STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition

of

P-H FINE ARTS, LIMITED

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 September 1, 1984 through August 31, 1987.

In the Matter of the Petition

of

ROBERT C. GUCCIONE, OFFICER OF P-H FINE ARTS, LIMITED

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 September 1, 1984 through August 31, 1987.

In the Matter of the Petition

of

ANTHONY J. GUCCIONE, OFFICER OF P-H FINE ARTS, LIMITED

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 September 1, 1984 through August 31, 1987.

DECISION
DTA Nos. 807866, 807862, 807860, 807864, 807867, 807863, 807861 AND 807865

In the Matter of the Petition	:
of	:
DAVID J. MYERSON, OFFICER OF P-H FINE ARTS, LIMITED	:
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 September 1, 1984	:

through August 31, 1987. :

In the Matter of the Petition :

of :

STEPPLONG CORPORATION :

for Revision of a Determination or for Refund :
of Sales and Use Taxes under Articles 28 and 29
of the Tax law for the Period March 1, 1984 :
through May 31, 1984.

In the Matter of the Petition :

of :

ROBERT C. GUCCIONE,
OFFICER OF STEPPLONG CORPORATION :

for Revision of a Determination or for Refund
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax law for the Period March 1, 1984
through May 31, 1984. :

In the Matter of the Petition

:

of

:

ANTHONY J. GUCCIONE,
OFFICER OF STEPPLONG CORPORATION :

for Revision of a Determination or for Refund :
of Sales and Use Taxes under Articles 28 and 29
of the Tax Law for the Period March 1, 1984 :
through May 31, 1984.

In the Matter of the Petition :

of :

DAVID J. MYERSON,
OFFICER OF STEPPLONG CORPORATION :

for Revision of a Determination or for Refund :
of Sales and Use Taxes under Articles 28 and 29
of the Tax law for the Period March 1, 1984
through May 31, 1984. :

Petitioners P-H Fine Arts, Limited, Robert C. Guccione, officer of P-H Fine Arts, Limited, Anthony J. Guccione, officer of P-H Fine Arts Limited, and David J. Myerson, officer of P-H Fine Arts Limited, c/o General Media International, 1965 Broadway, New York, New York 10023 and Stepplong Corporation, Robert C. Guccione, officer of Stepplong Corporation, Anthony J. Guccione, officer of Stepplong Corporation and David J. Myerson, officer of Stepplong Corporation, c/o General Media International, 1965 Broadway, New York, New York 10023 filed an exception to the determination of the Administrative Law Judge issue on August 27, 1992. Petitioners appeared by Rosenman & Colin (Stephen L. Ratner and Howard J. Rothman, Esqs., of counsel) and Lefrak, Newman & Myerson (Joseph S. Lefrak, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (James Della Porta, Esq., of counsel).

On January 11, 1993, petitioners filed a motion requesting that the August 27, 1992 determination of the Administrative Law Judge be vacated and that the record in this matter be reopened. The Administrative Law Judge issued an order denying the motion on April 1, 1993. No exception was filed to this order. The Tax Appeals Tribunal held petitioners' exception to the August 27, 1992 determination of the Administrative Law Judge in abeyance pending the issuance of the order on the motion. Pursuant to the schedule established after the issuance of the order, petitioners filed a brief in support of their exception, the Division of Taxation filed a brief in opposition and petitioners filed a reply. Oral argument was heard on May 19, 1994 which began the six-month period for the issuance of this decision.

On January 20, 1994, the Tax Appeals Tribunal issued an order granting the motion of Harmon Fines Arts, Inc. to file a memorandum of law amicus curiae. Harmon Fine Arts, Inc. appeared by Proskauer, Rose, Goetz & Mendelsohn (David I. Goldblatt, Esq., of counsel).

The Tax Appeals Tribunal renders the following decision per curiam.

ISSUES

I. Whether purchases of artwork by P-H Fine Arts Limited are subject to sales tax under Tax Law § 1105(a) or compensating use tax under Tax Law § 1110.

II. Whether Stepplong Corporation is subject to sales tax or compensating use tax for its acquisition and use in New York of works of art acquired in exchange for issuance of its stock.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

On December 20, 1988, the Division of Taxation (the "Division") issued to petitioner P-H Fine Arts, Ltd ("Fine Arts") two notices of determination and demands for payment of sales and use taxes due. The first notice assessed sales tax for the period September 1, 1984 through August 31, 1987, in the amount of $302,893.92 plus penalty and interest. The second notice assessed an additional penalty for the period September 1, 1985 through August 31, 1987 in the amount of $1,560.90. On the same date, notices of determination and demands for payment of sales and use taxes due assessing identical amounts of tax, penalty and interest for the same periods were issued to Robert C. Guccione ("Guccione"), Anthony J. Guccione and David J. Myerson, as officers of Fine Arts.

On December 20, 1988, the Division issued to petitioner Stepplong Corporation ("Stepplong") a Notice of Determination and Demand for Payment of Sales and Uses Taxes Due, assessing tax for the period March 1, 1984 through May 31, 1984 in the amount of $173,893.50 plus penalty and interest. On the same date, notices of determination and demands for payment of sales and use taxes due were issued to Guccione, Anthony J. Guccione and David J. Myerson, as officers of Stepplong, assessing identical amounts of tax, penalty and interest as that assessed against the corporation, for the same periods.

During the audit period, Fine Arts, a New York corporation formed in March 1983, was the wholly-owned subsidiary of Penthouse International, Ltd. ("Penthouse") which was also a New York corporation.[1] Along with other endeavors, Penthouse publishes Penthouse magazine. Guccione, David J. Myerson and Anthony J. Guccione were the officers of Fine Arts.

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[1]Subsequent to the audit period, Penthouse changed its name to General Media, Inc. and Fine Arts changed its name to General Media Fine Arts.

Stepplong was a Delaware corporation, incorporated on February 16, 1982 by the New York law firm of Lefrak, Fischer & Myerson (the "Law Firm"). Its incorporator was Stephen P. Long, a Law Firm attorney, and the name Stepplong was intended as an abbreviation of his name. On the same date that Stepplong was incorporated, Mr. Long incorporated three other Delaware corporations, Jolef, Inc., Stepgraf Inc., and Jaynew, Inc. Each of the corporate names was derived from the name of a Law Firm attorney. The corporations were "shelf corporations"; they were not formed for any particular purpose or for any particular client. Except for the names, the certificates of incorporation for Stepplong, Jolef, Stepgraf and Jaynew are identical.

The Law Firm created the four shelf corporations to take advantage of anticipated changes in Federal tax law. In late 1981, the United States Congress was considering legislation which would have precluded Subchapter S corporations from electing a fiscal year. The Law Firm anticipated that corporations formed in 1982 would not be subject to the new legislation and created the four shelf corporations to have them available for use by the Law Firm's clients if needed.

In 1984, the Law Firm caused Prentice-Hall Corporation System, Inc. to file a 1983 Delaware Annual Franchise Tax Report for Stepplong. The report

indicated that Stepplong was inactive and was signed by Stephen Long as sole incorporator. Stepplong had no officers, directors, shareholders or assets in 1983 and was not used for any particular Law Firm client in that year.

At the time Stepplong was formed, neither Guccione nor anyone else associated with Penthouse had any knowledge that any such corporation had been formed. Stepplong was not formed for or at the behest of Penthouse.

On or about December 15, 1983, the Law Firm informed Penthouse that it had created a shelf corporation, Stepplong, which was available for Penthouse's use in effectuating a dividend transaction involving a subsidiary of Penthouse, Penthouse Clubs International Establishment

("PCIE"). PCIE was a Lichtenstein corporation with significant income from overseas operations. Penthouse was its sole shareholder.

In December 1983, a decision was made to distribute the earnings of PCIE to its parent, Penthouse, by means of a corporate dividend transaction. Upon the advice of the Law Firm, the transaction was carried out as described below.

On December 30, 1983 and January 31, 1984, PCIE declared dividends payable to Penthouse in the aggregate amount of $2,107,800.00. On January 16, 1984, Mr. Long, as Stepplong's sole shareholder, adopted corporate resolutions which provided for the election of Guccione as the sole shareholder and director of Stepplong and for the adoption of the by-laws of Penthouse as the by-laws of Stepplong. On January 16, 1984, PCIE made a capital contribution of artwork having a value of $2,107,800.00 to Stepplong in exchange for ten shares of the common stock of Stepplong. This capital contribution was made pursuant to corporate resolutions adopted on January 16, 1984 by Guccione, as the sole director of Stepplong. On February 6, 1984, resolutions adopted by the board of directors of PCIE authorized the distribution of 10 shares of Stepplong common stock to Penthouse in full payment of the dividends previously declared by PCIE on December 30, 1983 and January 15, 1984, in the aggregate amount of $2,107,800.00. In short, when the transactions were completed, Penthouse was the sole shareholder of Stepplong, and Stepplong's sole capital asset was artwork having a value of $2,107,800.00. After the dividend distribution was completed, the artwork owned by Stepplong was brought to New York where it was kept.

At the time of its receipt of the artwork from PCIE, Stepplong was not engaged in any business in New York. Stepplong did not file New York corporation franchise tax reports during the audit period; it did not possess a certificate of authority to collect sales tax; and it did not file sales tax returns. Sometime in 1987 or 1988, Stepplong was merged into Fine Arts.

Fine Arts was incorporated for the purpose of buying and selling fine art. Guccione was its chief executive officer. Fine Arts filed consolidated Federal income tax returns with its parent corporation, Penthouse. It also filed New York State corporation franchise tax reports,

indicating that its principal business activity was that of an art wholesaler. On April 24, 1984, the Division issued to Fine Arts a Certificate of Authority which authorized Fine Arts to collect sales tax on behalf of the State of New York. During the audit period, Fine Arts consistently filed quarterly sales tax returns reporting no gross or taxable sales.

A sales tax field audit of Fine Arts commenced in October 1987. Fine Arts was represented on audit by Stephen Long, who provided the auditor with copies of sales tax returns, Federal, State, and City income and corporation franchise tax returns, a schedule of artwork acquired by Fine Arts before the commencement of the audit period and some purchase invoices. Among Fine Arts' acquisitions were 12 paintings and drawings by world renowned artists such as Picasso, Chagall, Degas, Matisse and Renoir. The purchase prices for these works ranged from $500.00 (for three drawings by Gisbert Fluggen) to $1,565,000.00 (for a Picasso entitled "Boy With a White Collar"). Fine Arts' business offices, as indicated on filed tax returns, were located at 1965 Broadway in New York City. The auditor was informed that the works of art were kept in a townhouse located at 14-16 East 67th Street in Manhattan (the "Townhouse").

The Townhouse (actually two separate brownstones) was purchased by Penthouse in April 1980 and extensively renovated for the use of Guccione. The first two floors serve as Mr. Guccione's personal corporate offices. The four floors above that house a production studio and the personal residence of Guccione and his wife, Kathy Keeton.

On December 16, 1987, the auditor and his supervisor visited the Townhouse and conducted an observation. They were met by Guccione's personal assistant who led them through the first and second floors of the Townhouse, where the artwork owned by Fine Arts and Stepplong was kept. The audit report contains this description of the Townhouse:

> "The interior of the premises seemed to be recently and beautifully renovated and decorated. There was a swimming pool immediately to the right of the foyer. As we proceeded further into the house we could see paintings, statues and antique furniture. All seemed to be original and very expensive. All the artwork was located in the living room, dinning [sic] room, library and other living quarters as well as in the bathroom. After viewing all the works of art listed as investment through-out [sic] the house we left. The entire observation of the premises took approximately 45 minutes...."

The auditor thought that the rooms he observed looked like a large office space rather than a personal residence. The auditor had no education in the fields of art and art history, and he formed no impressions regarding the artistic quality of the artwork he observed. In his handwritten log, the auditor stated:

> "The paintings were all over the house including the bathroom. The paintings had no description or prices attached. My conclusion based on the observation is that the paintings were bought for personal use."

The auditors did not attempt to match the paintings listed on Fine Arts' inventory list with those displayed in the Townhouse. However, they noted that there were many more paintings on display than the number allegedly purchased by Fine Arts. Upon inquiry, they were informed that the additional works were owned by Stepplong. Mr. Long provided the auditors with a list of the Stepplong artwork. It details approximately 71 pieces with a total value of $2,107,800.00. The purchase prices range from $100.00 to $288,000.00. Among the artists represented are: Derain, Picasso, de Vlaminck, Degas, Rouault, Leger, Gaugin, Greco, Holbein, Soutine and Dali.

During their tour of the Townhouse, the auditors did not list or identify the artwork on display. They were not taken to the private living quarters on the upper floors of the Townhouse. They did not determine whether Guccione or Ms. Keeton had a private art collection unconnected to the works owned by Fine Arts.

The auditors were told that Fine Arts had no sales during the audit period. After viewing the Townhouse and the art displayed there, the auditor and his supervisor came to the conclusion that the art was not purchased for resale by Fine Arts but rather was purchased for the personal use of Penthouse and Guccione and held for investment. This conclusion was based upon the following factors:

(a) The Townhouse appeared to the auditor and his supervisor to be a large business office, with paintings and other works of art displayed throughout.

(b) The artwork was not displayed in what the auditors considered to be a traditional gallery setting. The Townhouse was not open to the public and there were no visible signs, catalogues or other indications that the artwork was for sale.

(c) The auditor read an article in the real estate section of Newsday (November 14, 1987) which indicated to him that the art displayed in the Townhouse was purchased for the personal use of Guccione and Ms. Keeton (his fiancee at the time). The pertinent portions of that article state:

> "Bob Guccione doesn't need to remember to bring the pooper-scooper when his five Rhodesian Ridgebacks thunder outside for a walk. Why? Because he doesn't walk them. His three full-time dogwalkers do.
>
> The dogwalkers are part of a staff of 22 that he and his fiancee, Kathy Keeton, employ for the Upper East Side house that they say is the largest privately owned residence in the city. There are maids, cooks, and, of course, security personnel. You need 24-hour security when your house is filled with original art by big-name artists. Keeton's bathroom, for example, has a Picasso and a Dali.
>
> * * *
>
> There are also seven guest suites and the couple says they wish they had space for more. Also more space for the art collection that is so large they've catalogued it. We're talking Chagall, Modigliani, Degas, just to name drop a few. According to Guccione, the collection is worth $35 million. A terrific investment, yes, but remember it is also a passion: Guccione had wanted to be a painter before he got into publishing."

(d) The auditor saw an episode of the Oprah Winfrey television show featuring Kathy Keeton. During the show, Ms. Keeton indicated that she and Guccione had a large collection of original art in their home.

(e) In his review of Fine Arts' Federal income tax returns for 1983 through 1986, the auditor noted that the works of art were categorized in the assets portion of the Federal return balance sheet as "other investments", rather than inventory. These were "pro forma" returns, since Fine Arts filed Federal returns on a consolidated basis with Penthouse.

Based on the conclusions reached by the auditors, the Division determined that the works of art acquired by Fine Arts and Stepplong during the audit period were the business assets of the two corporations, acquired without payment of sales tax. Based on information provided by petitioners, the Division determined that assets costing $3,671,441.46 were acquired by Fine

Arts during the audit period. The property acquired included statues and antiques as well as paintings and drawings. The Division then assessed sales and use tax against Fine Arts and its officers, calculated on the purchase prices of the property acquired during the audit period. The Division also assessed sales and use tax against Stepplong and its officers based upon the value of the artwork acquired by the corporation as part of the stock transaction which occurred in 1984.

Before he began publishing Penthouse magazine, Guccione was a painter. He lived in England and travelled in Europe, where he informally studied art and became quite knowledgeable in the fields of art and art history. Guccione was the chief executive officer of Fine Arts. Guccione conducts all of his business with respect to Penthouse and its subsidiaries, including Fine Arts, from the Townhouse. Business meetings are held in the conference room on the second floor, clients are entertained in the formal rooms on the first two floors, and the production studios located in the building are used in connection with editing, copyrighting, photography and graphic artwork.

As an art dealer, Fine Arts pursues a marketing strategy that is not unique in the art world. That strategy was described in testimony by Guccione and Ronald E. Cayen. Mr. Cayen graduated from Syracuse University with a degree in art history. He has been employed as a museum curator in Syracuse, New York and as a museum director in New York City. For the past 20 years, he has been a private art dealer and has worked for several hundred individual and corporate clients. He is knowledgeable in the field of buying and selling art and has worked extensively with Fine Arts. He is not employed by Fine Arts. Additional information regarding Guccione's conduct of the business of Fine Arts was provided by the affidavit of Thomas A. Andrews, a fine art broker and dealer. Mr. Andrews acted as an independent broker in the 1990 sale of "Le Cirque Mauve" by Marc Chagall, a painting purchased by Fine Arts before the start of the audit period.

Fine Arts began doing business in 1983. During the audit period its activities consisted primarily of acquiring an inventory consisting of the best examples of art work by world known artists. Fine Arts did not advertise in any media or hold itself out to the public as an art dealer or the operator of a gallery. In fact, every effort was made to create the public impression that the artwork acquired by Fine Arts was part of the private collection of Guccione and his wife. These works were displayed in the formal rooms located on the first two floors of the Townhouse. These formal public areas were designed to create an air of grandeur and opulence. To persons entering and viewing the works of art displayed there, the art appeared to be displayed for decorative purposes and for the pleasure of the owners. There is nothing about these areas which would lead an observer to think that a retail business was being conducted there.

Guccione explained his reasons for representing to the public that he personally, rather than Fine Arts, was building a private art collection and that he was not a dealer in fine art. First, by doing so, he was given the opportunity to buy before anyone else. As he explained it, dealers and collectors prefer to sell directly to a collector because a higher price can be demanded from a collector than from a dealer. Because it was known (or thought) that Guccione was amassing a collection, other dealers contacted him when they had a piece to sell which they thought might interest Guccione. If he wanted to purchase that work, he would do so through a friendly dealer who could negotiate a "dealer's" price. In addition, Guccione believed that the monetary value of the art was increased by giving the impression that none of the artwork on display in the Townhouse was for sale.

Displaying the art collection to individuals invited to the Townhouse in connection with other businesses conducted by Penthouse served several purposes. It reinforced the impression that the art was owned by Guccione as a private collector and, at the same time, exposed the collection to potential buyers. In addition, it increased Guccione's and Penthouse's prestige in the business community. As he stated:

> "[I]n my other business as a publisher it is extremely important to me, because we do all of our entertaining, all of our business entertaining at our house,

> that I'm perceived by these people as a collector. These people with whom we do tens of million dollars a year. That gives me a certain image in their eyes, and if I was just a, just a, dealer, and known to be a dealer, it would be another business and they would not be impressed. This way I get the chairman of advertising, committees and president and executive officers of some of the huge companies we do business with...where they will come to our house for dinner and see the walls and see the house, and the house is so designed that people can't go away and not talk about it, and that gets the word out. Whether that guy who came to dinner who was an advertiser and being entertained because he was an advertiser, and he wanted to buy a piece of art, that would be something -- he would come to me in that way." (Transcript at 100-101.)

As noted by the auditors, the Townhouse is not open to the public. Some dealers, Ron Cayen for one, were aware that Fine Arts sold as well as purchased art and arranged to bring potential buyers to the Townhouse to view the collection. These persons were told that none of the art displayed in the Townhouse was for sale. Guccione explained this sales strategy as follows:

> "Ron [Cayen] brings the guy. This is a guy that wants to buy paintings but he is not going to say anything, he is going to look at everything, he is not going to ask the price because that's going to embarrass him. And he hears these are not for sale, and [Ron]...tells him they are not for sale. And he says: 'Why do you bring me there?' Ron says: 'Look, if you really want to buy something and are really serious, I can go back to Bob, and after all, everything is for sale, I can go back and try.' Now, the collector is put at a disadvantage. The guy that wants to buy from me, he is immediately at a disadvantage. He wants that painting. He wants it more now that he knows it is not for sale, and now, knowing how good it is and hearing from Ron who is an expert as well..., he is really interested. He comes back to visit a second time and says: 'I want to own a painting like that.' And I say: 'Yes, that's one of my best.' And in the end, if the painting is worth $2 million, he would feel ashamed to go for less than $2 million. He would offer, if I want to sell that particular painting at that time at that price, he will offer me that price without me having to solicit it." (Transcript at 105-106.)

During the audit period, Ron Cayen frequently brought potential buyers to view the artwork owned by Fine Arts or Stepplong. Cayen arranged appointments for viewing the art through Diane O'Connell, Guccione's assistant. Potential buyers viewed only the first two floors of the Townhouse. They were never brought to the upper floors. Most of the artwork was displayed on the second floor which Mr. Cayen described as follows:

> "[I]t's beautiful. It's an atmosphere that's...like a reception area. It's like a public kind of space, although people live there, and it's like a large...living room.... It's a very public space. It's primarily to show the art, and functions are held there, receptions and whatnot for Mr. Guccione's clients and for the publishing business, and...all the art is displayed there that's for sale." (Transcript at 233-234.)

Mr. Cayen stated that he would classify the second floor rooms as a kind of art gallery, since art was displayed there for potential buyers. In his experience, many dealers conduct business from their homes and display art which they intend to sell in their residences. He stated that the manner in which the artwork is displayed in the Townhouse is ideal for the kind of business conducted by Fine Arts and that the rooms and displays were successfully designed to enhance the monetary value of the artwork.

Petitioners offered rather confusing evidence with regard to three paintings purportedly sold by Fine Arts during the audit period. Two paintings which were included on the Stepplong inventory list were allegedly sold by Fine Arts: "Nu Debout et Couche" by Pablo Picasso and "Vue Sur Une Petite Ville" by Maurice de Vlaminck. A third painting sold on April 17, 1985, "Clown Reveur" by George Rouault, does not appear on the purchase lists provided to the auditor. As evidence of the sale of the Rouault, petitioners offered a copy of a check dated April 17, 1985 made out to P-H Fine Art in the amount of $85,000.00, and as evidence of the sale of the Vlaminck, petitioners offered a check dated June 25, 1987, made out to P-H Fine Arts Ltd in the amount of $81,000.00. Petitioners did not offer a check, sales invoice or similar document to evidence the sale of the Picasso.

The profit from the sale of the Rouault was reported by Stepplong on a consolidated 1985 Federal income tax return. Penthouse's director of tax administration, Marc Bendesky, testified that the Rouault was owned and sold by Fine Arts and that the profit from the sale was reported erroneously as Stepplong's income. The record does not reveal how or when this painting was acquired by Fine Arts. The profits from the sales of the Picasso and Vlaminck were similarly reported as income to Stepplong in 1987. Mr. Bendesky testified that this was done in error and that the paintings were actually sold by Fine Arts. Petitioners did not explain how these paintings, which appear on the Stepplong inventory list, came to be the property of Fine Arts in 1987. Petitioners asserted that Stepplong was merged with Fine Arts at the beginning of 1988 (testimony of Marc Bendesky, transcript at 160). On the consolidated 1987 Federal return of

Penthouse and its subsidiaries, Fine Arts reported "other inventories" of $10,074,413.00, and Stepplong reported zero.

Fine Arts does not maintain a general ledger or sales journal. Because it has so few transactions in any fiscal year, such records are deemed unnecessary by Fine Arts' accountants. The accountants do maintain a comprehensive inventory listing which shows when the artwork was acquired, how much it is insured for, from whom it was purchased, etc. This information is maintained for every acquisition Fine Arts has made. The consolidated balance sheets and statements of income of Penthouse and its subsidiaries are audited each year by an outside accounting firm. The audited financial statements prepared by these outside accountants treat "Works of Art" as a separate asset in the general category of current assets. They are not listed in the investment category. Mr. Bendesky testified that the "inventory" account is restricted to publishing inventory which explains why the works of art were not classified with other inventory.

Mr. Bendesky testified that the acquisitions made by Fine Arts were financed by loans from Penthouse. All loans made by Penthouse to Fine Arts were reflected on the books and records of the corporations as intercompany indebtedness, and income recognized by Fine Arts from sales of artwork was remitted to Penthouse in reduction of this intercompany debt.

On corporation franchise tax reports filed by Fine Arts for the years 1984 through 1987, the artwork owned by Fine Arts was categorized as inventory of the corporation. Although Fine Arts reported no allocated net income in the years 1983 through 1987, it paid New York corporation franchise tax in those years based upon allocated capital in the following amounts: $3,871.00 in 1983; $10,316.00 in 1984; $12,757.00 in 1985; $16,481.00 in 1986; and $10,174.00 in 1987. Fine Arts also paid New York City corporation franchise tax and Metropolitan Transportation Business Tax Surcharge for these years.

Other evidence of sales transactions involving Fine Arts support petitioners claim that Fine Arts purchased artwork for resale. In a letter to Diane O'Connell, dated December 26,

1988, an art dealer confirmed an offer to buy, on behalf of an undisclosed client, a painting by Chaim Soutine ("Paysage de Ceret") for $150,000.00. This painting appears on the Stepplong inventory list. In a letter to Guccione dated July 28, 1987, a dealer made an offer, on behalf of his client, of $750,000.00 for "Le Cirque Mauve" by Marc Chagall. Mr. Cayen was to receive a share of the sales commission. The offer was refused, and in 1990 the Chagall was sold to SEIBU Corporation of America for $4,200,000.00. This painting was purchased by Fine Arts for $423,000.00 as shown on the purchase list provided to the auditors. Mr. Cayen received a commission on this sale.

Both Mr. Cayen and Mr. Andrews stated that many world famous dealers in fine art conduct their business in much the same manner as does Fine Arts and Guccione.

Guccione owns a private art collection consisting of approximately 50 paintings. Ms. Keeton also owns a private art collection unrelated to Fine Arts. These works are displayed on the third through sixth floors of the Townhouse and were not purchased for resale.

Approximately 30 percent of the space in the Townhouse is used by Guccione purely as a personal residence, and Guccione pays General Media 30 percent of the operating costs of the Townhouse.

The City of New York issued a Notice of Tax Due, dated July 24, 1989, to Fine Arts, assessing New York City Commercial Rent Tax in the aggregate amount of $8,193.02 in connection with Fine Arts' payment of rent to Penthouse for use of the Townhouse premises. Fine Arts made and continues to make rent payments to Penthouse of $15,000.00 per year and to pay commercial rent tax to the City of New York.

Fine Arts maintains an all-risk insurance policy that covers the entire inventory of art owned by the corporation.

Petitioners filed 82 proposed Findings of Fact with regard to Fine Arts. All of the proposed Findings of Fact were substantially incorporated into these Findings of Fact with the following exceptions. Proposed Findings of Fact "6", "8", "12", "13", "14", "15", "25", "26",

"27", "30", "32", "60", "69", and "73" were rejected as being unnecessary to the resolution of the controversy. Proposed Finding of Fact "81" was rejected on the ground that it included facts not supported by the evidence.

Petitioners filed 24 proposed Findings of Fact with regard to Stepplong Corporation. All of the proposed Findings of Fact have been substantially incorporated into this determination.

OPINION

We will first address the issues raised on exception with respect to Fine Arts.

The Administrative Law Judge determined that Fine Arts was "actively engaged in the business of buying and selling works of art" (Determination, conclusion of law "A"), but that its purchases of artwork did not qualify for the resale exclusion provided by section 1101(b)(4)(i) of the Tax Law because Fine Arts did not show that the artwork was purchased exclusively for resale. The Administrative Law Judge found that until the artwork was resold it was put to use by Guccione and Penthouse by creating a "'certain image' in the eyes of the corporate clients" (Determination, conclusion of law "B"). Although the Administrative Law Judge stated that it was unfortunate that the Division did not develop the use by Guccione and Penthouse as a basis for denying the resale exclusion and failed "to cite to any statute or regulation in support of its position or to frame a legal argument beyond that one articulated by the auditors" (Determination, conclusion of law "B"), the Administrative Law Judge nonetheless concluded that "it was incumbent upon petitioners to prove by clear and convincing evidence that the artwork was purchased exclusively for resale and was not diverted to a taxable use" (Determination, conclusion of law "B").

On exception, petitioners argue that they proved that the artwork purchased by Fine Arts was not subject to sales tax because Fine Arts purchased the artwork with the intent of reselling it and that Fine Arts acquired it exclusively for resale. Petitioners also argue that the Administrative Law Judge's conclusion that Guccione and Fine Arts used the artwork is irrelevant here because the issue is whether Fine Arts made any other use of the artwork and that the separate legal existence of Fine Arts cannot be disregarded. Next, petitioners assert that

even if the use by Guccione and Penthouse could be attributed to Fine Arts it would change nothing as this use was the necessary result of Fine Arts' overall business strategy. Petitioners also argue that the use of the artwork by Fine Arts did not constitute a taxable use subject to the tax imposed by section 1110 of the Tax Law, that the Division did not attempt to distinguish among the uses to which the paintings may have been used, but simply assessed tax based on all of Fine Arts' purchases and that the Administrative Law Judge erred in basing her determination on a ground that was not raised or argued by the Division.

We affirm the Administrative Law Judge's determination on this issue for the reasons stated below.

We begin our analysis of this case by noting several points with which we agree with petitioners. First is the fact that Fine Arts proved that it purchased the artwork for resale. The Administrative Law Judge made this conclusion, it was based on the Administrative Law Judge's evaluation of the credibility of the witnesses and the Division has not excepted to it; therefore, we accept this conclusion and it is the point from which our analysis of the case begins.

Second, we agree with petitioners that the notice of determination issued to Fine Arts assessed tax based on the purchase by Fine Arts of artwork during the audit period. The transaction that was taxed was the purchase by Fine Arts, not a subsequent use by Fine Arts.

Third, we agree with petitioners that, because the sales tax is a transaction tax, whether or not these purchases are subject to tax depends on Fine Arts' intent at the time of the purchase (see, Matter of D.J.H. Construction v. Chu, 145 AD2d 716, 535 NYS2d 249; see also, Matter of Datascope Corp. v. Tax Appeals Tribunal, 196 AD2d 35, 608 NYS2d 562 [which addresses the complement to the sales tax: the use tax]). Our disagreement with petitioners begins with what petitioners had to prove to establish that the purchases were not subject to tax. Petitioners appear to argue that because they proved the purchases were intended for resale, they necessarily proved their case. We disagree.

Section 1105(a) of the Tax Law imposes the sales tax on "[t]he receipts from every retail sale of tangible personal property," except as otherwise provided by Article 28. Retail sale is defined as "[a] sale of tangible personal property to any person for any purpose, other than . . . for resale as such" (Tax Law § 1101[b][4][i]). Pursuant to these provisions, Fine Arts had the burden to show that each of the pieces of artwork was purchased for one and only one purpose: resale (Matter of Savemart, Inc. v. State Tax Commn., 105 AD2d 1001, 482 NYS2d 150, 152, lv denied 65 NY2d 604, 493 NYS2d 1025; Matter of Micheli Contr. Corp. v. New York State Tax Commn., 109 AD2d 957, 486 NYS2d 448). Therefore, we conclude that in addition to proving that Fine Arts purchased the artwork with the intention of reselling it, petitioners were required to prove that this was the only purpose for which Fine Arts acquired the artwork.

We find that petitioners failed to satisfy this burden because the record indicates that Fine Arts intended to use the artwork for a purpose other than resale: to allow the artwork to be displayed in a setting where it served the business interests of Penthouse and Guccione. We make this conclusion as to Fine Arts' intent based on the evidence in the record indicating that the artwork was actually used by Guccione and Penthouse and that this was in accord with Fine Arts' intention at the time of acquisition. Although the events subsequent to the purchase are not determinative of intent, they are relevant to ascertain intent (Matter of D.J.H. Construction v. Chu, supra).

We do not believe that our conclusion disregards the separate legal existence of Fine Arts (see, Matter of Morris v. New York State Dept. of Taxation & Fin., 82 NY2d 135, 603 NYS2d 807). So long as the use by Guccione and Penthouse was intended by Fine Arts it was a purpose, other than for resale, for which Fine Arts purchased the artwork. Petitioners' argument suggests that the only purposes that are other than for resale are those that result in a direct economic benefit to the purchasing entity. We are not aware of the source of such a restriction, as the statute and cases state none. The statute and cases, e.g., Savemart and Micheli Contracting, simply state that any purpose other than resale results in a retail sale. If, as here, one entity acquires property with a purpose of allowing another entity to use the property, that is

a purpose other than for resale. In an analogous situation, an automobile dealer uses its inventory vehicles by allowing the employees to use them for their personal use (Matter of Philanz Oldsmobile, Tax Appeals Tribunal, November 23, 1988).

Petitioners argue that the use by Guccione and Penthouse cannot deny the artwork the benefit of the resale exclusion because "[t]o the extent that the display of the artwork can be said to have improved the image of Mr. Guccione or Penthouse, it was a benefit to Fine Arts, and was a necessary result of its overall business strategy of portraying the artwork as part of Mr. Guccione's collection" (Petitioners' brief on exception, p. 14). Again, we believe that petitioners are reading a restriction into the statutory scheme that does not exist. We see nothing in the statute that suggests that only purposes that are inconsistent with resale are purposes other than for resale. The cases also do not suggest such a restriction. For example, the cylinders used to contain the gases sold by the petitioner in Matter of Valley Welding Supply Co. v. Chu (131 AD2d 917, 516 NYS2d 366) were necessary to that petitioner's business of selling gas and renting cylinders, nonetheless it was determined that the cylinders were acquired for a purpose other than resale because some of the cylinders were used by customers without charge.

Our conclusion that petitioners did not prove that Fine Arts purchased the artwork exclusively for resale rests on a different basis than the Administrative Law Judge's conclusion. The Administrative Law Judge's determination rests on her conclusion that Fine Arts diverted the artwork to a taxable use after its acquisition. Our decision is based on our conclusion that at the time Fine Arts acquired the artwork it had at least two purposes for the acquisition: resale and the use by Guccione and Penthouse. Thus, Fine Arts has failed to show that at the time of purchase it acquired each piece of artwork exclusively for resale. As noted earlier, in our view of the case, the evidence in the record as to the use of the artwork after its acquisition is relevant to ascertain Fine Arts' intent at the time of the acquisition (see, Matter of D.J.H. Construction v. Chu, supra), we are not relying on this subsequent use to determine separate taxable events.

Under our disposition of this issue, we see no basis for any claim of prejudice by petitioners. Petitioners have always asserted that the purchases were not subject to tax because they were for resale (see, Exhibit "E," the petition of Fine Arts) and they acknowledge that the issue at the hearing was the intent at the time of acquisition (Petitioners' reply brief on exception, p. 13). To prevail on this claim, Fine Arts was required to show that this was the only purpose for which each of the items was acquired (Matter of Micheli Contr. Corp. v. New York State Tax Commn., supra), not simply that resale was one purpose of acquisition. In the absence of such proof for any specific item, the appropriate result is to sustain the entire assessment against Fine Arts (Matter of Valley Welding Supply Co. v. Chu, supra).

Because we decide this case based on the purposes for which the artwork was acquired and not its subsequent use, we will not address petitioners' claims that the subsequent use was not a taxable one under section 1110 of the Tax Law.

The next issue is whether the Administrative Law Judge correctly decided that the transfers to Stepplong were not within the exclusion from the definition of retail sale provided by section 1101(b)(4)(iii)(D). This section provides that a retail sale does not include "[t]he transfer of property to a corporation upon its organization in consideration for the issuance of its stock." Pursuant to this section, the Division has promulgated 20 NYCRR 526.6(d)(5) which reads as follows:

> "Transfers of property to a corporation upon its organization. (i) The transfer of property to a corporation upon its organization, in consideration for issuance of its stock, is not a retail sale.
>
> "(ii) Corporate existence is deemed to begin upon the filing of the certificate of incorporation with the Secretary of State. Only transfers made at the time of the commencement of the corporate business, or within a reasonable time thereafter, while the corporation is still in the process of organizing its business, are eligible for the exclusion.
>
> "(iii) Transfers made to a dormant corporation, which is being activated, are not eligible for the exclusion.
>
> "Example 4: A corporation filed a certificate of incorporation with the Secretary of State on February 1, 1974. On March 10, 1976 it is decided that the corporation is to be activated, and on March 15, 1976 a stockholder transfers

tangible personal property - a truck - to the corporation, in consideration of the issuance of shares of stock. The transfer is not excluded from the definition of retail sale, as it was not made upon the organization of the corporation.

"(iv) Where a transfer of property is made to a corporation upon its organization in consideration of the issuance of stock, and other property, the transfer is a sale to the extent of the other consideration.

"Example 5: A contribution of tangible personal property is made to a corporation upon its organization in consideration of the issuance of $3,000 in shares of stock and $7,000 in notes. The transfer is a retail sale to the extent of $7,000.

"(v) Where a transfer of property is made to a corporation upon its organization in consideration of the issuance of stock, and the assumption of debts and liabilities representing security interests in the property transferred, the transfer is eligible for exclusion from the definition of retail sale."

The Administrative Law Judge held that through this regulation the Division chose to give a narrow interpretation to the exclusion provided by section 1101(b)(4)(iii)(D), i.e., the Division interpreted "organization" to mean "incorporation" and limited the exclusion to transfers made within a reasonable time after incorporation. The Administrative Law Judge rejected petitioners' reliance on a portion of the regulation, 20 NYCRR 526.6(d)(5)(ii), holding that this provision of the regulation had to be read in the context of the entire regulation and that subparagraph (iii) and example 4 of the regulation were a further qualification of the statement in subparagraph (ii). The Administrative Law Judge relied on Matter of Noar Trucking Co. v. State Tax Commn. (139 AD2d 869, 527 NYS2d 597) to support her ultimate conclusion upholding the Division's interpretation of the regulation and the result that the transfers to Stepplong were taxable.

On exception, petitioners reassert their argument that the Division has misinterpreted the regulation. With respect to this argument, we agree with the Administrative Law Judge that the regulation was intended to equate "organization" with "incorporation" and we affirm the determination of the Administrative Law Judge on this issue for the reasons stated in the determination.

On exception, petitioners raise the additional argument that if the regulation treats "organization" as synonymous with "incorporation" it is inconsistent with the statute and, therefore, invalid. Petitioners argue that there is a "uniformly recognized distinction between 'organization' and 'incorporation'" (Petitioners' brief on exception, p. 27) and that "[g]enerally, incorporation refers to the process of bringing the corporation into existence, while organization refers to the process of making the corporation functional for business" (Petitioners' brief on exception, p. 28). Petitioners illustrate their argument by asserting that the Business Corporation Law recognizes this distinction in section 403, which deals with the effect of a certificate of incorporation, and in section 404, which deals with the organizational meeting.

Petitioners' point that in other circumstances the incorporation of a corporation and its organization may be separate events is not compelling evidence that the Legislature intended these to be distinct events for purposes of the exclusion from the definition of retail sale. Petitioners have offered us no direct evidence of what the Legislature did intend by the use of the term "organization," nor of the legislative purpose behind the section 1101(b)(4)(iii)(D) exclusion.

On the other hand, as the Administrative Law Judge noted, the Appellate Division, Third Department has already held the Division's regulation to be rational:

> "In promulgating the regulation, respondent could rationally interpret the statutory phrase, 'upon its organization,' functionally and practically, roughly equating that event with a corporation's commencement of business upon incorporation, and thereby limit the sales tax exclusion to those initial transfers made contemporaneously with such inception of business activity or 'within a reasonable time thereafter' (20 NYCRR 526.6[d][5][ii]). Petitioner has not carried its burden to show that the regulation is irrational or inconsistent with the statute" (Matter of Noar Trucking Co. v. State Tax Commn., supra, 527 NYS2d 597, 598-599).

Finally, we think it is important to note that the Division's interpretation of "organization," as the equivalent of "incorporation," has the value of linking the exclusion to an objective, readily verifiable event. To decouple "organization" from "incorporation" would leave the meaning of organization ill defined and would introduce another area of uncertainty

into the sales tax. For example, petitioners would define "organization" as the first of the following events to occur: the commencement of business, the acquisition of assets or the issuance of stock (Petitioners' brief on exception, p. 27). It is not clear to us why "organization" would be limited to the first of these to occur, nor what the commencement of business would mean.

For all of these reasons, we conclude that the transfer of artwork was not within the exclusion from the definition of retail sale provided by section 1101(b)(4)(iii).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of P-H Fine Arts, Limited, Robert C. Guccione, officer of P-H Fine Arts, Limited, Anthony J. Guccione, officer of P-H Fine Arts, Limited, David J. Myerson, officer of P-H Fine Arts, Limited, Stepplong Corporation, Robert C. Guccione, officer of Stepplong Corporation, Anthony J. Guccione, officer of Stepplong Corporation and David J. Myerson, officer of Stepplong Corporation is denied;

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

3. The petitions of P-H Fine Arts, Limited, Robert C. Guccione, officer of P-H Fine Arts, Limited, Anthony J. Guccione, officer of P-H Fine Arts, Limited, David J. Myerson, officer of P-H Fine Arts, Limited, Stepplong Corporation, Robert C. Guccione, officer of Stepplong Corporation, Anthony J. Guccione, officer of Stepplong Corporation and David J. Myerson, officer of Stepplong Corporation are denied; and

4. The notices of determination and demand dated December 20, 1988 are sustained.

DATED: Troy, New York
October 13, 1994

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

/s/Francis R. Koenig
Francis R. Koenig

Commissioner