STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

VGR SYSTEMS CORPORATION :

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 March 1, 2003 through February 28, 2006. :

: DETERMINATION
DTA NOS. 823639 AND 823640

In the Matter of the Petition :

of :

MICHAEL J. SCHNEIDER :

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 June 1, 2005 through February 28, 2006. :

Petitioner VGR Systems Corporation 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 March 1, 2003 through February 28, 2006.

Petitioner Michael J. Schneider 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 June 1, 2005 through February 28, 2006.

A hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on October 25, 2011, at 10:00

A.M., with all briefs to be submitted by March 26, 2012, which date commenced the six-month period for issuance of this determination. Petitioners appeared by Keith J. Roland, Esq. The Division of Taxation appeared by Mark F. Volk, Esq. (Osborne K. Jack, Esq., of counsel).

ISSUE

Whether the transactions between petitioner VGR Systems Corporation and various store owners are subject to sales tax pursuant to Tax Law § 1101(b)(5) as a transfer of possession, rental, lease or license to use for a consideration.

FINDINGS OF FACT

1. Petitioner VGR Systems Corporation (VGR) manufactures, installs and services video viewing booths for adult book stores. VGR's headquarters are located in Cleveland, Ohio. VGR sells video equipment to customers who operate these machines as their own business. Another portion of VGR's business consists of the installation of video machines in a store owner's premises and sharing the revenue generated by the video booths. It is this portion of VGR's business operation that is the subject of this matter.

2. On March 17, 2006, the Division of Taxation (Division) sent a letter to VGR stating that the business's sales and use tax records had been scheduled for a field audit for the period March 1, 2003 through February 28, 2006. A schedule of books and records to be produced was attached to the letter. The letter specifically requested, among other records, federal income tax returns, New York State corporation tax returns and sales tax returns, the general ledger, sales invoices and bank statements for the entire audit period.

3. Petitioner VGR, on November 22, 2006, appointed Jeffrey D. Donohoe, of J Donohoe & Associates LLC, as its representative in the sales tax audit.

4. In response to the Division's request for records, VGR provided copies of its sales tax returns and New York State corporation tax reports for the years 2003 and 2004. In reviewing the information in these documents, the auditor discovered a discrepancy between income reported on the corporation tax reports and the amount of sales reported on the sales tax returns.

5. In response to the auditor's inquiries as to the basis of the discrepancy, Mr. Donohoe wrote to the auditor on May 31, 2007 and provided copies of an agreement between VGR and one of its New York State customers and a statement of VGR's operations in New York State.

6. The May 31, 2007 letter from Mr. Donohoe stated that a copy of a service agreement was enclosed, and further stated that: "[t]he general terms and conditions of this agreement are consistent with the other NY locations. Fees and the length of the contract are the primary variables."

7. On June 12, 2007, the auditor requested that petitioner provide "a listing of service contracts in New York State, all information containing the amount of revenue generated by each service contract in New York State, and the [*sic*] a depreciation schedule listing the equipment held in New York State by VGR Systems Corporation." The auditor added that "[u]pon review of the single service contract that you mailed to me it is necessary to obtain and review all of the service contracts for the audit period." No additional service contracts were provided to the auditor.

8. The agreement between VGR and the proprietor located in New York State was effective June 2003 and was for a five-year period. Introductory paragraphs of the agreement state that the proprietor "wishes to secure the use of a number of video viewing booths at the Premises," and that VGR "will incur certain expenses in the installation, servicing and

maintenance of the video viewing booths . . ., and those expenses and activities form a part of the consideration of this Agreement. . . ."

Paragraph 1 of the agreement is entitled "Licenses," and provides the respective rights and privileges relating "to the installation, servicing, maintenance, use and/or operation of the video viewing booths. . . ." Pursuant to the agreement, the proprietor grants to petitioner "the right and privilege to install, service, and maintain video viewing booths on the Premises . . . ." The placement of the video viewing booths (machines) on the premises is to be determined by mutual agreement. The term "machine" as used in the agreement includes "the booths, furniture, signs, electronic equipment, video players, coin changers, control panel, and any other related equipment but do[es] not include any videos or video disks." VGR grants to the proprietor "the right and privilege to use and operate the Machines at the Premises . . . ."

Paragraph 3 of the agreement is entitled "Fees & Taxes," and provides that the proprietor agrees to pay VGR a fee equal to a percentage of the gross revenues derived from the operation of the machines. The term "gross revenues" from the operation of the machines is defined as "all proceeds of such operation, in whatever form, including but not limited to coins, bills, tokens or other monetary equivalents."

Paragraph 7 of the agreement is entitled "Proprietor's Representations and Obligations," and states the various material inducements to petitioner to enter into the agreement. The agreement states that the proprietor has received all permits required by any governmental authority related to the operation of the premises and the conduct of the business, will keep the machines insured for full replacement value against all type of loss and name petitioner as loss payee, notify petitioner of any failure of any machine or component to function properly and permit VGR, at any time, to remove service or repair all or part of the machine, maintain certain

business hours, keep the machines connected to electric and service outlets during business hours, in readiness for operation by customers, keep the areas in and around the machines in a clean and orderly condition, provide adequate security for the premises, agrees that the machines installed on the premises are owned, installed and serviced by VGR and will keep machines marked to indicate VGR's ownership, continue to comply with all governmental rules and regulations regarding operation of the business, be solely responsible for all payments and other fees due to the owners of any copyrights related to the tapes, videos and other disks which are utilized in the machines and be solely responsible for the selection and provision of the tapes, videos and disks utilized in the machines.

Paragraph 8 of the agreement is entitled "Contractor's Representations and Obligations," and states the various material inducements to the proprietor to enter into the agreement. The agreement states that VGR will provide and install the machines on the premises; repair or replace defective or nonfunctional machines within a reasonable period of time; maintain an adequate number of machines in its sole discretion to properly service the demand for entertainment at the premises, with the option to remove or replace machines, consult with the proprietor concerning the number of machines and to inform the proprietor before any equipment is removed due to insufficient usage (the agreement defines an amount of average weekly gross revenue measured over any four consecutive weeks as sufficient usage); consult with the proprietor about increasing the number of machines where weekly gross collections indicate that additional machines could be operated profitably, provide trained service technicians on a weekly basis to insure the equipment is operating properly, collect, account for, and promptly pay over to the proprietor the appropriate amount of revenue and change the proprietor-supplied tapes, videos and disks in the machines on a regular basis.

9. Petitioner VGR executed two consents extending the period of limitations for assessment of sales and use taxes under Articles 28 and 29 of the Tax Law that collectively extended the period in which to assess sales and use taxes due for the period March 1, 2003 through February 28, 2006 to March 20, 2009.

10. At the time of the audit, VGR had filed its New York State general business corporation franchise tax returns, form CT-3, for the years 2003 and 2004. In computing its business allocation percentage, and specifically receipts received in the regular course of business, the returns indicate amounts for "Sales of tangible personal property allocated to New York State," but do not report any expenses for rent paid.

For the year 2003, VGR reported sales of tangible personal property allocated to New York State in the amount of $284,038.00. From this amount, the auditor subtracted sales reported on VGR's sales tax returns for the period March 1, 2003 through February 29, 2004 of $120,752.00 to arrive at additional taxable sales of $163,286.00.

On its 2004 General Business Corporation Franchise Tax Return, VGR reported sales of tangible personal property allocated to New York State of $246,336.00. From this amount, the auditor subtracted sales reported on VGR's sales tax returns for the period March 1, 2004 through February 29, 2005 of $16,503.00 to arrive at additional taxable sales of $229,883.00.

Although VGR had not filed its General Business Corporation Franchise Tax Return for the year 2005, petitioner did provide to the auditor an operations report, which indicated sales of tangible personal property in New York State of $348,949.00 for the year 2005. Subtracting sales reported on VGR's sales tax returns for the period March 1, 2005 through February 29, 2006 of $100,075.00, the auditor arrived at additional taxable sales of $248,874.00.

In total, the auditor determined additional taxable sales of tangible personal property in New York State of $641,993.00 and additional sales tax due of $54,207.93 for the audit period.

11. In addition, the auditor determined that VGR had failed to pay sales tax collected in the amount of $4,138.36, owed additional tax on sales of equipment in the amount of $4,216.48 and owed additional tax of $1,880.00 where an incorrect sales tax rate was applied. Petitioners stipulated that they owe sales tax of $10,234.84 relating to these three areas of the audit.

12. During the audit, the auditor visited a proprietor located in New York State that had VGR machines on its premises. The screens of the video viewing booths identified the proprietor as the operator of the machines.

13. On the basis of the audit performed, the Division issued a Notice of Determination (assessment number L-030703077), dated October 3, 2008, to VGR, which assessed sales and use tax for the period March 1, 2003 through February 28, 2006 in the amount of $64,442.77, plus interest.

14. On December 1, 2008, the Division issued to petitioner Michael J. Schneider a Notice of Determination (assessment number L-031111890) of sales and use taxes due in the amount of $21,987.55, plus interest, for the period June 1, 2005 through February 28, 2006. The notice indicated that Mr. Schneider was being assessed as an officer or responsible person of VGR Systems Corporation, pursuant to sections 1131(1) and 1133 of the Tax Law. Petitioner Michael J. Schneider stipulated at hearing that he was, during the period June 1, 2005 through February 28, 2006, an officer or responsible person of VGR, pursuant to sections 1131(1) and 1133 of the Tax Law.

15. During the audit period, VGR would install the video booths and other equipment in a customer's location at no cost to the customer. The customers of VGR were operators of adult

bookstores that existed prior to the installation of the video booths. VGR was not involved in the bookstores' business of selling movies, DVDs and adult novelties.

16. Members of the public visiting the adult bookstores had three methods of paying to view the programs in the video booths. Viewers could make payment to the store owner for tokens, which operated the devices. To deter loitering, VGR established a minimum purchase of $5.00 in tokens. The money received by the store for tokens was placed into a secured lockbox belonging to VGR. Only the VGR employee had access to the lockbox. Viewers could also purchase tokens directly from a token dispenser. The dispensers were kept under lock and key, with VGR having the only keys to access the money. Store owners did not have a key, and were not permitted to withdraw or access the token dispensers. The third and final method was for viewers to place quarters or paper money directly into the video booths. All of these direct payments into the machines were kept under lock and key, with only VGR having the keys to access and remove the money. The store owner had no key and was unable to remove the money from the machines.

17. VGR serviced the video booths, collected the monies on a weekly basis, determined gross revenues from the operation of the video booths and paid over to the store owner the appropriate percentage of the gross revenues as rent. Each week, a VGR employee would visit the stores and review the meter readings on the machines, which indicated the amount of money or tokens used in that particular booth. Meter readings were also taken from the token machines. The VGR employee would then perform a reconciliation by totaling the amount indicated by the meter readings of all the video booths, and then comparing the total with the money in the video booths, the money in the token machines and the money collected by the store clerks and placed in the lockbox. After determining the total gross revenue associated with the use of the

machines, the VGR employee would calculate the amount to be paid to the store owner based upon the contractual percentage of the gross revenue. Monies due to the store owner were paid by the VGR employee at the time the monies were collected at the store.

18. During the hearing, the parties stipulated that the Division had properly requested VGR's books and records and that the audit was conducted based on the records provided.

CONCLUSIONS OF LAW

A. The issue in this matter concerns the relationship between VGR and the proprietors of the store locations where VGR's video viewing booths were installed. VGR contends that the relationship constituted a lease of space in the store where VGR would install, maintain and operate its video devices. It is the position of the Division that the transactions at issue constituted a rental, lease or license to use tangible personal property subject to the imposition of sales tax.

B. Section 1105(a) of the Tax Law imposes a sales tax upon "[t]he receipts of every retail sale of tangible personal property, except as otherwise provided by this article." The term "sale" is defined by Tax Law § 1101(b)(5) as "[a]ny transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume . . ., conditional or otherwise, in any manner or by any means whatsoever for a consideration, or any agreement therefor . . . ."

The phrase "transfer of possession" is defined at 20 NYCRR 526.7(e)(4) as follows:

> Transfer of possession with respect to a rental, lease or license to use, means that one of the following attributes of property ownership has been transferred:
>
> (i) custody or possession of the tangible personal property, actual or constructive;
>
> (ii) the right to custody or possession of the tangible personal property;

> (iii) the right to use, or control or direct the use of, tangible personal property.

It is a well-settled principle that "only transactions involving passage of title or of actual exclusive possession constitute sales" (***Matter of Darien Lake Fun Country v. State Tax Commn.***, 118 AD2d 945, 946 [1986], ***affd*** 68 NY2d 630 [1986], ***citing Matter of Shanty Hollow Corp. v. State Tax Commn.***, 111 AD2d 968, 969 [1985], ***lv denied*** 66 NY2d 603 [1985]). Further, rental agreements and licenses to use may meet the definition of a sale (***Matter of American Locker Co. v. Gallman***, 32 NY2d 175 [1973]; Tax Law § 1105[b][5]).

C. Several cases cited by both the Division and petitioners are instructive in determining the factors to consider in reaching a conclusion to the issue presented herein. In ***Matter of Bathrick Enterprises, Inc. v. Murphy*** (27 AD2d 215, 277 NYS2d 869 [1967], ***affd*** 23 NY2d 664, 295 NYS2d 489 [1968]) the taxpayer was the owner and operator of coin-operated amusement devices such as automatic phonographs and bowling games. The devices were installed in places such as restaurants and taverns pursuant to agreements with the operators of these establishments whereby they and the taxpayer would share the receipts from the devices. Upon a motion to dismiss the complaint, Special Term held that the receipts from these devices were subject to sales tax under Tax Law § 1105(a). On appeal, the Appellate Division reached a different conclusion and stated, in pertinent part, as follows:

> The respondent's contention that the receipts from these devices are subject to the tax because the use thereof grants a license to use personal property, is untenable. In the operations under consideration, it was never intended that there be (nor was there) any passage or transfer of title nor were they such that actual, exclusive possession was transferred.
>
> The principle here involved has been passed upon in ***American Locker Co. v. City of New York*** (308 NY 264), wherein a similar city tax was attempted to be levied on receipts from coin-operated lockers used for storing baggage. The Administrative Code of the City of New York defined a sale substantially as here,

> including the "license to use" language in the statute under interpretation. The court there (p. 267) held that 'The purpose of the sales tax is not to impose tax on all transactions, but only on transactions which involve the passage or transfer of title (see Personal Property Law, § 82, for definition of sale), or transactions in which the actual, exclusive possession is transferred'. (***Matter of Bathrick Enterprises, Inc. v. Murphy***, 277 NYS2d at 871).

In ***Matter of Rowe Cigarette Services Co. v. Graves*** (247 App Div 852[1936]) the retention of the right to exclusive access to the money contained in cigarette vending machines rendered the store owner to have granted a license to the supplier to use real property. Retaining control over the access to the money in the machines resulted in a decision that the supplier of the machines had failed to effect a transfer of "actual, exclusive possession," the prerequisite to the establishment of a "sale."

Finally, in an Advisory Opinion (TSB-A-83[16]S [corrected copy]) dated March 28, 1983 that contains factual circumstances similar to the matter at issue, the Division concluded that as the taxpayer retained total control over the money, there was no transfer of possession so as to constitute a sale within the meaning of Tax Law § 1101(b)(5).

D. The Division correctly points out that there are several provisions in the 2003 service agreement that are consistent with the conclusion that the transactions between VGR and the store owners constitute a rental or lease of tangible personal property. The agreement provides that the proprietor is to pay VGR a percentage of the gross revenues derived from the machines, obtain all governmental permits, insurance, electricity and security for the machines, clean the area around the machines and provide all tapes, videos and disks used in the machines.

However, the agreement also contains provisions that support petitioners' position that VGR retained control of the machines and was merely renting space from the proprietors. The agreement provides that VGR would incur certain expenses to install, service and maintain the

machines, continued to own the machines, would repair or replace defective machines, determine the number of machines in the store, provide trained technicians to service the machines, would change the tapes, videos and disks on a regular basis and would collect, account for and pay over to the proprietor the appropriate amount of revenue earned by the machines.

As the case law and the Division's own advisory opinion make clear, the most important factor in determining whether VGR relinquished exclusive possession of the video viewing booths to the proprietor of the stores in which they were placed is which party to the transaction had the right to access to the money contained in the machines, token dispensers and lockbox. Customers had three methods of paying to view the programs in the video booths: cash payments to the store clerk for tokens; purchasing of tokens from a token dispenser; and cash payments directly into the video booths. The cash payments received by the store clerk were placed in a secured lockbox owned by VGR. Only VGR employees had keys to access the lockbox, the token dispensers and the video booths. The store owners were not given a key to the lockbox, token dispensers or video booths. Furthermore, VGR employees serviced the booths, collected the money on a weekly basis, determined gross revenues from the operation of the video booths and paid over to the store owner the appropriate percentage of the gross revenues. By retaining the right to exclusive access to the money contained in the lockbox, token dispensers and video booths, VGR did not effect a transfer of "actual, exclusive possession" of the video viewing booths, and was not involved in a sale of tangible personal property within the meaning and intent of Tax Law § 1101(b)(5) and 1105(a) (***Matter of Bathrick Enterprises, Inc. v. Murphy***; ***Rowe Cigarette Services v. Graves***; TSB-A-83[16]S [corrected copy]). Therefore, the portion of the notices of determination that assessed additional sales tax due of $54,207.93 for the audit

period based upon the determination that VGR had additional taxable sales of tangible personal property in New York State of $641,993.00 is canceled.

E. It is noted that this determination relies on the testimony of an officer of VGR concerning the business relationship between VGR and the store proprietors. The Division argues that such testimony should be ignored where the language of the original agreement is unambiguous, citing, among other cases, ***Matter of Landmark Dining Systems, Inc. v. Tax Appeals Tribunal*** (224 AD2d 785, 637 NYS2d 524 [1996]). Unfortunately for the Division's position, the 2003 agreement is internally inconsistent as to the key factor of which entity is to pay the other. Under these circumstances, it was appropriate to use the officer's testimony in reaching a determination in this matter.

F. Petitioners stipulated that they owe sales tax of $10,234.84 relating to three other areas of the audit. These areas consist of the failure of VGR to pay sales tax collected in the amount of $4,138.36, the determination of additional tax due on sales of equipment in the amount of $4,216.48 and the determination of additional tax due of $1,880.00 where an incorrect sales tax rate was applied. This portion of the notices of determination is sustained.

G. The petitions of VGR Systems Corporation and Michael J. Schneider are granted to the extent indicated in Conclusion of Law D and denied to the extent indicated in Conclusion of Law F. The Division of Taxation is directed to recompute the notices of determination issued to VGR Systems Corporation, dated October 3, 2008, and to Michael J. Schneider, dated December 1, 2008, accordingly.

DATED: Albany, New York
June 14, 2012

/s/ Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE