a penalty pursuant to Tax Law § 1145(e) equal to the tax imposed against the corporation, plus additional penalty and interest. A further statement in Tax Law § 1145(e) demonstrates that this result was not intended. As relevant, section 1145(e) states:

> [The penalty imposed by 1145(e)] shall be determined, assessed, collected and paid in the same manner as the tax required to be prepaid by section . . . eleven hundred three. . . . *Provided, however, that the penalty provided for by this subdivision shall not be imposed on any person* on account of the failure of such a distributor or agent to pay the tax required to be prepaid by . . . section eleven hundred three . . . of this article *if such person is liable for such tax pursuant to . . . subdivision (b) of such section eleven hundred three.*

Tax Law § 1103(b) provides as follows:

> (b) Except as otherwise provided in this section, the taxes required to be prepaid pursuant to this section shall be administered and collected in a like manner as the taxes imposed by sections eleven hundred five and eleven hundred ten of this article. *All the provisions of [article 28] relating to or applicable to the administration, collection and disposition of the taxes imposed by such sections shall apply to the tax required to be prepaid under this section so far as such provisions can be made applicable to such prepayments of tax with such limitations as set forth in [article 28] and such modifications as may be necessary in order to adapt such language to the tax so imposed*. . . . Such provisions shall apply with the same force and effect as if the language of those provisions had been set forth in full in this section *except to the extent that any provision is either inconsistent with a provision of this section or is not relevant to the tax required to be prepaid by this section*.

Thus, Tax Law § 1103(b) allows some modification of the provisions of article 28 if necessary, and a modification is necessary to prevent a person from being found liable for tax under Tax Law § 1133(a) and for penalty under Tax Law § 1145(e).

In short, there is no prohibition against the issuance of officer liability assessments under Tax Law §§ 1131(1) and 1133(a), but there is a prohibition against issuing both an officer

liability assessment and the penalty imposed under Tax Law § 1145(e). It is well established that where the Legislature enacts a specific provision directed at a particular class, and a more general provision in the same statute which might appear to encompass that class, the specific provision will be applied (***see***, ***People v. Marraro***, 71 AD2d 346, 349-350; McKinney's Cons Laws of NY, Book 1 Statues § 238). Inasmuch as the penalty provision of Tax Law § 1145(e) is the more specific provision, it should be applied except in those instances where it is totally inapplicable. Accordingly, petitioners should have been assessed a penalty equal to the tax not paid, plus, penalty and interest pursuant to Tax Law § 1145(e).

C. It is well established that defects on the face of the notice will not invalidate the notice, absent evidence of harm or prejudice to the petitioner (***Matter of Agosto v. Tax Commn.***, 68 NY2d 891, 508 NYS2d 934; ***Matter of Pepsico, Inc. v. Bouchard***, 102 AD2d 1000, 477 NYS2d 892; ***Matter of Mon Paris Operating Corp. v. Commissioner of Taxation & Fin.***, Sup Ct, Albany County, March 16, 1988, ***affd on other grounds*** 151 AD2d 822, 542 NYS2d 61; ***Matter of Cheakdkaipejchara***, Tax Appeals Tribunal, April 23, 1992; ***Matter of Tops***, Tax Appeals Tribunal, November 22, 1989). Here, there is no evidence that petitioners were prejudiced by the information on the face of the notice. Whether assessed as tax, penalty and interest or a penalty equal to the tax due, plus penalty and interest, the total amount assessed against petitioners is the same. Both Tax Law §§ 1131(1) and 1133(a) and the penalty provisions of Tax Law § 1145(e) place liability upon petitioners as a result of their status as corporate officers under a duty to act for Herkimer in complying with the Tax Law. Petitioners were informed of their rights to protest the assessments and availed themselves of those rights. The issues to be addressed are similar, if not identical, whether the amount owed was assessed as

a tax or a penalty. Petitioners were not misled or prejudiced in any way by the manner in which the notices were drafted.

The cancellation of penalties by the conciliation orders does not cancel the assessments in their entirety. The conciliation orders sustained the tax amount of $427,560.00 but canceled penalties imposed on that amount. It is apparent that the conciliation orders simply followed the form of the notices and were not intended to relieve petitioners of all liability for the prepaid sales taxes owed by Herkimer, but merely to cancel the penalty imposed on the amount of the unpaid sales tax.

As modified by the conciliation orders, the notices of determination issued to petitioners are deemed to be notices of determination of a penalty equal to the amount of prepaid sales tax not paid by Herkimer, plus interest, pursuant to Tax Law § 1145(e).

D. As pertinent here, Tax Law § 1145(e) places liability for the penalty imposed by that section only on corporate officers "under a duty to act for such corporation in complying with any provision of [article 28]." Inasmuch as this language is identical to that found in Tax Law § 1133(a), it is appropriate to look to the case law construing that section to determine whether petitioners were responsible officers pursuant to section 1145(e).

Whether an individual is under a duty to act for a corporation with regard to its tax collection responsibilities so that the individual would have personal liability for the taxes not collected or paid depends on the particular facts of the case (***Matter of Cohen v. State Tax Commn.***, l28 AD2d l022, 5l3 NYS2d 564). The question to be resolved in any particular case is whether the individual had or could have had sufficient authority and control over the affairs of the corporation to be considered a responsible officer or employee. The case law and the decisions of the Tax Appeals Tribunal have identified a variety of factors as indicia of

responsibility: the individual's status as an officer, director, or shareholder; authorization to write checks on behalf of the corporation; the individual's knowledge of and control over the financial affairs of the corporation; authorization to hire and fire employees; whether the individual signed tax returns for the corporation; and the individual's economic interests in the corporation (***Matter of Martin v. Commr. of Taxation & Fin.,*** 162 AD2d 890, 558 NYS2d 239; ***Matter of Cohen v. State Tax Commn., supra***, 5l3 NYS2d at 565; ***Matter of Constantino***, Tax Appeals Tribunal, September 27, 1990).

The holding of corporate office is not in and of itself a sufficient basis upon which to impose personal liability for sales taxes found owing by a corporation (***Chevlowe v. Koerner***, 95 Misc 2d 388, 407 NYS2d 427, 429). Likewise, the existence of some of the other factors enumerated above does not definitively resolve the issue of liability for sales taxes. Rather, the various factors provide a framework for deciding the ultimate question, whether an individual had a "*duty to act*" for a particular corporation in complying with article 28 of the Tax Law (Tax Law § 1131[1]). In most instances, a corporate officer with an economic stake in the corporation will be found to be under such a duty to act (***see***, ***e.g.***, ***Matter of Martin v. Commr. of Tax & Fin***., ***supra***; ***Matter of LaPenna***, Tax Appeals Tribunal, March 14, 1991). Exceptions have been found where the facts establish that the corporate officer has been precluded from acting on behalf of the corporation with regard to payment of sales taxes (***e.g.***, ***Matter of Constantino***, ***supra*** [where a majority stockholder prevented the petitioner from acting with regard to the financial and management activities of the corporation]; ***Matter of Stern***, Tax Appeals Tribunal, September 1, 1988 [where the corporation's assets, including all of its financial records, were seized by a creditor]). In addition, the Tax Appeals Tribunal has recognized that in a large corporation with a complex corporate structure even an officer with an influential financial role

may not be personally liable for sales taxes, because a finding that a person had a "duty to act" for a corporation must be premised upon a factual determination that the corporate officer had the authority to ensure that sales taxes owed by the corporation were paid (***see***, ***Matter of Roncolato***, Tax Appeals Tribunal, August 15, 1991).

Here, petitioners claim that, although they were corporate officers and had both a duty to act for Herkimer and authority to do so during most of the time during which the corporation existed, they are not liable for the assessed penalty because they were precluded from paying these specific taxes by the actions of Marine. I agree for the following reasons.

A cigarette agent is one licensed by the Commissioner of Taxation and Finance to purchase stamps and to affix stamps on packages of cigarettes pursuant to article 20 of the Tax Law. As a cigarette agent, Herkimer was required to pay, as prepayment on account of the taxes imposed by article 28, a tax on the cigarettes it possessed for sale in New York—the prepaid sales tax on cigarettes. The prepaid sales tax on cigarettes is required to be paid at the same time and in the same manner as the cigarette tax imposed under article 20 (Tax Law § 1103[a][2]).

Herkimer and the Division entered into an agreement whereby Herkimer was allowed to purchase tax stamps on a 30-day credit. Payment for stamps purchased on October 6, 1997 came due on November 5, 1997; payment for stamps purchased on October 7, 1997 came due on November 6, 1997; and so forth. Under the terms of the credit agreement, payments for stamps purchased between October 6, 1997 and November 7, 1997 came due between November 5, 1997 and December 5, 1997. However, when the ACH debits submitted to Herkimer's Marine operating accounts were returned, the Division accelerated the payment due dates so that all the tax became due and payable as of November 8, 1997. Accordingly, on December 8, 1997, the Division issued to Herkimer a Notice and Demand for Payment of sales tax due for the period

ended November 8, 1997 in the amount of $427,560.00, plus penalty and interest. The Proof of Claim filed by the Division in Herkimer's bankruptcy proceeding refers to the Notice and Demand of December 8, 1997. The notices of determination issued to petitioners were for the period October 7, 1997 through November 8, 1997. Moreover, the Division takes the position that Herkimer's liability for the prepaid sales tax runs from the date of purchase and not the payment due dates under the 30-day credit agreement (Division's Further Bill of Particulars, Exhibit "H", ¶ 1[c]). The conclusion drawn from these facts is that Herkimer acquired no debt for prepaid sales taxes after November 8, 1997. This conclusion becomes significant when considering whether petitioners were precluded from paying that debt.

The payment for tax stamps purchased by Herkimer was debited from its operating accounts 30 days after the purchase. Before November 5, 1997, the ACH debits submitted by Fleet Bank on behalf of the Division were paid. Pursuant to its loan agreements with Marine, overdrafts on Herkimer's operating account were routine and did not result in the return of items drawn on that account. Furthermore, on November 5, 1997, Herkimer's operating account had sufficient funds in it to satisfy the ACH debit submitted by Fleet Bank. On that date, Marine froze Herkimer's operating account without notice to petitioners and applied approximately $148,800.00 in deposits then existing in that account to Herkimer's outstanding loan balances. Marine did not inform petitioners of this action until November 7, 1997. As a result of Marine's actions, all ACH debits issued by Fleet Bank on November 5, 6 and 7, 1997 were returned unpaid. On November 7, 1997, Marine served Herkimer with a restraining order issued by the State Supreme Court which prohibited Herkimer from using or transferring any of Marine's collateral (essentially all of the assets and cash of Herkimer wherever located). From this point forward, petitioners had no authority to pay any bills or use any funds of the corporation.

The Division is wrong in its assertion that petitioners were not restrained from utilizing Herkimer's capital until November 12, 1997 when Marine filed for a restraining order in the bankruptcy proceeding. This assertion ignores the effect of the State Supreme Court's order. Herkimer was restrained by that order from expending any monies, not just the funds on deposit in Marine accounts, but also funds deposited by Herkimer in an Albank account. Moreover, the filing of an involuntary petition in bankruptcy by other creditors did not free petitioners to expend Herkimer's capital to pay debts which became due before the filing of that petition (***see***, ***Matter of Ft. Dodge Co.***, 121 Bankr 831, 835).

I do not detect a nefarious motive in Herkimer's deposit of daily receipts in an Albank account. Payments from customers continued to be received by Herkimer after its Marine accounts were frozen, and Herkimer was required to do something with those payments. There is no evidence that Herkimer hid deposits from Marine or attempted to divert receipts, despite any statements to the contrary in Mr. Ricci's affidavit. Marine would certainly have addressed this issue in the hearing held on December 10, 1997 if it believed Herkimer was hiding funds. In fact, the stipulation between Herkimer and Marine addressed the Albank deposits directly when Marine agreed to allow Herkimer to use a portion of those funds to pay its employees for wages due. This is further evidence that any monies deposited in the Albank account were subject to the authority of the Bankruptcy Court and could only be expended by order of that court. Mr. Ricci's claim that Herkimer deposited over $380,000.00 in the Albank account between November 5 and November 7, 1997 is pure speculation and, in light of other evidence in the record, very unlikely.

Petitioners never regained the authority to pay the outstanding tax liabilities after November 5, 1997. Petitioners were subject to the restraining order of the State Supreme Court

until the involuntary petition was filed on November 10, 1997. At that point, Herkimer became subject to the authority of the Bankruptcy Court. Although the case was converted to a chapter 11, voluntary petition, Herkimer continued to operate under the constraints of its stipulation with Marine until February 24, 1998 when Herkimer ceased operations and all of the assets of the debtor-in-possession reverted to Marine.

Herkimer was restrained by the order of the Bankruptcy Court and the stipulation from using Marine's cash collateral for any transactions "outside the ordinary course of business." Contrary to the Division's assertions to the contrary — Herkimer was authorized to pay debts as they became due and had no authority to satisfy the claims of other unsecured creditors, such as the Division. Furthermore, Herkimer was required to deposit all receipts in a Marine collateral account from which monies were transferred to the debtor-in-possession account subject to Marine's approval of each expenditure on a daily basis. As a result of the bankruptcy proceeding, Herkimer was prohibited from paying any pre-petition debt, including tax debts incurred prior to the filing of the petition in bankruptcy (***see, Matter of Bulk Transport,*** 23 Bankr 538, 539). As the Division's Proof of Claim demonstrates, all of the taxes in issue in this proceeding were pre-petition debt.

The facts and circumstances of this case are distinguishable from cases where a corporate officer has been held liable for sales taxes collected while the corporation was a debtor-in-possession (***e.g., Matter of Binder***, Tax Appeals Tribunal, August 19, 1993 [where the debtor-in-possession continued to collect sales tax from its customers but failed to pay that tax over to the State]). Here, there is no evidence that any tax liabilities were incurred during any period of time when petitioners were in control of Herkimer's finances. No taxes owed by Herkimer went unpaid until Marine froze Herkimer's accounts on November 5, 1997. No

further liabilities were incurred after Herkimer resumed operation of its business as a debtor-in-possession. Herkimer's tax liability is coextensive with that period of time in which petitioners were prevented from exercising their duty to pay the taxes. In its Further Bill of Particulars, the Division states: "the Division will concede that the responsible officers can be relieved of [tax] liability if it is established that their authority to act was extinguished *prior to the due date for payment of the tax*" (Exhibit "H", ¶ 1[d]). Petitioners' authority to pay the $427,560.00 in prepaid sales tax in issue was extinguished before the due dates for payment of the tax, November 5, 1997 through November 8, 1997, by the following: (1) the freezing of Herkimer's operating account by Marine on November 5, 1997; (2) the State Supreme Court temporary restraining order filed on November 7, 1997; (3) the order of Judge Gerling issued on November 12, 1997; and (4) the stipulation between Herkimer and Marine which was made an order of the Bankruptcy Court on December 10, 1997.

Petitioners lacked the authority to see that the prepaid sales tax was paid when payment came due, and, consequently, they were not under a "duty to act" for Herkimer with respect to the payment of those taxes.

E. Inasmuch as petitioners are found not liable for the assessment in issue, I need not address whether there was reasonable cause for failure to pay the tax or whether the Division had any obligation to seek return of the stamps or payment for them from Marine.

F. The petition of Michael D. Button and James F. Button is granted, and the notices of determination issued on December 8, 1997 are cancelled.

DATED: Troy, New York
October 12, 2000

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE