STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **STRATA SKIN SCIENCES, INC.** 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, 2014 through August 31, 2017.	: : : : :	DETERMINATION DTA NO. 828704

Petitioner, Strata Skin Sciences, Inc., 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, 2014 through August 31, 2017.

A hearing was held on February 13, 2020 in New York, New York, at 10:30 a.m., with all briefs to be submitted by July 23, 2020, which date began the six-month period for issuance of this determination. Petitioner appeared by Wilson Law Group LLC (Margaret C. Wilson, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Anita Luckina, Esq., of counsel). After due consideration of the documents and arguments submitted, James P. Connolly, Administrative Law Judge, renders the following determination.

ISSUE

Whether the Division of Taxation erred in determining that petitioner's sales under its usage agreements were subject to sales and use tax as the sale of tangible personal property.

FINDINGS OF FACT

1. Petitioner is a publicly traded Delaware corporation that develops, manufactures, and commercializes products for the treatment of dermatological disorders. In June 2015, petitioner acquired an excimer laser technology called the XTRAC laser from PhotoMedex, Inc.

(PhotoMedex). The XTRAC laser is an ultraviolet light excimer laser system that generates and delivers targeted ultraviolet light at the 308 nanometer (nm) wavelength to affected skin areas. Petitioner manufactures the XTRAC lasers that it provides to physicians.

2. The XTRAC laser is not a tool for general use for the physician; instead, it performs only one function: the delivery of phototherapeutic light treatments for the clinical treatment of skin diseases approved by the Federal Food and Drug Administration (FDA). Currently, the FDA has approved it to be marketed for the treatment of psoriasis, vitiligo, and other skin disorders.

3. Phototherapeutic light treatments of 308nm wavelength can only be delivered using a device that produces that light. There is no inventory of light in the XTRAC laser. The phototherapeutic light is created on demand inside the device when a mixture of two gases is excited by an arc of electricity. The light is guided and dispensed through a light guide, ending in a handpiece that is placed on the affected skin. The patient cannot see or feel the therapeutic treatment when it is delivered by the XTRAC laser, as the light emitted by the device has no tangible properties and cannot be perceived by touch or sight.

4. In July 2016, the Division of Taxation (Division) commenced a field audit of petitioner for the period (after extensions) of March 1, 2014 through August 31, 2017 (audit period). The audit was conducted in detail. The audit determined that petitioner had properly collected sales tax on its outright sales of the XTRAC lasers in New York and those sales are not at issue herein. The parties disagreed during the audit, however, about the sales tax consequences of petitioner's recurring revenue model for marketing the XTRAC laser in New York and nationally during the audit period. Under this model, petitioner placed the XTRAC laser in a physician's office at no up-front cost to the physician and charged the physician to use

the laser on a per-treatment basis, pursuant to a usage agreement, which also entitled the physician who entered into the usage agreement (participating physician) to a suite of services. The Division contended that, for sales tax purposes, the usage agreements embodied taxable sales of the XTRAC lasers. Petitioner disagreed, arguing that the revenue it received under the usage agreements was for phototherapy light services and thus not subject to sales tax. Alternatively, petitioner argued that the its sales under the usage agreements were exempt from sales tax as drugs or medicines, citing Tax Law § 1115 (c) (3). When the parties could not come to an agreement, the Division issued to petitioner notice of determination number L-047770120, dated February 23, 2018, asserting additional sales and use tax due of $529,935.46, plus penalty and interest.[1]

Payments Under the Usage Agreement

5. To use the XTRAC laser, the participating physician first had to purchase treatment codes from petitioner. In fact, before petitioner would locate an XTRAC laser in the physician's office, the doctor would generally have to buy an initial set of treatment codes from petitioner. The cost of the treatment code was governed by the participating physician's usage agreement, which used three Current Procedure Terminology (CPT) codes established by the Center of Medicare Services (CMS). CMS set a different approximate national payment amount for each CPT code, as shown in the following table for 2016:

[1] The parties stipulated that on May 3, 2018, petitioner paid (i) $36,154.75 in use tax, computed based on the depreciated materials cost of its XTRAC laser equipment placed in its physician customers' clinics in New York State during the audit period, and (ii) $6,458.15 for the period May l, 2014 through May 31, 2015, on issues not in dispute in this matter, reducing the amount still at issue between the parties to $487,322.56 in tax.

CPT Code	Skin Surface Area Affected	Approximate National Payment Amount
96920	Less than 250 square centimeters	$158.27
96921	250 to 500 square centimeters	$174.42
96922	More than 500 square centimeters	$240.81

The usage agreement for each participating physician included a table showing the cost of a treatment code for each of the above CPT codes. Generally, petitioner charged an amount that was approximately 50% of the insurance reimbursement for that CPT code for that physician, although petitioner did offer some discounts based on volume, usage, or longevity of the customer. Thus, the cost of the treatment code was based only on the size of skin surface area being treated and was not related to what model XTRAC laser petitioner placed in the participating physician’s office, or the length of time in which the device was in the doctor’s office. After the physician completed the purchase of treatment code lots (typically 30), petitioner would supply the participating physician with a random-access code that, once entered into the XTRAC laser’s software, would load the treatment uses and make them available for delivery to the patient. Each time the XTRAC laser was used, a treatment is deducted from the total number of treatments available to be delivered. After purchasing the treatment codes, the physician customer incurred no additional charges from petitioner at any time before, during or after the XTRAC laser was placed in the physician's office.

6. The audit file includes four invoices for payment under the usage agreement. All four show only charges for treatment codes.

The Usage Agreement's Description of Petitioner's Services

7. The parties' stipulation of facts contains five examples of petitioner's usage agreement, four dated in 2016, and one dated in 2017. The five agreements are similar, appearing to vary mostly in the amounts charged for the treatment codes. The agreements include a cover page and terms and conditions on one or more subsequent pages. A four column table at the top of the cover page entitled "Treatment Fee Schedule" details petitioner's charges for four categories of treatments, the first three that correspond to the CPT codes set forth in finding of fact 5, while the fourth is for the purchase of a bundle that includes a combination of the first three categories. Beneath that table is a two-column grid, showing nine "Support Services Included With Usage Agreement," identically worded in all five agreements:

Reimbursement Support	Dedicated Line, Highest Priority Status
Phone Support Priority	Highest Priority Status
Clinical Support	Highest Priority Status
Marketing Support/Marketing Allowance	✓
Patient Co-Pay Support Value	Up to $10,000 Annual
Laser Consumables and Accessories	✓
Service Response Time	Highest Priority Status
Software Upgrades	Included, Guaranteed Non-obsolescence
Laser Renewal Program	Guaranteed Non-obsolescence

The reverse side of the agreement is entitled "Usage Agreement Terms and Conditions." It explains that petitioner has "consigned" an XTRAC laser to the customer physician at the customer's site listed on the cover page, and that petitioner retains all ownership rights in the equipment. Under the agreement, the physician may not relocate the device without petitioner's

prior written approval and must use the device only for its intended uses. The participating physician must give petitioner access to the device for purposes of maintaining it at petitioner's own cost. Petitioner is to "upgrade" the device as provided on the cover page and provide all consumable supplies needed during the life of the device. The consumables in question are the gases used in the device, the arm on the device, and goggles worn by the clinician using the device. Under the agreement, "if the Customer intends to use an excimer light source to treat a patient, Customer shall use the equipment to do so, provided the treatment falls within the intended uses of the equipment and that use of the equipment is judged by the physician to be in the patient's best interest." There were no minimum purchase obligation or time-based payment requirements under the agreement, nor was there a time-based limitation or conditions on the use of petitioner's services so long as the agreement was in place. The parties stipulated that petitioner can "remove the XTRAC Laser from the physician's office anytime at [p]etitioner's sole discretion," including if a participating physician ceases to make purchases from petitioner.

Dr. Rafaeli's Testimony Regarding Petitioner's Services

8. At hearing, petitioner presented the testimony of Dr. Dolev Rafaeli, who has been president and chief executive officer (CEO) of petitioner since 2018 and is in overall operational control of the company. He became aware of the XTRAC laser technology in 2007, when it was owned by PhotoMedex, and he was the president and CEO of a different company, which eventually merged with PhotoMedex. Dr. Rafaeli managed the business of the combined companies until 2015 when the assets of PhotoMedex were sold to a company by the name of MELA, which eventually changed its name to Strata Skin Sciences, Inc. As a result of his role as president and CEO of petitioner since 2018 and its predecessor company, he was familiar with

the financial statements of petitioner going back to 2007 and had closely monitored the company's business from that time.

9. Dr. Rafaeli testified that initially the company that owned the XTRAC laser technology leased the devices to the doctors using the device to treat patients in exchange for per treatment payments from the physician customers. That proved uneconomical, however, because of insufficient usage, so, starting in 2006 or 2007, the company adopted the present recurring revenue model of making the device available to doctors as part of a suite of services, which aimed to facilitate the use of the technology and the flow of the patients into its physician customers' offices, with the physician paying per use of the device. Dr. Rafaeli testified at length about the services petitioner performs under the usage agreement, as enumerated above, based on printouts of slides that petitioner uses in making sales presentations to prospective participating physicians, from which testimony the facts below are derived.

10. An introductory slide used in petitioner's sales presentation shows a picture of the XTRAC laser encircled by a series of balloons that detail the services and other items that the participating physician would receive under the usage agreement. These encompass the same items that are set forth on the second table on that agreement's cover page (***see*** finding of fact 7). While the usage agreement refers to all the items as "services," for sales tax purposes, three of the items -- "software," the "Laser Renewal Program," and "Laser Consumables and Accessories" are tangible personal property, not services.

11. At the heart of petitioner's service package is its patient awareness/direct to the customer (DTC) advertising program, which is designed to drive more patients to participating physicians' offices for possible XTRAC laser treatments. In 2011, when the patient awareness program first started, petitioner advertised on national and local radio stations by media market.

Since 2017, petitioner has moved most of its advertising to social media, which allows it to target persons who might benefit from the XTRAC laser technology within the zip codes surrounding a participating physician's location. The advertisements promote the name "XTRAC," and always include petitioner's contact information, as the goal is to have the prospective patient search for treatment under that term, and thereby be led to petitioner's phone bank. It will be difficult for a patient without an existing relationship with a dermatologist to find a doctor that has the XTRAC laser but is not under a usage agreement with petitioner because petitioner's contact information will dominate the results when that term is searched for on popular search engines, in part due to copyright restrictions on the use of that term in advertisements. Petitioner also helps its participating physicians to create their own advertising for the XTRAC laser technology, by assisting them in developing mailers and in-office advertisements. Petitioner spent 13.3%, 11%, and 4.5% of its revenue on its patient awareness advertising in 2015, 2016, and 2017, respectively.

12. Another sales presentation slide shows that, through its advertisements in 2015, petitioner generated around 36,000 inquiries. These inquiries resulted in approximately 10,000 patients being added to petitioner's proprietary database system of patients receiving treatments from petitioner's participating physicians (RDX database program). In 2015, the participating physicians themselves generated another around 16,000 patients to that database. Some of those 16,000 patients probably first learned of petitioner's XTRAC laser technology through petitioner's advertisements since, when petitioner significantly decreased its national advertising in 2017, the number of patients added by the participating physicians also significantly decreased.

13. When a potential patient clicks on petitioner's on-line advertisement, or calls the patient support phone lines, the potential patient is connected with petitioner's in-house call center, where petitioner has a staff of about 20 persons. The call center staffers educate the patients about the XTRAC laser treatments and the medical outcomes to be expected based on clinical studies. If the caller is interested in receiving the treatment, the staffer then obtains the caller's personal information, his or her social security number, health insurance information, and clinical history, including any other medical conditions the patient might have, which information is entered into petitioner's RDX database program for tracking the course of patients' treatment. Next the staffer asks the caller if he or she would like to be set up for a consultation with a participating dermatologist. If the caller wants to take that step, the staffer would first call the prospective patient's insurance company to see if the XTRAC laser treatment would be covered and to ascertain what the person's co-pay and/or deductible would be. Secondly, the staffer would find the participating physician that is closest to the prospective patient who would accept the patient's insurance. This is important because the treatment generally requires two visits a week to the doctor's office for anywhere from 4 to 16 weeks, with the average being 8 weeks. The staff person works with the office of the chosen doctor and the patient to find an acceptable appointment time. Then, 24 to 48 hours before the appointment, the staff person calls both the patient and the doctor's office to remind both of the impending appointment. At the appointment, the patient may or may not get any XTRAC laser treatment, as that is up to the clinical judgement of the participating physician. These reminder phone calls are helpful, according to Dr. Rafaeli, because the appointment will have been made sometime out in the future, and the patient could easily have forgotten it, while some dermatologists see 50 to 150 patients a day and can easily lose track of the fact that a patient potentially needing an

XTRAC laser treatment would be coming in for an appointment. Those physicians who buy an XTRAC laser outright do not benefit from petitioner's call center service, as the call center staff does not set up prospective patients for appointments with those physicians.

14. Dr. Rafaeli emphasized the importance of the liaison work that petitioner's call center does – the participating physician ends up with a visit by a patient "with a predisposed decision that they are going to be getting an XTRAC treatment," whose preexisting conditions are known, and whose insurance company has authorized reimbursement for the XTRAC laser treatment. The table below, compiled from a slide in petitioner's sales presentation, shows the effectiveness of petitioner's advertising and call center activities in referring patients who potentially might benefit from an XTRAC laser treatment.

Year	Appointments Made by the Call Center	XTRAC Treatments Resulting
2015	8648	2463
2016	6149	1646
2017	1119	367

15. As part of its patient assistance service, petitioner provides participating physicians with access to its RDX database program. This database has the insurance information obtained by petitioner's call center staff from the patient's insurance company. The database facilitates the physician's work with the insurance companies to get full reimbursement for XTRAC treatments they provide. Participating physicians can also use the system to track the course of treatment of those patients who come to their office other than through petitioner's call center, as they can add the patient to the RDX database program. If the physician encounters difficulty with obtaining reimbursement from an insurance company, it can enlist the assistance of petitioner's staff of 12 employees assigned to help with insurance reimbursement issues. That

team of employees also seeks to obtain reimbursement reauthorization for XTRAC treatments regarding each of the active patients in the RDX database program each year. This is important because insurance companies only authorize a medical treatment for an annual period and the diseases on which the XTRAC laser is used are long-term in nature and may straddle two such annual periods. If an insurance company that has authorized coverage later refuses to reimburse the participating physician for the treatment, petitioner will reimburse the physician. Finally, petitioner works with the participating physician's new back office staff to train them in obtaining full reimbursement from insurance companies.

16. Under the patient assistance program, petitioner's call center staff assists patients in understanding the cost of treatment with respect to their deductible and co-pay obligations, in addition to assisting the patients with insurance company disputes.

17. Petitioner also assists patients in satisfying the co-pay portion of their financial obligation through a mail-in rebate program. The program appears to be limited to $10,000.00 per practice per year and petitioner's advertisements indicate that a patient is limited to $400.00 in co-pay reimbursements. Petitioner spent 3.8% of its revenue on this co-pay support program in 2015 and 2016, and 3.9% in 2017.

18. During the audit period, the XTRAC device was available in several models, which differed in the speed at which the phototherapeutic light is delivered. Under the laser renewal program in the usage agreement, petitioner commits itself to providing the participating physician with a non-obsolete model. In its sole discretion, petitioner decides which model of the XTRAC laser to place with each physician based on the number of potential patients to be treated with phototherapeutic light treatments in that office. During the term of the usage

agreement, petitioner may decide to upgrade or downgrade the XTRAC model at the customer's site at petitioner's sole discretion.

19. Under the clinical support aspect of the usage agreement, petitioner's clinical training team works with its participating physicians one-on-one in the physician's offices to train their staff in treating patients using the XTRAC laser during an initial training period, and then as needed and without limitation throughout the term of the usage agreement. This is an important benefit because some practices have a 30 to 40 percent turnover in clinical staff per year. Only clinical individuals who had been specifically authorized by the physician and trained by the physician (e.g., nurse, nurse practitioner or physician assistant) are allowed to deliver the phototherapeutic light treatments. Petitioner has five employees as part of its clinical training team, as well as 31 territory managers who typically visit each participating physician's office between two and four times a month, providing training and retraining to existing participating physicians and their medical staff.

20. The usage agreement requires petitioner to maintain the XTRAC lasers, for which it has 15 employees across the country. Petitioner has a 24-hour cycle time between when a problem is reported until it is resolved, which is important because patients need to be treated twice a week, and a non-functioning device might interfere with that schedule.

21. In 2015, petitioner charged $80,000.00 per XTRAC laser that it sold outright. Outright purchasers of the equipment during the audit period did not receive any of the services listed on the usage agreement, except that they could purchase, for an additional amount, a maintenance program and supplies from petitioner. They can use the devices without the need for any authorization or treatment code from petitioner.

22. Dr. Rafaeli testified that an XTRAC laser has a useable life of 10 years or more and that petitioner's participating physicians paid petitioner $40,000.00 on average in 2015 for treatment codes. Petitioner provided no documentation showing how Dr. Rafaeli arrived at the $40,000.00 per participating physician figure. Review of petitioner's 2016 form 10-K reveals that 775 XTRAC devices were being used under a usage agreement in that year. In that year, petitioner reported revenue from its recurring revenue model of $24,558,000.00, meaning that, on average, petitioner received $31,687.74, per participating physician that year, according to the form 10-K.

23. The form 10-K also states that the XTRAC lasers have an "estimated useful life of five-years." Dr. Rafaeli testified that an XTRAC laser had a "useable life" of 10 years or more. He did not explain the difference between that figure and the 5-year "useful life" figure provided in the form 10-K.

Dr. Nazareth's Testimony about Petitioner's Services

24. Petitioner also presented the testimony of Dr. Michael Nazareth, a practicing dermatologist who owns a dermatology practice in Buffalo, New York. In 2017, Dr. Nazareth entered into a usage agreement with petitioner. He testified that the sales presentation for the usage agreement that Dr. Raffaeli discussed in his testimony looked familiar to him, except that he did not think he saw as much about the DTC advertising program. Prior to entering into the usage agreement with petitioner, he considered purchasing the XTRAC laser outright, but, "given the difficulties with reimbursement and copays and cost, we decided it was an avenue we did not want to pursue." He explained that he wanted to purchase the full suite of services from petitioner, not just the XTRAC laser alone, because it would have been very difficult to navigate the prior authorization process with patients' insurance companies, and the arrangement with

petitioner relieved his practice of the risk of nonpayment of the co-pay due from the patient or the reimbursement due from the insurance company:

> "[I]f a patient can't afford co-pays or now you get a red[u]ction on that or, you know, you finally go through this process and then I have to re-up everything for the next year, for the amount of effort that is going into that, I didn't see us getting enough patients to make the ROI worth it, or return on investment worth it."

He also testified that:

> "I think that one of the biggest advantages for my practice and why we chose it in the first place is prior authorization, which is a very time-consuming process. Because of this system, it is Strata who is actually doing the work behind the scenes with the insurance company to get it approved and if it is not approved they tell us. It saves my team of people a lot of time in doing that."

25. Dr. Nazareth's practice uses petitioner's RDX database program, which he referred to as "a complete tool for us," both with regard to patients he gets from petitioner and those patients that come directly to him for which he prescribes the XTRAC laser treatment. Petitioner has assisted him in resolving reimbursement issues where patients' insurance companies have retracted payment after patients received treatment. In cases where the insurance coverage dispute could not be resolved, petitioner reimbursed Dr. Nazareth's practice, although he did not recall if petitioner reimbursed the amount of the cost of the treatment code or the amount of his practice's charge to the insurance company. Dr. Nazareth also explained that petitioner's reimbursement of co-pays for patients is important because in 2017, for most of his patients, the co-pay for an office visit to a specialist, such as a dermatologist was about $40, which has increased since then. According to Dr. Nazareth, "[f]or a lot of patients this would not be an affordable therapy if they need 20 treatments and they have to pay $40 or $50 . . . twice a week for 10 weeks" without petitioner's co-pay reimbursement program.

26. Dr. Nazareth estimated that the amount his practice pays petitioner was "probably in the six-figure range" annually, although not initially.

Petitioner's 2016 10-K

27. Petitioner's 10-K for 2016 under the heading "Critical Accounting Policies and Estimates," and the subheading "Revenue Recognition" states:

> "We recognize revenue from product sales when the following four criteria have been met: . . .
>
> * * *
>
> We have two distribution channels for our phototherapy treatment equipment. We either (i) place our lasers in a physician's office (at no charge to the physician) and generally charge the physician a fee for an agreed upon number of treatments or (ii) sell our lasers through a distributor or directly to a physician. In some cases, when the lasers placed in a physician's office at no charge, we and the customer stipulate to a quarterly or other periodic target of procedures to be performed and accordingly revenue is recognized ratably over the period.
>
> When we place a laser in a position's office, we generally recognize revenue based on the number of patient treatments performed, or purchased under a periodic commitment, by the physician."

In the form 10-K, petitioner reports the revenues and expenses of its recurring revenue model business in its "Dermatology Recurring Procedures" business segment. The form 10-K shows both petitioner's revenue and its expenses from that business segment.

28. The parties entered into a stipulation of facts, relevant portions of which were incorporated into this determination.

CONCLUSIONS OF LAW

A. Tax Law § 1105 (a) imposes sales tax on the retail sale of tangible personal property. "Sale" for purposes of the sales tax is defined as "[a]ny transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume" (Tax Law § 1101 [b] [5]). A "retail sale" is a sale of tangible personal property other than sale for resale as such" or for use by the purchaser in performing certain of the services taxable under Tax Law § 1105 (c) (***see*** Tax Law § 1101 [b] [4]). Here, it is undisputed that petitioner, under its usage agreement, is

transferring its XTRAC lasers to participating physicians, as well as performing certain services and providing the necessary consumables, while receiving payments when the doctors purchase treatment codes that permit them to use the device. The Division argues that the revenues are taxable because the usage agreements involve a transfer of possession of tangible personal property for consideration in the form of per treatment charges. In support of its position that its revenues under the usage agreement are not subject to sales tax, petitioner makes several arguments, including that its usage agreement does not constitute a rental or a license to use the XTRAC laser, citing ***Matter of EchoStar Satellite Corp. v Tax Appeals Trib. of the State of N.Y.*** (20 NY3d 286 [2012]), and that the "true object" of the usage agreement or its "primary function" is the provision of a nontaxable "integrative therapy service," and not the transfer of the XTRAC laser, citing, ***inter alia***, ***Matter of SSOV '81 Ltd. d/b/a People Resources*** (Tax Appeals Tribunal, January 19, 1995).

B. When, as here, tangible personal property is provided by a seller to a customer in conjunction with the seller's performance of a service for the customer, a perennial sales tax issues arises: is the property being leased to the customer? If it is being leased, the sale may be subject to tax as the sale of tangible personal property and the resale exclusion in Tax Law § 1101 (b) (4) may apply to the property's purchase. In considering whether the transfer of the tangible personal property to the customer is a lease, a prerequisite for the existence of a lease is that the seller's agreement with the customer is structured as a lease and uses lease language (***see e.g.*** 20 NYCRR 526.7 [c]; ***Matter of Galileo Intl. Partnership***, Tax Appeals Tribunal, March 25, 2005***, confirmed Matter of Galileo Intl. Partnership v Tax Appeals Trib.***, 31 AD3d 1072 [3d Dept 2006], ***lv denied*** 7 NY3d 715 [2006] [concluding that an agreement by the owner of an electronic travel reservation system to transfer computer equipment to a travel agent constituted

a taxable lease]; ***Matter of Lincare, Inc.,*** Tax Appeals Tribunal, September 11, 2014 [concluding that petitioner had a lease agreement with the customer to supply oxygen systems equipment]). This factor is also one of the factors considered by the Court of Appeals in ***EchoStar*** (20 NY3d at 292). Another important prerequisite to the existence of a lease for sales tax purposes is that there be a separate charge for the tangible personal property in question (***see Matter of Albany Calcium Light Co. v State Tax Commn.***, 44 NY2d 986, 987 [1978], ***rearg denied*** 45 NY2d 839 [1978] [rejecting application of resale exclusion to the purchase of gas cylinders used by the purchaser to provide gas to its customers in the absence of a specified charge for that rental]; ***Matter of U-Need-A-Roll Off Corp. v New York State Tax Commn.***, 67 NY2d 690 [1986] [rejecting application of the resale exclusion to a waste removal company's purchase of containers where the company's single flat charge was not for rental of the containers, but rather for the waste removal service]).

C. Applying these factors leads to the conclusion that the usage agreement does not constitute a lease for sales tax purposes. Here, as petitioner points out, the usage agreement is not entitled a lease, has no lease language in it, and is not structured as a lease, as it refers to the XTRAC laser as being "consigned" to the participating physician. In fact, the agreement does not specify the model XTRAC laser the customer is to receive, and the parties stipulated that petitioner has the right to remove the device at any time without the participating physician's prior consent. Moreover, petitioner's charge under its usage agreement is for "treatment codes" and is not explicitly for the rental of the XTRAC laser. While that charge is related to petitioner's possession and use of the laser, that does not make the charge a rental charge (***see Matter of Atlas Linen Supply Co. v Chu***, 149 AD2d 824 [1989], ***lv denied*** 74 NY2d 616 [1989] [resale exclusion found inapplicable to a company providing a laundering service where the "per

unit" charge found not to constitute a separate charge for the purchased linen]). Therefore, the Division's claim that the usage agreement is taxable as a sale of the XTRAC laser is rejected.[2]

D. In further support of its claim that the usage agreement is not a lease of the XTRAC laser, petitioner argues that it did not transfer "exclusive possession" of the XTRAC lasers to the participating physicians and, therefore, no sale of the XTRAC laser occurred for sales tax purposes, citing, *inter alia*, ***Bathrick Enterprises v Murphy*** (27 AD2d 215 [3d Dept 1967], ***affd*** 23 NY2d 664 [1968]) and ***American Locker Co. v Gallman*** (308 NY 264 [1955]). The cited cases are distinguishable, as they both involved much simpler coin-operated devices that remained on the premises of third parties and which the customers had no right to move. Thus, this line of argument does not add significantly to petitioner's larger claim that the usage agreements do not constitute leases.

E. Petitioner also argues that the proper characterization of its usage agreement sales should be determined using the "true object" or "primary function" tests and that, under either test, those sales are best characterized as "integrated therapy services" and thus not taxable. While moot in light of conclusion of law C, this argument is meritorious and will be discussed below, for the sake of completeness. Petitioner's remaining arguments are not meritorious, but will also be discussed below, albeit with greater brevity.

F. The New York cases cited by petitioner do not explicitly adopt a "true object test" for characterizing transactions, but are consistent with such an approach (***see Dun & Bradstreet, Inc. v City of New York***, 276 NY 198, 205 [1937] [New York City's sales tax on tangible

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[2] In claiming that the usage agreement is not a lease, petitioner frames its argument around the factors mentioned by the Court of Appeals in ***EchoStar*** (20 NY3d at 291-292). The first of the factors analyzed in that case is the existence of an agreement structured as a lease and containing lease language, which is discussed above. This determination will not analyze the remaining factors raised in ***EchoStar*** because, under the caselaw discussed above, the lack of lease language or structure in the usage agreement, as well as the lack of an explicit charge for the claimed leased equipment (which was not at issue in ***EchoStar***) is fatal to the Division's claim herein that the usage agreement constitutes a lease of tangible personal property.

personal property found not to apply to a transaction in which a credit-rating company provided reference books to its clients as an incidental part of a transaction]; ***Bus. Statistics Org. v Joseph***, 299 NY 443, 452 [1949] [given restrictions, as argued by the City of New York, on the transferability of certain publications provided to the customer, along with certain services, transaction would not be characterizable as the sale of tangible personal property under the City's sales tax because the publications would only be an incidental part of the transaction, agreeing with outcome in ***Dun & Bradstreet, Inc.***]; ***Matter of Galileo Intl. Partnership*** [Appellate Division finds that substantial evidence existed to uphold Tribunal's determination "even if we were to apply a test in the nature of the true object test urged by petitioners"]). While the Tribunal has not applied the true object test, it has applied the closely related "primary function" test in the context of determining the taxability of sales that involved exclusively services (***see SSOV***; ***Matter of Principal Connections LTD.,*** Tax Appeals Tribunal, February 12, 2004). The Division, however, has applied the primary function test to transactions, such as the one at issue here, involving both the transfer of tangible personal property and the performance of services (mixed bundled sales) (***see e.g.*** TSB-A-20[28]S [applying the primary function test to petitioner's multiple component product that included both a "data/prewritten software" component and a coupon processing component]). Given the consistency between the primary function test and the reasoning in the Court of Appeals in ***Dun & Bradstreet, Inc.*** and ***Bus. Statistics Org.***, which also involved mixed bundled sales, it is determined that the primary function test applies to such sales.

G. In ***SSOV***, the petitioner (SSOV) described itself in its Federal and State tax returns as a "social club" or "private club for singles." It conducted its business by having every member submit a profile, which included certain biographical information and a video-taped interview.

Members used the profiles to choose other members to whom they might want to send an invitation to meet. As part of its service, petitioner helped members prepare an appealing interview. Petitioner would pass on a member's invitation to the invited party and would only release the name and telephone number of the inviting member to the invited member after the invitation was accepted. The Division contended that the service was taxable as an information service, citing the member profiles available to members. In its decision, the Tribunal first addressed the issue of how to analyze the taxability of multiple component services: "the analysis employed by the New York courts and the Tax Appeals Tribunal focuses on the service in its entirety, as opposed to reviewing the service by components or by the means in which the service is effectuated" (***id.***, citing ***Matter of Building Contractors Association v Tully***, 87 AD2d 909 [3d Dept 1982], and ***Matter of Woolworth Co.***, Tax Appeals Tribunal, December 1, 1994). Applying that standard, the Tribunal concluded that, despite an information service component, the overall purpose of the service was "to allow members to meet others," which was not one of the services enumerated for taxation in Tax Law § 1105 (c) and was thus not taxable. In describing the service's primary function as one of fostering relationships, the Tribunal thus adopted a description that encompassed all that SSOV did in order to help its members accomplish their ultimate goal of entering into a relationship with another member. Consistent with this approach, the Division has treated as nontaxable a number of services that included components that, viewed separately, would have been taxable, where the service's goal was a broader, nontaxable one (***see e.g.*** TSB-A-13(12)S [petitioner's operations and management contract for investment portfolio managers found to be nontaxable notwithstanding its inclusion of components, which, viewed separately, would be taxable]; TSB-A-13(6)S [notwithstanding that it included an information service component, petitioner's provision of a wellness service

found to be nontaxable because the information service component is part of a broader, nontaxable, health-related service]).

H. At the hearing, Dr. Rafaeli explained that the initial model for monetizing the XTRAC laser technology was to transfer the device to the doctor's office without charge, and to collect a fee from the physician for each treatment code. When that business model failed to generate sufficient usage, a new business model was developed under which the company would still transfer the device to the physician and receive payment in the form of the purchase of treatment codes, but now the company would perform a suite of services designed to facilitate the use of the technology, including the flow of patients. Thus, when petitioner makes a sales presentation to doctors interested in the XTRAC laser technology, one of the initial slides the doctor is shown is a picture of the device encircled by a series of balloons that describe eight services that the doctor would receive under the usage agreement, summarized below.

First, petitioner took steps to help ensure a sufficient patient flow to the participating physician's practice. It did this by increasing public awareness of the effectiveness of excimer laser treatments through advertising on traditional media and in later years through social media in order to target zip codes adjacent to a particular participating physician's office. It also increased the appeal of treatments by covering a certain amount of the copays due from the patient.

Second, it decreased the participating physician's transaction costs related to providing the treatments. In this regard, petitioner prescreened those potential patients calling its phone bank to educate them about the treatments, including the time commitment involved, and confirmed (annually) that the patient's insurance company would cover the treatments. The result of these efforts is that the participating physician ended up with a visit by a patient "with a

predisposed decision that they are going to be getting an XTRAC treatment," whose preexisting conditions are known, and whose insurance company has authorized reimbursement for the XTRAC laser treatment. Petitioner also relieved participating physicians of another burden by assuming the responsibility for training the participating physician's clinical staff in the use of the XTRAC laser and its billing staff in obtaining proper reimbursement from insurance companies. This may occur several times a year, depending on the turnover in the doctor's office staff. Furthermore, petitioner maintained the XTRAC lasers, including providing all consumables, eliminating one more transaction cost of using the device to provide treatments.

Third, petitioner took several steps to ensure that the participating physician received correct reimbursement from insurance companies, while minimizing the time the practice had to spend haggling with the insurance company: (i) it obtained proper authorization from insurance companies for the treatment each annual period, as discussed above; (ii) it provided its RDX database program for tracking patient information that has all the information the physician needs to properly bill the insurance company; (iii) it provided a staff of 12 persons to work with the patient and insurance company in the case of a billing dispute; and (iv) it guaranteed that it would reimburse the doctor if the insurance company reneges on its promise to cover the treatment.

As additional support for the importance of the services petitioner commits to under the usage agreement, petitioner presented the testimony of Dr. Nazareth, a participating physician. Dr. Nazareth explained that he had considered buying an XTRAC laser outright but decided that the outright purchase option would leave his practice with an inadequate return on investment, citing the cost of the device, patients' failing to pay their co-pay charges, the burden of having to annually obtain insurance pre-authorizations, and insurance companies' reneging on those

authorizations. Dr. Nazareth confirmed Dr. Rafaeli's testimony regarding the importance of petitioner's services under the usage agreement, pointing out the helpfulness of having petitioner obtain insurance authorization annually for each of his XTRAC patients, and also mentioning the importance of petitioner's co-pay support program at a time when co-pay amounts are escalating.

Dr. Nazareth's testimony illustrates that, while the primary concern of medical service providers is the welfare of their patients, in choosing which therapies to provide as a practice, they must also be careful to receive an adequate return on the treatments they provide, i.e., a stream of payments sufficient to meet practice salaries and expenses, in order to ensure the long-term viability of the practice. The purpose of the array of services provided under the usage agreement – referred to by petitioner as "integrative therapy services" -- appears to be to give participating physicians access to the XTRAC laser technology in a way that increases the doctor's likelihood of achieving an adequate return on investment in relation to the practice's expenses of providing that therapy. Petitioner does this under the usage agreement by essentially managing most of the non-medical aspects of using the XTRAC lasers to provide treatment, including helping to ensure proper patient flow through its DTC advertising program (and bearing the risk of inadequate patient uptake of that treatment method by retaining ownership of the devices), assisting with the insurance reimbursement process (and bearing the risk of the insurance company reneging on its preauthorization), maintaining the devices, and training the doctor's staff in the use of them. This bundle of services minimizes the economic risks a participating physician faces in choosing to use the XTRAC laser to provide medical treatments. Thus, just as the Tribunal description of SSOV's primary function encompassed all the company did in order to help its members accomplish their ultimate goal of entering into a relationship with another member, a fair description of petitioner's primary function under the usage

agreement is the nontaxable one of managing the nonmedical aspects of the business of providing XTRAC laser treatments (***see SSOV***; TSB-A-13[12]S; TSB-A-13[6]S). The predominance of the value of the services provided under the usage agreement compared to the value of the XTRAC laser itself is also consistent with the fact that participating physicians have been willing to pay petitioner between $30,000.00 and $40,000.00 per year under the usage agreement when they could have purchased outright a device, with its 5-year useful life, for $80,000.00 (***see*** findings of fact 21 through 23).[3]

I. In claiming that the primary function of petitioner's usage agreement is not the provision of services, but rather the sale of the XTRAC lasers, the Division makes two main arguments. First, it claims that the services petitioner provides under the usage agreement are irrelevant in determining the taxability of its revenue under the agreements because those services are merely additional expenses petitioner must bear in making its sales of its XTRAC lasers. The problem with this argument is that it assumes its own conclusion that, in transferring the XTRAC lasers to a participating physician and performing services for that physician, petitioner is selling its XTRAC lasers, and not its services. It is true that petitioner incurs expenses in providing its services under the usage agreement, but it also incurs expenses in connection with its manufacturing of the XTRAC lasers. More importantly, the services are not just expense items – included as they are in the usage agreement, they are part of petitioner's offering to customers, for which petitioner earns revenue. The Division also points out that the

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[3] Against this purchase price proof, the Division likens petitioner's charges under the usage agreement to rental payments, and asserts that manufacturers will often collect more in rental payments over a product's useful life than the manufacturer's price for selling that product outright because the manufacturer must compensate itself in the rental situation for retaining all the risks of ownership, such as the risk that the equipment will be superseded by new technology before the end of its useful life, and thus lose value. While this may be true, it does not appear sufficient here to explain a participating physician's willingness to pay almost half the outright purchase price of the XTRAC laser each year under the usage agreement.

services attested to by Dr. Rafaeli are not spelled out in great detail in the usage agreement. While it is true that the usage agreement is scanty in its description of the services to be provided, Dr. Rafaeli testified in great detail, based on the company's sales presentations, that petitioner stresses the various services it performs in making sales pitches to doctors, which Dr. Nazareth confirmed in his testimony. Thus, the Division's arguments are not sufficient to undermine the conclusion that petitioner's provision of the device itself under the usage agreement is best viewed as just a part of its overall service of managing the non-medical aspects of providing XTRAC laser therapy.

Finally, the Division claims that treating petitioner's sales under the usage agreement as primarily the sale of a service is inconsistent with petitioner's accounting practices as described in its 2016 form 10-K. Specifically, the Division asserts that the form 10-K "states that [petitioner] markets its XTRAC laser as a product and recognizes revenue from product sales – not sales of an integrated therapy service -- under a recurring revenue model." Review of the form 10-K does not support the Division's claim that the form treats all of petitioner's sales as "products." While the form 10-K does use the term "product," in discussing its accounting policy for recognizing revenue, the form appears to be referring only to its policy with regard to outright sales of its XTRAC laser; when the form refers to its sales under the usage agreement, it does not use that word (***see*** finding of fact 27). In any case, the Division's argument rests on the unfounded assumption that a "product" cannot refer to a set of services. The Division also asserts that the form 10-K "indicates that petitioner performs marketing and selling activities related to its products, and that it recognizes these activities as expenses and not a source of integrated therapy service revenue." This is also not a fair reading of the form 10-K. The form is very clear that petitioner has two "distribution channels" for XTRAC lasers, outright sales and

its recurring revenue model business, with the latter encompassing sales under the usage agreements. Petitioner reports the revenues and expenses of its recurring revenue model business in its "Dermatology Recurring Procedures" business segment. The form 10-K shows both petitioner's revenue and its expenses from that business segment. Thus, the Division's argument that the form 10-K treats the services petitioner performs under the usage agreements as only a source of expense and not income is rejected.

In sum, the primary function of petitioner's sales under its usage agreements is managing the non-medical aspects of providing medical treatments using the XTRAC laser and those sales are, therefore, not subject to sales tax.

J. Moving to petitioner's next argument, it claims that, because the laser treatments provided by the XTRAC lasers are not perceivable, the transactions at issue are not subject to tax. As discussed above, however, review of the usage agreement reveals that petitioner obligates itself to furnish an XTRAC laser to the participating physician, along with specified services, in return for the participating physician's purchase of treatment codes. Accordingly, this argument's depiction of petitioner's sales as consisting of an intangible is inconsistent with the usage agreement and is rejected (***see Matter of Galileo Intl Partnership***, 31 AD3d at 1074 [holding that petitioner's sales should be treated as sales of tangible personal property because the underlying agreements took the form of a lease]).

K. Lastly, petitioner argues that its sales under the usage agreement are covered by the exemption in Tax Law § 1115 (a) (3) for "[d]rugs and medicines intended for use, internally or externally, in the cure, mitigation, treatment or prevention of illnesses or diseases in human beings." Petitioner reasons that "even if one overlooks the entirety of the integrated therapy service, the ultimate deliverable to the patient is an exempt drug," noting the rule that "the base

or vehicle used (oil, ointment, talc, etc.) and the medium used for delivery (disposable wipe, syringe, saturated pad, etc.) of a drug or medicine will not affect its exempt status" (20 NYCRR 528.4 [b] [2]). Petitioner is apparently arguing that, even if its sales under the usage agreement are treated as sales of the XTRAC lasers, the sales should be exempt because the exemption for drugs and medicines would apply to those sales. This argument is rejected. Tax Law § 1115 (a) (3) provides:

> "Drugs and medicines intended for use, internally or externally, in the cure, mitigation, treatment or prevention of illnesses or diseases in human beings." medical equipment (including component parts thereof) and supplies required for such use or to correct or alleviate physical incapacity, and products consumed by humans for the preservation of health but not including cosmetics or toilet articles notwithstanding the presence of medicinal ingredients therein or medical equipment (including component parts thereof) and supplies, other than such drugs and medicines, purchased at retail for use in performing medical and similar services for compensation."

The Division's regulations define "drug or medicine" as follows:

> "(i) *articles*, whether or not a prescription is required for purchase, which are recognized as drugs or medicines in the United States Pharmacopeia, Homeopathic Pharmacopeia of the United States, or National Formulary, and intended for use in the diagnosis, cure, mitigation, treatment or prevention of disease in humans;
> (ii) *articles* (other than food) intended to affect the structure or any function of the human body" (20 NYCRR 528.4 [b] [1] [emphasis added]).

If the usage agreement sales are determined to be subject to sales tax, it is because they are deemed to constitute the sale of the XTRAC laser. Petitioner does not contend that the devices themselves constitute a drug or medicine. Its argument appears to be, instead, that the devices constitute "the base or vehicle used [or] the medium used for delivery * * * of a drug or medicine" for purposes of 20 NYCRR 528.4 (b) (2). The flaw in this argument is that the treatments do not constitute a drug or medicine. To be a drug or medicine, the treatments must be an "article." The treatments provided by the XTRAC lasers are an intangible, energy in the form of light. Therefore, those treatments do not constitute an "article" for purposes of the above regulation and thus cannot

qualify as a "drug or medicine." Rather than being delivery devices for a drug or medicine, the XTRAC lasers constitute medical equipment. Medical equipment is excluded from the exemption in Tax Law § 1115 (a) (3) when sold to persons using it to perform medical services for compensation (***see*** Tax Law § 1115 [a] [3]; 20 NYCRR 528.4 [e] [4]).

L. Petitioner also challenges imposition of penalty in this matter. Based on the conclusion above that petitioner's sales under the usage agreements are not subject to sales and use tax, the penalties imposed are cancelled.

M. The petition of Strata Skin Sciences, Inc., is granted, and the Division of Taxation is directed to modify notice of determination L-047770120, dated February 23, 2018, consistent with conclusions of law C, I and L.

DATED: Albany, New York
January 21, 2021

/s/ James P. Connolly
ADMINISTRATIVE LAW JUDGE