STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petitions	:	
of	:	
CLAYTON FUNDING CORPORATION AND ROBERT J. TADLER, AS OFFICER	:	DECISION DTA Nos. 802638 & 802639
for Revision of Determinations or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period September 1, 1980 through February 29, 1984.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on November 27, 1991 with respect to the petitions of Clayton Funding Corporation and Robert J. Tadler, as officer, 82 Main Street, P.O. Box 534, Mineola, New York 11501. Petitioners appeared by Robert J. Tadler. The Division of Taxation appeared by William F. Collins, Esq. (Robert J. Jarvis, Esq., of counsel).

The Division of Taxation (hereinafter the "Division") filed two requests for an extension to file an exception to the determination of the Administrative Law Judge. Pursuant to the second extension, the Division filed an exception on February 11, 1992. On March 26, 1992, petitioners filed a motion requesting that the Tax Appeals Tribunal dismiss the Division's exception 1) because the Division did not file a brief in the proceeding before the Administrative Law Judge and 2) because the Division did not state "good cause" for its request for an extension to file an exception. By order dated November 5, 1992 the Tax Appeals Tribunal denied petitioners' motion.

Both parties filed briefs on exception. Petitioners' brief in opposition to the Division's exception was received on January 11, 1993 which began the six-month period for the issuance of this decision. The Division's request for oral argument was denied.

Commissioner Dugan delivered the decision of the Tax Appeals Tribunal. Commissioner Koenig concurs.

ISSUES

I. Whether the audit methodology utilized by the Division may be accurately characterized as an estimating procedure, and if so, whether such a methodology was authorized by the Tax Law.

II. Whether agreements entered into by Clayton Funding Corporation were true leases or security agreements.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "1," "3" and "4" which have been modified. We have also made an additional finding of fact. The Administrative Law Judge's findings of fact, the modified findings of fact and the additional finding of fact are set forth below.

We modify finding of fact "1" of the Administrative Law Judge's determination to read as follows:

> Petitioner Clayton Funding Corporation ("Clayton") began doing business in New York in 1978. During the audit period, petitioner Robert J. Tadler was Clayton's sole stockholder and president of the corporation. Clayton's business can best be described as equipment leasing and financing.
>
> The Sales Tax Field Audit Report describes the Division's understanding of petitioners' business as follows:
>
> "BUSINESS ACTIVITY:
>
> "The vendor operates a leasing company. Most of their leases are for telephone systems, computers and other office and manufacturing equipment.
>
> "Clayton's leases are entered into in the following manner: the prospective lessee intends to purchase some type of equipment, however, they do not have sufficient capital. Therefore, they will approach Clayton, and they will arrange a lease for them (a copy of a blank lease is enclosed in the case folder). Clayton will receive a loan from a financial institution (Bank Leumi, Ultra Leasing, Tilden Commercial, etc.), and use the

funds to purchase the equipment for the lessee.

> "The lease is usually entered into for a term of 24, 36, 48, or 60 monthly installments. Clayton will ususally (sic) receive 2 to 6 installments from the lessee before they discount the lease with the financial institution from whom they received the loan. The payments that Clayton receives include the sales tax. After Clayton discounts the lease with the financial institution two situations occur. 1) The financial institution receives the monthly installment and the sales tax. In this situation the bank will send Clayton a check for the sales tax that they collected for the month. 2) The financial institution receives the monthly installment and Clayton receives the applicable sales tax payment (this arrangement is applicable to Clayton's oral agreement with Bank Leumi). A letter which Clayton sends to the lessee about this situation is enclosed in the case folder. In both situations no records are maintained by Clayton to determine from which lease sales tax is being remitted. When checks for the tax arrive in the mail they are placed in a desk draw [sic] until they are remitted with the sales tax returns."[1]

The Division began a sales tax field audit of Clayton early in September 1983. The auditor originally assigned to the case was named Mitchell Ackerman. The Tax Field Audit Record (commonly referred to as the "contact sheet") completed by Mr. Ackerman indicates that he spoke with Victor Della Fave, Clayton's accountant, and requested Clayton's books and

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[1] Finding of fact "1" of the Administrative Law Judge's determination read as follows:

> "[p]etitioner Clayton Funding Corporation ('Clayton') began doing business in New York in 1978. During the audit period, petitioner Robert J. Tadler was Clayton's sole stockholder and president of the corporation. Clayton's business can best be described as equipment leasing and financing. A typical transaction involving Clayton occurred in this manner. A person wishing to purchase office equipment (a copying machine, telephone system, etc.) who was unable to finance the transaction himself or to obtain bank financing contacted Clayton. Usually, the potential purchaser had been in contact with the manufacturer or supplier of the equipment who referred the purchaser to Clayton. Clayton investigated the potential purchaser's financial condition and credit standing, and, if the purchaser's finances proved satisfactory, Clayton then approached a bank or other funding source to obtain the necessary financing. Once the funding source agreed to finance the transaction, Clayton purchased the desired equipment for the sole purpose of leasing it to the purchaser. Clayton entered into an agreement with the purchaser which most often took the form of a document characterized as a 'lease,' with Clayton identified as the 'lessor' and the purchaser as the 'lessee.' The equipment was shipped directly to the purchaser/lessee by the equipment supplier. The purchaser/lessee made an advance payment to Clayton consisting of the first lease installment payment and the last two payments plus sales tax calculated on the total amount of the payments made to Clayton. The 'lease' was then assigned to the bank or finance institution for collection of the remaining payments."

We modified this finding of fact by inserting the description of petitioners' business activities as reflected in the Sales Tax Field Audit Report.

records for the audit period. A checklist of records made available indicates that the Division was provided with the following documents for the period under audit: sales tax returns and related worksheets; Federal and State income tax returns, a sales journal, a cash receipts journal, sales invoices, a check disbursements journal, a general ledger, monthly bank statements, resale certificates, exempt organization certificates, and exempt use certificates. There are no entries under the heading for books requested but not made available. Mr. Ackerman completed transcripts of Clayton's Federal income tax returns and cash receipts journal and a schedule of expense purchases. He also obtained a copy of the lease form typically used by Clayton, samples of other documents exemplifying a typical transaction and a brochure describing Clayton's services.

We modify finding of fact "3" of the Administrative Law Judge's determination to read as follows:

> In December 1983, the audit was transferred to a second auditor, John Perotti.
>
> During the audit, Mr. Della Fave contended that after a lease was assigned to a third-party, Clayton was no longer responsible for collection of sales tax on the individual installment payments. Based upon its analysis and understanding of the nature of Clayton's business, the Division determined that Clayton was responsible for collecting sales tax on each and every installment payment, whether that payment was paid or payable to Clayton or to another party. The Division then attempted to calculate the total amount of all payments made to Clayton or Clayton's assignees during the audit period. The Sales Tax Field Audit Report completed by Mr. Perotti states:
>
> > "All of the vendor's leases that were entered into since the inception of the business were analyzed for installments due within the audit period, 9/1/80 - 9/29/84."
>
> This is not a completely accurate statement. Referring directly to this statement in the audit report, the Administrative Law Judge conducted the following questioning of Mr. Perotti:
>
> "Q: When you say they were analyzed, just explain to me exactly how you did that.
>
> "A: These invoices per se?
>
> "Q: Did you look at the invoices themselves, one by one?

"A: These were summaries of the lease agreements. This had the information on the lease agreement, such as who is the lessee, the date that it was entered into, the term that it would run for, the amount of the monthly leasing, lease payments, the amount of the monthly sales tax payment" (Tr., p. 66).

On cross examination, the auditor testified that his audit of Clayton was his first audit of an equipment leasing company. He also testified as to the manner in which he conducted subsequent audits of equipment leasing companies where payments were assigned to a funding source:

"Q: In your audit of equipment leasing companies where payments were assigned to a funding source, whether it be another equipment leasing company that the lessor assigned the payments to, or a bank or other financial institution, who paid the taxes, the sales taxes, on the payments that were assigned to these funding sources?

"A: Sales taxes were usually paid to the financial institution, sometimes they were paid to the lessor.

"Q: In your audit of these other equipment leasing companies where the taxes were paid to financial institutions, how were you able to determine that the taxes were indeed collected by and paid by, or, in fact, the responsibility of the financial institutions?

"A: The financial institution usually maintained a record of the sales tax collections and what they remitted to the State, and this information I would review on audit" (Tr., pp. 33-34, emphasis added).[2]

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[2] The Administrative Law Judge's finding of fact "3" read as follows:

"In December 1983, the audit was transferred to a second auditor, John Perotti. During the audit, Mr. Della Fave contended that after a lease was assigned to a third-party, Clayton was no longer responsible for collection of sales tax on the individual installment payments. Based upon its analysis and understanding of the nature of Clayton's business, the Division determined that Clayton was responsible for collecting sales tax on each and every installment payment, whether that payment was paid or payable to Clayton or to another party. The Division then attempted to calculate the total amount of all payments made to Clayton or Clayton's assignees during the audit period. The Sales Tax Field Audit Report completed by Mr. Perotti states:

"'All of the vendor's leases that were entered into since the inception of the business were analyzed for installments due within the audit period, 9/1/80 - 9/29/84.'

"This is not a completely accurate statement. Referring directly to this statement in the audit report, the Administrative Law Judge conducted the following questioning of Mr. Perotti:

"'Q: When you say they were analyzed, just explain to me exactly how you did that.

We modify finding of fact "4" of the Administrative Law Judge's determination to read as follows:

> The "summaries" referred to by Mr. Perotti were computer-generated schedules created by Mr. Tadler and his children in an attempt to estimate Clayton's future income. The lease summaries did not show actual amounts collected by Clayton. That information was contained in Clayton's cash receipts journal. At hearing, the auditor on recross examination stated as follows:
>
> "Q: However, in your Audit Report, Mr. Perotti, there are listings as to what records were available to you, and I presume when you say 'available' you looked at them; they weren't just there and you did not peruse them?
>
> "A: I believe I earlier testified, stated that Mr. Ackerman did a sales reconciliation from the cash receipts to the sales tax returns and perhaps the federal returns. I personally did not look at the cash receipts journal and do any analysis or reconciliation from that" (Tr., p. 194).
>
> With reference to the examination done by Mr. Ackerman, the first auditor, Mr. Perotti, testified on recross examination as follows:
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> "ADMINISTRATIVE LAW JUDGE: Why don't you start with answering the question as you understood it. Do you know for a fact whether or not Mr. Ackerman looked at those sales tax returns? I mean you have seen much more of the audit file than we have. Do you know?
>
> "THE WITNESS: Based on what's in the audit file and from his audit log, he did do a sales reconciliation and examine the cash receipts journal, and he probably examined the sales tax returns and any accompanying work sheets, based on what I have seen in the audit file" (Tr., pp. 196-197).

> "'A: These invoices per se?
>
> "'Q: Did you look at the invoices themselves, one by one?
>
> "'A: These were summaries of the lease agreements. This had the information on the lease agreement, such as who is the lessee, the date that it was entered into, the term that it would run for, the amount of the monthly leasing, lease payments, the amount of the monthly sales tax payment' (Tr., p. 66)."

We modified this finding of fact by inserting the testimony of the auditor on cross examination to fully reflect the record.

> The Division's determination of sales tax due for the audit period was based primarily upon information taken from the summaries.[3]

The auditor obtained the following information from the summaries: the lease number, the name and address of the lessee, the taxing jurisdiction (the jurisdiction in which the lessee was located), the term of the lease, the amount of each monthly payment, the purchase option amount (if any), the name of the assignee, the date discounted, and the option due date. A computer program was used to segregate each lease transaction by taxing jurisdiction, and then, based upon the number of installment payments falling due within each sales tax quarter, the computer program calculated audited sales receipts per quarter. The amount of the purchase option was treated as a receipt received on the option due date. In this way, audited sales receipts were calculated by quarterly period, within sales tax jurisdictions. The appropriate tax rate was applied by jurisdiction to determine tax due per quarter. Sales tax remitted was subtracted from audited sales tax due to calculate a sales tax deficiency for each quarterly period.

Mr. Perotti asked to be provided with the actual lease document for each transaction shown as nontaxable on the summaries. Based upon the following lease provision, the Division determined that none of the leased equipment was or could have been incorporated into a capital improvement project:

> "Equipment to remain unattached to real property. Each item of equipment leased hereunder shall at all times remain the property of the Lessor and Lessee shall have no right, title or interest therein or thereto except as expressly set forth in the lease. The equipment is, and shall at all times remain, personal property irrespective of the way it may be affixed to the realty, and lessee shall maintain

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[3] The Administrative Law Judge's finding of fact "4" read as follows:

> "The 'summaries' referred to by Mr. Perotti were computer-generated schedules created by Mr. Tadler and his children in an attempt to estimate Clayton's future income. The lease summaries did not show actual amounts collected by Clayton. That information was contained in Clayton's cash receipts journal. The Division's determination of sales tax due for the audit period was based primarily upon information taken from the summaries."

We modified this finding to more accurately reflect the record.

> each item so that it may be removed from any building in which it is placed without damaging such building. The Lessor, at its option, shall be permitted to display notice of its ownership of the equipment by affixing to each item of equipment an identifying stencil, plate, decalomania, or any other indicia of ownership" (Clayton Lease, ¶ 7).

The Division also determined that leased equipment, by definition, could not be resold. Furthermore, Mr. Perotti testified:

> "The resale certificates were not accepted because I believe in the lease agreement itself the leased equipment could not be resold" (Tr., p. 45).

The Clayton lease states:

> "Lessee shall not, without Lessor's prior written consent, remove the equipment from such location, part with possession or control of the equipment or sell, pledge, mortgage or otherwise encumber the equipment or any part thereof or assign or encumber any interest under this lease" (Clayton Lease, ¶ 9).

Based on its examination of the lease agreements, the Division treated as taxable each sale for which a resale certificate or certificate of capital improvement was provided to Clayton. This amounted to 22 transactions out of a total of over 900 transactions. Clayton was unable to produce certificates for 12 transaction shown as nontaxable on the summaries, and these too were treated as taxable sales. Tax due on these transactions was calculated in the manner described above. Clayton produced exemption certificates for all transactions claimed to involve parties exempt from taxation. No sales tax was found due in the areas of recurring expense purchases or fixed asset acquisitions.

As a result of its audit, the Division issued to petitioner Clayton Funding Corporation a Notice of Determination and Demand for Payment of Sales and Use Taxes Due, dated September 20, 1985, for the period September 1, 1980 through February 29, 1984, assessing tax of $376,748.26 plus penalty and interest. A notice of determination, assessing identical amounts of tax, penalty and interest, was issued to petitioner Robert J. Tadler on or about September 20, 1985. The notice issued to Mr. Tadler contains this explanation:

> "You are personally liable as officer of Clayton Funding Corp. under Sections 1131(1) and 1133 of the Tax Law for the following taxes determined to be due in accordance with Section 1138(a) of the Tax Law."

The Division and Clayton, by Mr. Tadler as president of Clayton, executed a series of four consents extending the period of limitation for assessment of sales and use taxes under articles 28 and 29 of the Tax Law. Together the consents extended the final date for assessment of taxes for the period September 1, 1980 through February 28, 1982 to June 20, 1985. Each consent identifies the "vendor" to whom it applies as Clayton. No consents were obtained extending the period of limitation for assessment of taxes due from Mr. Tadler.

The notices of determination issued to petitioners have a checkmark in a box next to the following statement: "The tax assessed above has been estimated in accordance with the provisions of section 1138(a)(1) of the Tax Law."

With regard to the audit methodology used, the Administrative Law Judge and Mr. Perotti had the following exchange:

"Q: . . . Maybe you should look at the listing of records available during audit. Is this your memory of what was provided?

A: Yes.

Q: Did you determine that these were adequate for audit purposes? Was there an adequate set of books and records here?

A: Yes.

Q: My understanding is that it was the books and records themselves that were used to assess the tax. The notice indicates that the tax was estimated. I will show it to you. There's an X next to the estimate box.

A: Yes.

Q: Was it estimated?

A: In my opinion, it was not. I myself didn't prepare the assessment document. I feel that I did a detailed audit. I don't believe I did any estimates.

Q: Were there any projections?

A: No" (Tr., pp. 33-34).

After Clayton assigned a lease, it did not and could not know whether timely payments were being made to the assignee. Clayton's books and records did not show actual amounts collected by the assignees. The Division calculated taxable sales for each lease by multiplying the amount of each installment payment by the number of payments to be made in a sales tax

quarter. Actual amounts received by Clayton or its assignees were not considered. Purchase option amounts as shown on the lease summaries were treated as received on the option due date, and no attempt was made to determine whether the purchase options were actually exercised and whether Clayton received the full option amount.

Clayton provided the Division with a brochure used in its business entitled "To Buy or To Lease?" The brochure contains the following statements:

> "Leasing makes good business sense. It generally provides a more economical way to use hard-earned capital to acquire equipment than a bank loan or an outright purchase.
> . . . Leasing allows a company to use the equipment while it pays for it, thus enjoying a better profit picture when current income covers current expenses.
> CASH PURCHASE VS. LEASING
> By purchasing equipment for cash a company may be tying up scare, productive capital that would provide extra income if properly invested. When a cash purchase is made, the earning power of that cash is lost to the company. Equipment purchased with cash must be paid long before it can generate any profits. Under a leasing arrangement, the equipment is paid for as it generates profits."

The brochure asserted that leasing through Clayton provided the lessee with investment tax credits which would be assigned to the lessee automatically along with full depreciation benefits.

During the audit period, approximately 90% of Clayton's transactions were written on a standard form, identifying Clayton as the lessor. The material provisions of the agreements between Clayton and its lessees, in addition to those discussed above, provided as follows:

Paragraph 1 provided for the leasing by Clayton of a particular piece of equipment to be delivered to the lessee and correspondingly provided for the making of monthly payments by the lessee "until the total rent shall have been paid in full."

Paragraph 2 contained Clayton's agreement to order equipment from the supplier and the lessee's agreement to arrange for delivery of that equipment.

Paragraph 3 contained the lessee's acknowledgement that it had been given notice of Clayton's intention to assign its interest in the lease. The lessee represented that it had selected the equipment prior to having asked Clayton to purchase the same and agreed that Clayton made no representations or warranties as to the condition, merchantability or fitness for particular

purpose of the equipment. Clayton disclaimed any obligation to install, erect, test, adjust or service the equipment.

Paragraph 4 relieved Clayton of any liability "for loss or damage occasioned by any cause, circumstance or event of whatsoever nature."

Paragraph 5 required the lessee to supply insurance coverage on the equipment.

Paragraph 6 required the lessee to assume the risk of loss to the equipment. Upon destruction of the equipment, the lessee was to repair or replace the equipment or to pay a stipulated loss value to Clayton. The stipulated loss value was equal to the aggregate amount of unpaid total rent for the balance of the term of the lease, less any recovery received by Clayton from insurance.

Paragraph 8 required the lessee to bear the cost of all taxes, licensing and registration relating to the equipment, including sales taxes, and to assume responsibility for filing all required returns.

Paragraph 10 contained the lessee's agreement to indemnify Clayton against any loss arising out of the use of the equipment.

Paragraph 12 provided that, upon the lessee's default, Clayton could terminate the lease and declare the entire amount of the unpaid rent for the balance of the lease term immediately due and owable. Clayton was authorized to take possession of the leased equipment and to dispose of it as it chose without in any way affecting the obligation of the lessee to make payment of the balance of the rent.

Paragraph 13 provided:

> "Lessee shall have no option to purchase or otherwise acquire title to or ownership of any of the equipment and shall have only the right to use the same under and subject to the terms and provision of the lease."

Paragraph 20 authorized Clayton, at its option, to file a Uniform Commercial Code financing statement covering the equipment and signed only by Clayton. The lessee agreed to pay Clayton the actual fee for the filing.

Paragraph 25 required the lessee, upon the termination of the lease, to deliver the

equipment to Clayton, or to an address designated by Clayton, freight prepaid.

As stated above, the lease utilized by Clayton contained a specific provision stating that the lessee had no option to purchase at the end of the lease term. The pre-printed Clayton lease did not provide for a purchase option. The computer generated summaries used by the auditor to determine petitioners' sales tax liability did show purchase option amounts for each lease. Between 20 and 25 percent of the purchase option amounts were for amounts of $1.00 or less. The remaining purchase options were for amounts equal to 10 percent of the actual cost of the equipment. Depending on Clayton's agreement with a particular bank, leases were sometimes reassigned to Clayton at the end of a lease term and sometimes not. It was Clayton's hope, where the lease was reassigned, that Clayton would be able to sell the equipment to the customer at a price equal to 10 percent of its original cost. The purchase option amounts shown on the lease summaries represented amounts Clayton hoped to collect based on this estimated value. Mr. Tadler testified that each lease would have to be examined separately to determine whether or not a purchase option actually existed.

The amounts of the purchase options actually collected by Clayton were recorded in Clayton's cash receipts journal. The auditor segregated purchase option amounts for each tax jurisdiction but did not total the purchase option amounts for all tax jurisdictions for the entire audit period. According to Mr. Tadler's calculations, the Division determined that Clayton collected purchase option amounts totalling approximately $96,400.77. Mr. Tadler reviewed Clayton's cash receipts journal and, on the basis of that journal, determined that Clayton actually collected $11,827.14 in purchase options.

Petitioners provided a comparison of purchase option amounts shown on the lease summaries with actual amounts collected as shown in Clayton's cash receipts journal. In most instances where the option was actually exercised, the amount paid amounted to either approximately 10% of the original cost of the equipment or $1.00. In two instances, invoice numbers 1024 and 1343, the amount paid was approximately 20% of the original cost of the equipment.

It is not known whether Clayton ever took possession of the equipment at the end of a lease term.

Documents submitted in evidence show that, under the terms of the leases, total rental exceeded the purchase cost of the equipment by 35% to over 60%.

Clayton's transactions took several different forms depending on the requirements of the purchaser and funding source. In some instances, Clayton served only as a broker bringing together the potential purchaser and the funding source. In other instances, Clayton was the primary lessor entering into an agreement with the lessee and immediately assigning the lease to a third party. Clayton had different arrangements for reporting and paying sales tax to New York depending on the requirements of the funding source. It was Clayton's understanding that it was not under a duty to collect sales tax after a lease was assigned; however, it generally agreed to any arrangement for reporting and payment of sales tax required by its funding sources.

Transactions involving Beneficial Commercial Corporation ("Beneficial") and Walter Heller were written on Beneficial invoices which identify Beneficial as the lessor. Clayton served only as a middleman in these transactions, receiving a set number of monthly payments as a commission for its service of bringing together the potential purchaser and the funding source. The auditor's workpapers show 12 transactions involving either Beneficial or Walter Heller. In each case, the purchase option amount was zero. Clayton was found liable for collection of sales tax on each installment payment made to Beneficial or Heller during the audit period.

When Clayton prepared a lease on its own lease forms, the monthly installment payment and the sales tax due on that payment were stated separately. Once the transaction was discounted, the total payment and sales tax due were to be paid directly to the funding source. At least one funding source collected and paid the tax to New York in its own name. Others collected the tax and remitted it directly to Clayton which filed returns and paid the tax in its own name. Still others collected and deposited the tax in a bank account to which Clayton had

access for the sole purpose of paying the tax to New York. These arrangements were reflected in Clayton's contracts with the funding sources.

The auditor's workpapers establish that over 10 percent of Clayton's transactions involved Ultra Funding Corporation ("Ultra") as a funding source. A letter dated January 7, 1991, addressed to Mr. Tadler from Bernard Bortnick, president of Ultra, states:

> "Please be advised that any and all lease transactions discounted by Clayton Funding Corporation with Ultra Funding Corporation were serviced by Ultra Funding Corporation and its assignees and with regard to the collection of New York State Sales Taxes were the responsibility of Ultra Funding Corporation or its assignees, and said taxes were remitted directly to New York State."

Chase Commercial Corporation was another of Clayton's major funding sources. A copy of the financial agreement entered into between Chase and Clayton contains the following provision:

> "TAXES. The Bank will have the right, but will not be obligated to segregate the part of each collection made by Bank which constitutes any use or sales tax which may be payable. All such monies will be deposited to the Company's credit in a special non-interest-bearing checking account at the Bank, subject to withdrawal by check payable only to the appropriate taxing authorities. The Company will prepare all sales or use tax returns required to be prepared and filed by the Company and forward the same to the Bank at least seven days prior to the date such returns are due, together with a check payable to the appropriate taxing authority drawn on such special account with an envelope addressed to such taxing authority with first class postage affixed. The Bank will send the tax return and check to the taxing authority as directed by the Company and permit funds from the special account to be withdrawn to pay taxes due but only to the extent that a sufficient credit balance exists in favor of the Company in the account from moneys collected for such purpose. The Bank shall have no obligation to pay any taxes on such collections except from funds supplied by the Company for such purpose.
>
> At the time Obligations are assigned to the Bank, the Company will advise the Bank of the appropriate sales or use tax rate to be applied to any payments. The Company will be solely responsible for the accuracy of the information supplied to the Bank and for keeping it advised of any changes in such information.
>
> This procedure to facilitate the payment of sales or use taxes is solely an accommodation extended by the Bank to the Company and may be discontinued at any time upon five days notice.
>
> The Bank shall have no liability for errors or omissions with respect to segregating or paying any monies collected and the Company specifically agrees that the Company is solely responsible for billing, collecting, reporting and paying all taxes due with respect to the transactions contemplated by this Agreement. The

> Company further agrees to indemnify and hold the Bank harmless from and against all liabilities to any taxing authority arising out of this Agreement. To the extent collections are made by the Company, it will timely report and pay all sales or use taxes due from funds collected for such purpose. Copies of tax reports with proof of payment of taxes will be sent to the Bank upon request" (emphasis added).

Clayton prepared sales tax returns in compliance with the terms of its agreement with Chase.

Petitioner provided information with regard to its arrangements for collecting and remitting sales tax for each of its funding sources. What follows are representative examples of those arrangements.

(a) Barclay's Bank sent Clayton a monthly check representing sales tax collected on monthly lease payments. The checks were made out to the State of New York as payee. Clayton forwarded these checks directly to New York with its sales tax returns. Apparently, the amount of the check was included by Clayton in its statement of its own sales tax liability. The bank did not provide Clayton with a reconciliation of lease payments due, payments collected and sales tax collected.

(b) Tilden Commercial Alliance, Incorporated remitted a monthly check made out to Clayton and a schedule, apparently showing the name of the lessee, lease payments received and sales tax collected.

(c) First National Bank of Long Island remitted checks to Clayton on a quarterly basis. The actual amount remitted during the audit period was $237.76. The schedule relied on by the Division to calculate Clayton's tax liability shows that this bank should have collected and remitted $8,641.92.

Another of Clayton's major funding sources was Bank Leumi. From the beginning of the audit period until the second half of 1983, Bank Leumi collected sales tax at the time it collected the installment payment upon which the tax was due. Upon assignment of the lease by Clayton, Bank Leumi sent the lessee a letter advising him or her of the assignment and instructing the lessee to make all future payments to Bank Leumi. Included with the letter was a document entitled "Highlights of Lease." It showed the original term of the lease, the amount of

the monthly payment and sales tax due on the payment.

From September 1981 through February 1984, John J. Hurley was employed by Bank Leumi as the first vice-president in charge of the Installment Loan Department. In the course of his duties, Mr. Hurley reviewed the bank's recordkeeping system with regard to assigned leases and discovered that Bank Leumi had no system for segregating and keeping a record of sales tax collected. Any amounts in excess of the monthly installment payments were being recorded as overpayments, when, in fact, the additional amounts represented sales tax due on the installment. Upon inquiry, Mr. Hurley was advised that the bank's computerized recordkeeping system was inadequate for the purpose of collecting and maintaining records of sales tax so collected. In consultation with the bank's lawyers, Mr. Hurley instituted a new policy requiring all lease assignors (such as Clayton) to collect the sales tax payment separately from the bank's collection of the installment payment.

As of September 1983, Clayton required lessees whose lease was assigned to Bank Leumi to make a separate payment of sales tax. Lessees were required to send a monthly sales tax payment directly to Clayton and to pay by check made payable to N.Y. State Sales Tax. Clayton did not know whether a lessee was making timely payments to Bank Leumi or whether the terms of the lease agreement had been altered because Bank Leumi failed to provide Clayton with timely reports detailing the status of leases assigned to the bank. Bank Leumi did provide lessors with trial balances of each lessee's account. The bank tracked accounts using a numerical identification system rather than the lessee's name. The number assigned to each account was different from the lease number assigned by Clayton. For that reason, reports generated by Bank Leumi could not be used by Clayton to identify the accounts by name without aid from Mr. Hurley and the Bank's collection department.

Clayton's records of sales tax collected by the funding sources and remitted to New York State through Clayton consisted of worksheets attached to Clayton's file copies of the filed sales tax returns.

The arrangements between Clayton and its assignees were different depending on the

requirements of the assignee. Generally, Clayton assigned all its rights and remedies under the lease but none of its obligations. The assignee was authorized to collect payments due, compromise or discharge the debt, repossess the equipment and to exercise all other rights, remedies or claims of the assignor.

Clayton never funded a lease transaction using its own funds. In most cases, the bank or funding source issued a check in payment for the equipment directly to the supplier of the equipment.

The Division offered in evidence a series of documents which exemplify a typical transaction involving Clayton.

The first document is an agreement between Clayton and a company named Food Communications ("Food") and is dated January 4, 1983. The agreement states that Food requests Clayton "to extend credit to and to purchase notes, accounts and/or other obligations . . . from or otherwise to do business with" Food. Food authorized Clayton to obtain a credit report and guaranteed Clayton that it would pay all obligations incurred in its business with Clayton.

The second document is an executed copy of a Clayton lease agreement. Food is identified as lessee, Interconnect Telephone Services ("Interconnect") is identified as the equipment supplier and the equipment is shown as a telephone system. The term of the lease is shown as 36 months. Rental payments were to be $145.39 per month, plus sales tax of $11.99. Food was required to make an advance payment to Clayton of $361.68. The lease is dated February 7, 1983.

The next document is an Interconnect invoice. It is dated February 3, 1983. The invoice provides for billing to Clayton and shipment to Food. The terms of the transaction are shown as "lease." A description of the transaction shows that Interconnect was to furnish and install an ITT Key Telephone System. The amount due is shown as $3,616.80, from which a "10 percent Prepaid Purchase Option" of $361.68 was subtracted, resulting in a total amount due of $3,255.12.

Clayton assigned the lease to Bank Leumi. The lease assignment document is also dated February 7, 1983.

A letter, bearing the letterhead of Bank Leumi and dated February 7, 1983, advises Food that Clayton has assigned the lease to Bank Leumi. A second document, entitled "Highlights of Lease", provides that 35 payments of $145.39, plus sales tax of $11.99, are to be made by Food to Bank Leumi, beginning on March 8, 1983.

In addition to the facts found by the Administrative Law Judge, we find the following:

> At the conclusion of the hearing, the Administrative Law Judge set a briefing schedule and asked each party to address the following issues (in addition to any other issues each might wish to address):
>
> "First of all, [where a lease is assigned] who has the legal duty to collect the sales tax; is it the person to whom the lease is assigned or not.
>
> "Secondly, in the matter of the adequacy of the records, I would like to know in the kinds of transactions we have here, with assignments of leases, what the parties think an adequate set of books and records would be to reflect those transactions and to verify the sales tax that's due on those transactions . . ."
>
> "MR. JARVIS: I object to the issue. In the first place, I don't think there's a question or issue of adequacy of records. We used records that the taxpayer provided.
>
> "ADMINISTRATIVE LAW JUDGE: The taxpayer said more than once that they had adequate books and records, and I'm not certain what an adequate set of books and records would be under these circumstances.
>
> "MR. JARVIS: Okay.
>
> "[Third] I would like to know reasonable cause for cancellation of penalties. I just want to make sure that you address that in your brief" (Tr., pp. 205-206).
>
> The Division did not submit a brief at hearing. Petitioner submitted a brief which addressed the Administrative Law Judge's request and other issues petitioner felt relevant to its case.

OPINION

The Administrative Law Judge determined that the Division "impermissibly estimated the tax due" (Determination, p. 30). Her reasoning was as follows:

> "[i]t is beyond question that where the taxpayer maintains a complete set of books and records the Division's audit is restricted to those books and

records to determine the taxpayer's ultimate tax liability (see, Matter of Chartair, Inc. v. State Tax Commn., 65 AD2d 44, 411 NYS2d 41, 43; Matter of Cafe Europa, Tax Appeals Tribunal, July 13, 1989). In this case, the Division concedes that Clayton's records were complete and adequate for the purpose of verifying its tax liability. It maintains, however, that it did not estimate the tax due but used Clayton's records to determine its exact tax liability.

"The Division's position is problematic for several reasons. If, as the Division contends, Clayton was obligated to collect sales tax on each and every installment payment, it was also obligated to keep a record of every installment payment made and the tax due on that payment (Tax Law § 1135[a][1]). After assignment of the so-called leases, Clayton did not know whether installment payments were made or not and whether tax was collected or not; therefore, it could not have kept the required records, and its records of sales tax collected could not have been adequate for the purpose of verifying its tax liability.

"If either Clayton or the equipment supplier was obligated to collect sales tax at the time possession of the property was transferred to the purchaser/lessee, Clayton's records, especially its leases, invoices from suppliers and cash receipts journal, might have provided a basis for determining the exact amount of tax due. As the audit did not proceed on that basis, those records were not used by the Division to determine Clayton's tax liability. If the banks and other financial institutions were obligated to collect tax due after the assignments took place, Clayton's records would have been adequate for the purpose of determining Clayton's individual liability on amounts it actually collected, but again, the records were not used in this fashion.

"The one record which was used by the Division was a computer generated summary of each lease and assignment.[4] The lease summaries were not the source documents required to be kept as a true record of sales (Tax Law § 1135[a][1]), and, by themselves, the summaries did not constitute adequate books and records. The summaries may have been accurate records of amounts due and owing under each agreement, but they were not accurate records of the amounts actually collected on each transaction and were not prepared or maintained by Clayton as a record of sales. Moreover, while the Division's auditor repeatedly asserted that Clayton's tax liability was not estimated or based upon a projection, the record as a whole establishes that Clayton's taxable sales were projected based upon the summary. Where the taxpayer maintains complete records, Article 28 requires more than the 'use' of one individual record to estimate the taxpayer's liability. A test period audit 'uses' the taxpayer's records to project the taxpayer's tax liability for an entire audit period; however, such a methodology is unacceptable where complete records are available (Matter of Chartair, Inc., supra). If it is assumed that Clayton was obligated to collect tax on each installment payment made under the terms of the leases and that Clayton maintained adequate books

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[4] It may be inferred from the record as a whole that the summaries contained information taken from various documents, the leases, assignment documents, invoices, etc., and not only from the leases themselves.

> and records (these are the premises upon which this audit rests), it must be concluded that the audit impermissibly estimated the tax due" (Determination, pp. 28-30).

On the issue of who was responsible for collection of the tax in the transactions at issue, the Administrative Law Judge concluded that "it is first necessary to determine whether the . . . transactions were true leases or security agreements" (Determination, p. 23).

The Administrative Law Judge identified the following factors to be considered in making such determination: the intentions of the parties (citing Matter of Sherwood Diversified Servs., 382 F Supp 1359); whether the lessor was in the business of leasing the equipment in question (citing Leasco Data Processing Equip. Corp. v. Starline Overseas Corp., 74 Misc 2d 898, 346 NYS2d 288, affd 45 AD2d 992, 360 NYS2d 199, appeal dismissed 35 NY2d 963, 365 NYS2d 179); which party was responsible for maintaining insurance coverage (citing International Paper Credit Corp. v. Columbia Wax Products Co., 102 Misc 2d 738, 424 NYS2d 827, revd on other grounds 79 AD2d 700, 434 NYS2d 270); whether total rentals exceed the purchase price (citing National Equip. Rental v. Priority Elecs. Corp., 435 F Supp 236); the amount of the purchase option price as compared to the total rentals (citing section 1-201[37] of the Uniform Commercial Code) (e.g., purchase prices of 7.7 percent and 8.5 percent were found to make the lease one intended for security, citing respectively, Matter of Crown Cartridge Corp., 220 F Supp 914 and Matter of Merkel Inc., 45 Misc 2d 753, 258 NYS2d 118, revd on other grounds 25 AD2d 764, 269 NYS2d 190); and the fact that the absence of a purchase option is not a bar to a binding security interest (Leasing Serv. Corp. v. American Natl. Bank & Trust Co., 19 UCC Rep 252 [D. NJ 1976]).

The Administrative Law Judge pointed out that the only case considering whether a transaction constituted a true lease or security agreement in the context of New York's sales tax law is Matter of Sherwood Diversified Servs. (supra).

The Administrative Law Judge determined that:

> "[t]aking into consideration all of the factors outlined by the courts supports the conclusion that the Clayton leases were security agreements

> and that Clayton acted not as a seller but as a financing agent or a broker" (Determination, p. 26).

The Administrative Law Judge concluded that even if petitioners entered into:

> "true leases . . . the conclusion is inescapable that the agreements maintained their character as leases when they were assigned to banks or other lending institutions . . . . If true leases existed, the banks or other financial institutions must have stood in Clayton's place as lessors. Since the obligation to collect tax would arise at the time each rental payment was made, that obligation would rest with the party collecting payment" (Determination, pp. 27-28).

On exception, the Division asserts that the Administrative Law Judge erred in concluding that the audit methodology was wrong. The core of the Division's assertion is that: it performed a detailed audit of petitioners' leases; it utilized records, i.e., the summary of leases provided by the taxpayer; and it did not estimate petitioners' liability. Specifically, the Division submits that:

> "the ALJ's conclusion that the holding in Chartair applies to this case is in error. By so concluding, the ALJ has impermissibly extended that case's ruling with respect to the need to request books an (sic) records, to a holding that only a taxpayer's source documents may be used to determine tax due, even if the taxpayer presents documents which the taxpayer itself indicates accurately summarize the information contained in those source documents. The ALJ has not cited any authority for such a proposition.
>
> "(b) Since the summaries that were used to calculate the tax owed were represented to be accurate, any errors in the audited tax should be corrected by the proven error amounts, not by cancelling the assessment in its entirety" (Rider to Division's Exception, p. 3).

The Division urges us to conclude as a matter of law that:

> "2. Once a summary of petitioners' source documents was presented to the auditor, he was entitled to rely on the contents thereof in calculating tax due, and it was petitioners' obligation to point out any errors resulting from the use of the summary.

The Division also asserts that certain "Findings of Fact . . . are not entirely accurate as stated, and are therefore not fully supported by the evidence of record" (Rider to Division's Exception, p. 1) and consequently do not support the Administrative Law Judge's conclusion that the leases were "security agreements."

The Division urges us to conclude as a matter of law that:

"4. Clayton was responsible for collection and remittance of the sales tax due on each lease installment, even after the lease was assigned to a third party.

"5. Even if the subject transactions constituted security agreements, then Clayton was obligated, as either a vendor or a co-vendor, to collect and remit the tax due on the same as sales of tangible personal property" (Rider to Division's Exception, pp. 3-4).

The Division's final point is that:

"the ALJ made a very serious error in relying on Sherwood Diversified Services, a 1974 federal bankruptcy court case, as being the only case to consider whether a particular transaction constituted a lease or a security agreement in the context of New York's sales tax law. To the contrary, this very question was addressed in 1981 by New York's Appellate Division in Petrolane Northeast Gas Service, Inc. v. State Tax Commission, 79 AD2d 1043 (Third Dept. 1981). Although this case was cited to the Division of Tax Appeals in the Law Bureau's answer to the petition herein, the ALJ has chosen to ignore it. Disregarding this case constitutes reversible error because the court in Petrolane reached the opposite result of that reached in Sherwood. Furthermore, because Petrolane was decided by the Appellate Division of New York's court system, and Sherwood was decided by the United States District Court in the context of a bankruptcy proceeding, it is submitted that Petrolane is a better authority than is Sherwood. Application of the guidelines set forth in Petrolane to the facts of this case confirms the conclusion reached by considering the other factors discussed above, that Clayton engaged in leasing transactions" (Division's brief, pp. 18-19).

Petitioners assert that the determination of the Administrative Law Judge is correct in all respects.

We deal first with the Division's assertion that certain of the Administrative Law Judge's findings of fact "are not entirely accurate as stated, and are therefore not fully supported by the evidence of record" (Rider to Division's Exception, p. 1).[5] While the Division identifies the specific facts, it offers nothing but this general assertion as a reason for urging us to conclude

[5]The facts at issue describe Clayton's business relationships with its lessees and assignees. Specifically, #1 is a general description of Clayton's business operations; #3 contains the transcript of the examination of the auditor by the Administrative Law Judge concerning the basis for the assessment; #4 describes the lease summaries upon which the Division determined tax due; #11 indicates that after Clayton assigned a lease it could not and it did not know whether timely payments were being made to the assignee. It then describes how the Division calculated tax; #12 contains excerpts from Clayton's Business Brochure describing the benefits of leasing as opposed to buying; #13 describes the material provision of Clayton's standard lease form which covered approximately 90% of its transactions; #19 indicates that Clayton's transactions took several different forms depending on the requirements of the purchaser and the funding source and describes these forms in general terms; #29 describes generally the different arrangements between Clayton and its assignees; and #30 states that Clayton never funded a lease using its own funds.

that the Administrative Law Judge erred. We reject the Division's assertion. In our view, the Administrative Law Judge made reasonable inferences from the material in the record.[6]

We deal next with the correctness of the Division's audit methodology.

We affirm the determination of the Administrative Law Judge for the reasons stated therein.

In this case, the Division's audit proceeded on the premise that Clayton entered into "true leases" and, thus, was liable for tax on each and every rental payment as it accrued (see, Matter of Petrolane Northeast Gas Serv. v. State Tax Commn., 79 AD2d 1043, 435 NYS2d 187, 189, lv denied 53 NY2d 601, 438 NYS2d 1027).

The Division's task then was to calculate Clayton's tax on the rental payments collected by Clayton. This the Division did not do; instead it calculated the tax due based on the payments expected to be made as shown on the summary. The Administrative Law Judge concluded, properly, that this was an estimate of Clayton's liability.[7]

The crucial issue then became whether Clayton's books and records were inadequate, justifying the use of an estimate by the Division (Matter of Chartair, Inc. v. State Tax Commn., supra). Notwithstanding the auditor's testimony and Clayton's assertion at hearing that the books were complete and adequate, the Administrative Law Judge requested that each party address the issue in its post-hearing brief. Specifically, the Administrative Law Judge stated:

> "[s]econdly, in the matter of the adequacy of the records, I would like to know in the kinds of transactions we have here, with assignments of leases, what the parties think an adequate set of books and records would be to reflect those transactions and to verify the sales tax that's due

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[6]Our modification to findings of fact "1" and "3" should not be construed to lend support to the Division's assertion. Our modification of finding of fact "1," by insertion of the Division's description of Clayton's business activities as included in the Sales Tax Field Audit Report, was made because it reflects, first hand, the Division's own understanding of Clayton's business; one which, we might add, is not materially different from the analysis of the Administrative Law Judge in the original finding of fact "1."

Our modification to finding of fact "3" merely adds a portion of the transcript which illuminates for the record the manner in which the auditor conducted subsequent audits of leasing companies.

[7]The Notice of Determination also indicated that the liability was estimated.

on those transactions. Is that understood?

"MR. JARVIS: I object to the issue. In the first place, I don't think there's a question or issue of adequacy of records. We used records that the taxpayer provided.

"ADMINISTRATIVE LAW JUDGE: The taxpayer said more than once that they had adequate books and records, and I'm not certain what an adequate set of books and records would be under these circumstances.

"MR. JARVIS: Okay" (Tr., p. 205).

The Division did not submit a post-hearing brief. Clayton's brief reiterated its assertion that it provided complete books and records. Accordingly, the Administrative Law Judge determined that the Division "conceded" that the books and records were adequate. Thus, the Administrative Law Judge, relying on Matter of Chartair, Inc. v. State Tax Commn. (supra), properly concluded that the Division's estimate of Clayton's tax liability was impermissible.

The Division does not except to the determination of the Administrative Law Judge that Clayton maintained complete books and records. Thus, while this Tribunal has de novo review power of the Administrative Law Judge's determination (see, Matter of American Express Co. v. Tax Appeals Tribunal, ___ AD2d ___, 597 NYS2d 485, 488), we find no basis upon which to disagree with the Administrative Law Judge's conclusion that the Division conceded that Clayton had complete and adequate books and records from which its tax liability could be calculated, and that the estimate was, thus, impermissible.[8]

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[8]Additionally, we observe that the Division's method is inconsistent with the manner in which the auditor stated he conducted audits of leasing companies subsequent to petitioners' audit, i.e., by examining the books of the financial institution to which the leases were assigned, and that reliance on the summaries produced a clearly erroneous assessment. The purchase option amounts shown on the lease summaries were treated as received on the option due date with no attempt having been made by the Division to determine whether the purchase options were actually exercised and whether Clayton received the full option payment.

The facts are that the amounts of the purchase options actually collected by Clayton and upon which tax was properly due, were recorded in Clayton's cash receipts journal which was not examined during the audit. Clayton's review of the cash receipts journal at hearing showed that Clayton actually collected $11,827.14 in purchase options, not the approximately $96,400.77 asserted by the Division.

Moreover, while the Division asserts Clayton is liable for collection of sales tax on each installment payment made pursuant to twelve transactions with Beneficial and Walter Heller, the facts show that:
1) these transactions were written on Beneficial invoices which identify Beneficial as the lessor, and 2) Clayton served only as a middleman receiving a set number of monthly payments as a commission for its service of bringing

We next address the issue of whether the "lease transactions" were true leases or security agreements.

We affirm the determination of the Administrative Law Judge for the reasons stated therein.

We address finally the Division's assertion that the Administrative Law Judge committed "reversible error" in her treatment of the Sherwood case. We cannot agree.

Stated simply, the Administrative Law Judge was correct in her statement that Sherwood is the "only case considering whether a transaction constituted a true lease or security agreement in the context of New York's sales tax law" (Determination, p. 25, emphasis added). Matter of Petrolane, cited by the Division as "better authority than . . . Sherwood," dealt with a different issue, i.e., whether the transaction was a sale "made prior to the effective date of the sales and use tax statute, August 1, 1965, and, therefore . . . is not a taxable transaction" or a lease, in which case the rental payments received after the effective date of the tax would be subject to the tax. Moreover, the fact that the District Court's opinion in Sherwood arose from a decision in Bankruptcy Court does not, in our opinion, undercut the precedential value of Sherwood, since it does deal with the same issue as in this case. Accordingly, the Administrative Law Judge was perfectly justified in her reliance on Sherwood.

Finally, we would point out that, notwithstanding the Administrative Law Judge's specific request, the Division, at hearing, did not submit a brief, a memorandum of law or any other document containing its view of the law applicable in this case. In fact, the only document submitted to the Administrative Law Judge which shed any light on the Division's view of the law was the Division's answer to petitioners' petition at hearing. In its answer, the Division relied on Sherwood for the same principle as did the Administrative Law Judge, specifically, that:

> "a lease which has been entered into merely as a security agreement, and

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together the potential purchaser and the funding source.

> which does not in fact represent a transaction in which there has been a transfer of possession from the lessor to the lessee, is not a sale within the meaning of the Tax Law and is therefore not subject to tax under Tax Law Section 1105(a). 20 NYCRR 526.7(c)(3); In re Sherwood Diversified Services, Inc., 382 F Supp 1359 (SDNY 1974); Matter of the Bank of California, N.A., State Tax Commission, June 24, 1983, TSB-H-83(89)S" (Exhibit "E," p. 2, ¶ 6).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petitions of Clayton Funding Corporation and Robert J. Tadler, as Officer are granted; and

4. The notices of determination issued to Clayton Funding Corporation and Robert J. Tadler, as Officer, dated September 20, 1985, are cancelled.

DATED: Troy, New York
July 8, 1993

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner