STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
HOUSE OF LLOYD, INC.	:	DECISION DTA NO. 812039
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, 1986 through February 28, 1990.	:	

The Division of Taxation and petitioner House of Lloyd, Inc., 11901 Grandview Road, Grandview, Missouri 64030, each filed an exception to the determination of the Administrative Law Judge issued on May 29, 1997. Petitioner appeared by Morrison & Foerster LLP (Hollis L. Hyans, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (James Della Porta, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioner filed a brief in support of its exception and in opposition to the Division of Taxation's exception. The Division of Taxation filed a brief in opposition to petitioner's exception and in reply. Petitioner filed a reply brief. Oral argument, at the request of both parties, was heard on May 14, 1998 in New York, New York.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUES

I. Whether sales or use tax was properly due on certain tangible personal property known as “hostess free goods” delivered via common carrier from petitioner’s out-of-state location to recipients in New York State.

II. Whether petitioner is entitled to a refund of sales and use taxes paid with respect to demonstrator kits, premised on petitioner’s estimate of the number of such kits returned to petitioner and the number of such kits for which petitioner did not receive payment.

III. Whether penalties imposed against petitioner should be abated in whole or in part.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact “9,” “13,” “15” and “24” which have been modified. The Administrative Law Judge’s findings of fact and the modified findings of fact are set forth below.

During the period at issue petitioner, House of Lloyd, Inc., was a Missouri corporation with its headquarters in Grandview, Missouri. Petitioner is an importer and nationwide distributor of gifts and toys. Petitioner sells its merchandise in New York and other states through direct sales. Other well-known companies utilizing the direct selling method include Avon, Mary Kay Cosmetics and Tupperware. Petitioner's primary direct sales business is operated by its "Christmas Around the World" division and features Christmas related items. A second direct sales business is operated by its "Gifts by Lloyd" division and features toys and gift items.

Direct selling is a marketing method in which products are sold through personal explanation and demonstration, primarily in the home or office. Although the specific methods

of direct selling vary, most companies in the direct selling industry market their products through networks of independent contractors commonly called "direct sellers," "consultants" or "demonstrators".

Petitioner markets its products through independent contractors called demonstrators. Petitioner provides its demonstrators with materials describing petitioner's goods and its business, and suggestions as to how the demonstrator will exhibit and promote the sale of petitioner's merchandise. Petitioner sells most of its products through the "party plan" marketing method, and suggests that the demonstrators use this method. In general, petitioner recommends that the demonstrator make sales presentations, write up orders, and handle customer questions and concerns. Petitioner does not control the activities of demonstrators, who are free to carry out their sales activities in the manner of their choosing, including marketing methods other than the party plan. Demonstrators earn commissions from petitioner based on the dollar amount of merchandise ordered, with such commissions reported as income on Internal Revenue Service ("IRS") forms 1099 issued to the demonstrators.

In general, the party plan is simply a method of selling products through personal explanation and demonstration. There is no one set definition of a "party". Testimony at hearing identified at least four different methods of selling utilized by petitioner's demonstrators, each of which is considered to be "having a party", to wit, a social party, a catalog party, a single large-order party and a fund-raising party.

In a social party, a demonstrator seeks out a "hostess" or "host" who is willing to invite family members, friends, or co-workers into the hostess's home or office, where the demonstrator

will show petitioner's merchandise.[1] A hostess is advised that if she has a party, and pays for an order, she will receive "hostess free goods" ("HFGs"). Petitioner's catalog states, in this regard, the following:

> [b]e a Christmas Around the World Hostess[,][y]ou will receive $40.00 FREE MERCHANDISE of your choice, just for having a party! (No party minimum, but orders must be paid and shipped.) $5 ADDITIONAL FREE MERCHANDISE for each $25 sales over $100[.] $10 ADDITIONAL FREE MERCHANDISE for each $100 sales over $100[.]

As an example, if a hostess holds a social party at which three guests attend and merchandise with a total catalog price of $200.00 is ordered, the hostess is entitled to select and will receive an additional $70.00 in merchandise of her choice from petitioner's catalog, but only upon the remittance of the proper amount of money. Specifically, the proper remittance to receive the additional merchandise would be the $200.00 for ordered goods, plus a handling charge of $1.15 applicable to each individual's order (including the hostess's order) totalling in this instance $4.60 (hostess plus three guests), for a total of $204.60, plus tax on $204.60. Upon such remittance of $204.60 plus tax, the hostess would receive from petitioner a shipment of merchandise with a retail (catalog) price of $270.00.

At a social party, a demonstrator brings a kit, known as a demonstrator kit, with sample merchandise and catalogs, and makes a sales presentation. The demonstrator distributes petitioner's product catalog, and the hostess and guests are asked to complete guest order forms indicating the products they wish to purchase. A demonstrator writes his or her name and telephone number on petitioner's catalogs that he or she distributes. A demonstrator also wears a

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[1]According to petitioner, 99 percent of the individuals who host parties are women. Hence, the term "hostess" will be used throughout the balance of this determination.

name tag which designates him or her as a House of Lloyd salesperson. A hostess does not wear a name tag and does not place her name or address on catalogs. The guest order forms are in triplicate. The hostess receives a copy, the demonstrator receives a copy, and the guest receives a copy. Copies of guest order forms are not sent to petitioner. In many instances, the order period is held open after the social party (for ten days to two weeks) to allow those who were unable to attend the party, or who simply wanted to order merchandise, to view petitioner's catalog and place an order.

In contrast to the social party is the catalog party, where a group of people simply passes around a catalog provided by a demonstrator. A demonstrator does not make a sales presentation at a catalog party. In a catalog party, the group designates someone to be the "hostess", usually the person who brought the catalog to the group. That person will then call the demonstrator and give him or her an order. A catalog party may also consist of a single individual placing a large order (the single large-order party). In this type of catalog party, the "hostess" is the purchaser of the goods. One third to one half of all parties are catalog parties.[2]

Hostesses of catalog parties, single large-order parties, and fund-raising parties, like hostesses of social parties, receive HFGs. In this regard, while petitioner's catalog states that "[d]isplaying a catalog and taking orders from it is not considered a party," the catalog also states that "since all our salespeople are independent contractors who operate their own businesses, they may at times establish their own standards regarding the constitution of a party." Demonstrators decide when an order is a party, and when someone is entitled to HFGs. As a

[2]A fund-raising event may also be a party. In that situation, the sponsor of the organization or someone who designates herself as the leader is the hostess.

result, catalog parties are regularly treated as parties qualifying for the receipt of HFGs. Notwithstanding that they have not "hosted" anything, hostesses of catalog parties receive the same amounts of HFGs as hostesses at social parties, as long as they pay the same amount of cash to petitioner. Petitioner requires no particular services for a person to be designated a hostess and to receive HFGs. Once a hostess's order has been received, petitioner's only requirement for providing the HFGs is the receipt of the proper payment for the order and its subsequent shipment.

We modify finding of fact "9" of the Administrative Law Judge's determination to read as follows:

> No matter what type of party is held, a cash payment, which in some instances may consist solely of a shipping and handling charge, must always be made before HFGs are sent. The minimum payment to obtain HFGs is $18.65, upon receipt of which petitioner will ship the minimum $40.00 of HFGs available even if no other merchandise is ordered from the catalog. That is, in order to receive the $40.00 of HFGs "just for having a party," payment of the required shipping charge ($17.50) and handling charge ($1.15), totalling $18.65, must be made to petitioner. Based on its own cost of merchandise purchased, petitioner calculates that it makes a profit of $5.05 on its transfer of $40.00 in catalog priced merchandise as HFGs to a hostess in return for the payment of $18.65. During the relevant period, the ratio of profit to gross sales price in said transaction would be about 27% while the ratio was between 60% and 62% on sales where goods were purchased. HFGs are never shipped to a hostess absent the correct cash payment. HFGs are often shared by the hostesses and guests. Petitioner maintains that HFGs provide an incentive for hostesses to sell additional merchandise.
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> Petitioner's Vice President of Finance, Saul Kass, stated that the company suggested that the demonstrators encourage hostess home parties where hostesses would invite guests to that party. He conceded there were several party types but stated the ones with guests were the desired method. In addition, free goods were

earned when two or more guests booked parties within two weeks of a hostess's party (i.e., booking gifts).[3]

After a party, however it is constituted, the demonstrator compiles orders into a "party order" using a ledger sheet called a "master order form". The master order form lists the total quantities of each item of merchandise ordered at a party. The master order form does not list the individual order of each person at a party, and petitioner does not know the identity of individual guests or the individual order of each guest.[4] The demonstrator mails the hostess's master order form to petitioner. Petitioner's initial use of this form is to confirm the existence of sufficient inventory (ordered or in-stock) as against incoming orders, and thereafter to use the information gleaned from incoming master order forms to issue advice to demonstrators as to the future availability of petitioner's merchandise.

Petitioner accepts orders from hostesses, and does not accept orders from individual guests. After the order is submitted, the hostess collects payments from the individual guests. Thereafter, the hostess sends in payment to petitioner for the entire party order, including sales tax. As in the previous three-guest, social party example, the hostess will remit $204.60 ($200.00 merchandise ordered plus four handling charges at $1.15 each) along with sales tax on $204.60. There is no dispute that petitioner, a registered vendor for New York sales and use tax purposes, has remitted the sales tax on all merchandise sales, with the exception of tax calculated on HFGs. As with orders, petitioner accepts payments only from hostesses, and not from

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[3]We modified this finding of fact to more accurately reflect the record.

[4]Testimony at hearing indicated that the master order form does list the last name of each individual guest. Presumably such listing of names is a means of verifying that a handling charge has been included for each ordering guest.

individual guests who instead make their payments to the hostess. Petitioner's catalog states, in this regard, the following:

> ATTENTION GUEST: All guests order merchandise and pay the hostess. Merchandise is received from the hostess. Only the hostess orders directly from [petitioner] and only the hostess has a direct relationship with [petitioner]. In the event that you, as a guest, have questions please contact your hostess, who, in turn, will contact the demonstrator.

Nothing is shipped by petitioner unless payment in full for the entire order is received. Payment must be made in the form of a money order or a cashier's check. After full payment is received from a hostess, petitioner prepares an invoice, known as a "pic tic," and fills the order. The cash received for the order is payment in full for the entire order, including any HFGs. In filling the order, petitioner does not know what services, if any, have been provided by the particular hostess. Petitioner has no way of knowing whether the sales arose from a social party, a catalog party, a single large-order party, or a fund-raising party, and the same dollar amount of HFGs is provided regardless of the activity undertaken by the hostess.[5] Thus, a hostess who holds a lavish party receives the same in HFGs as a hostess who simply places a large order, if both hostesses pay the same amount of cash. Hostesses do not report their expenses, and petitioner never reimburses hostesses for expenses.

We modify finding of fact "13" of the Administrative Law Judge's determination to read as follows:

> Petitioner intends to make a profit on all merchandise that it sells, and calculates its catalog prices so that the cash it receives for

[5]Petitioner might reasonably assume that an order with only one handling charge was a single large-order party. However, it is at least possible that such an order could result from a social party at which only one guest placed an order.

> an order pays for the cost of all merchandise sent to hostesses, including HFGs, and yields an overall profit on all of the merchandise transferred to the hostess including the HFGs. In this regard, petitioner candidly admits that the handling charge is in fact a means of adding profit as opposed to an amount specifically tied to the costs of "handling" goods. Petitioner's catalog prices could be lowered if petitioner did not offer HFGs with every paid and shipped order. Petitioner's overall merchandise cost is approximately 25 percent of the retail (catalog) price for such merchandise. More specifically, petitioner's cost for merchandise is, on average, 22 percent of the catalog price for such merchandise, while its merchandise packaging cost is, on average, three percent of the catalog price of the merchandise. The cost of HFGs is factored into petitioner's calculation of its retail (i.e., catalog) prices, although not denominated as payment for services provided by the hostesses (if any).[6]

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Petitioner sends the entire party order, along with the pic tic, to the hostess by common carrier from its facility in Missouri. Petitioner prepays all shipping charges. Petitioner does not itself make any deliveries into New York State. Petitioner does not prepare an individual package for each guest, but rather sends all merchandise to the hostess, who is then responsible for the merchandise and for delivery of the individual items ordered to the various individual guests.

We modify finding of fact "15" of the Administrative Law Judge's determination to read as follows:

> Petitioner does not directly engage the hostesses to act as agents for petitioner or to represent petitioner. A demonstrator is not authorized to appoint agents on behalf of petitioner. Petitioner does not direct or control the activities of a hostess, and generally does not have any contact with a hostess before receiving an order for merchandise except as set forth in its written catalogs and brochures. Petitioner has no agreement, either oral or written, with the hostess besides the promises made in the catalogs. Petitioner

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[6]We modified this finding of fact to more accurately reflect the record.

> makes no attempt to monitor the hostess after the merchandise is delivered but expects her to distribute the items to purchasers/guests, if any. A hostess is not required to make any reports to petitioner other than her order and subsequent remittance. A hostess is not required, or even requested, to provide the identity of her guests. Hostesses, unlike demonstrators, do not receive IRS forms 1099 from petitioner. Hostesses could, in theory, mark up the prices of the goods. However, it seems extremely unlikely that a hostess would, or could successfully, charge prices higher than those printed in petitioner's catalog.[7]

It appears as though hostesses obtain title, as well as possession, of all merchandise in a party order. Once the merchandise is delivered to a hostess, petitioner does not have any control over it, and exercises no rights or powers with respect thereto. Petitioner assumes no responsibility to assist a guest if a hostess does not deliver merchandise ordered by a guest. If a guest contacts petitioner regarding a problem with a hostess, petitioner will send a form telegram to the hostess warning the hostess that guests may contact the local authorities. Petitioner also sends a letter to the guest which directs the guest to contact the hostess, and if satisfaction is not received, to pursue the matter with local authorities.

Petitioner assumes no responsibility for merchandise, including damaged, lost or stolen merchandise, after it is delivered to the hostess, and does not indemnify a hostess for lost or damaged merchandise. Petitioner does not insure merchandise once it is delivered to a hostess, although it does insure the merchandise while it is in its own warehouse. Petitioner accepts returns of merchandise only from hostesses, and such returns must be made within a prescribed period of time (i.e., 10 days in some years, 30 days in other years). Guests may not return merchandise to petitioner, but rather must return it to the hostess who may then return it to

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[7]We modified this finding of fact to more accurately reflect the record.

petitioner. All refunds (or replacements) made by petitioner on returned merchandise are made to the hostess.

Petitioner does not intend to create an agency relationship with hostesses. Hostesses generally have one party during a selling season. In contrast, a successful demonstrator makes one or more sales presentations every day during a selling season. Social parties are held, as noted, in hostesses' homes or offices, and not in locations connected with petitioner.

A demonstrator is not required to make an investment in order to receive a demonstrator kit from petitioner. Petitioner assigns a value of $150.00 to its demonstrator kits. After a demonstrator receives a kit, he or she may pay for the kit by generating $1,500.00 in sales of petitioner's merchandise. If a demonstrator does not generate $1,500.00 in sales, he or she is required to either pay $150.00, or to return the kit to petitioner in salable condition.

Petitioner has a department, known as its "kit department," which records the inflow and outflow of demonstrator kits. Aside from the records kept by this department, petitioner does not record a formal entry in its books of account when a kit is initially provided to a demonstrator. The kit department notes a $75.00 charge in its records if a demonstrator has not generated $750.00 in sales by October, and thereafter records a second $75.00 charge if a demonstrator has not generated $1,500.00 in sales by November. In turn, if a demonstrator generates $1,500.00 in sales by the end of the Christmas selling season, the $150.00 charge is reversed and nothing more is owed for the kit.

If a demonstrator fails to earn a kit by generating $1,500.00 in sales, and does not remit $150.00 or return the kit in salable condition, petitioner first undertakes in-house efforts to obtain a $150.00 payment for the kit. If petitioner's in-house efforts are unsuccessful, the debt is sent to

a collection service. These collection efforts (in-house and collection service) span a time period of roughly one year. Petitioner considers an amount owed for a kit to be uncollectible if a collection agency reports that it is unable to recover the debt.

Petitioner maintains its books of account on a cash basis, and accounts receivable, as such, are not recorded on petitioner's books. Accordingly, when an account for a demonstrator kit is considered worthless, no account receivable is written off because no account receivable for the kit was recorded on petitioner's books. Thus, petitioner does not record bad debt expense for demonstrator kits. At hearing, petitioner's vice-president for finance testified that an estimated 15.6 percent of demonstrator kits, on average, are returned to petitioner each year, and that an estimated 32.4 percent of demonstrator kits, on average, become uncollectible each year. These estimated amounts are allegedly based on information maintained by petitioner's kit department and credit department, and provided to petitioner's vice-president for finance. Detailed records regarding kits were not available to the Division of Taxation's auditors at the time of the audit at issue herein.

Petitioner's efforts to determine its sales and use tax obligations to New York State included a 1985 letter to the Division of Taxation ("Division"), providing information on petitioner's method of operation and inquiring about the sales and use tax treatment of HFGs. The Division's sales tax instructions and interpretations unit responded with a letter dated April 23, 1986, advising petitioner that "[a] sales tax is due from the demonstrator (not the hostess) on the cost of goods that will be given away as a bonus or premium to the hostess." After receiving this letter, petitioner sent additional letters seeking clarification. In response, the Division advised petitioner that use tax was due on HFGs. The Division did not advise petitioner

at any time during the audit period that a sales tax was due from petitioner on sales of HFGs. The Division now takes the position that the April 23, 1986 letter was unclear and was sent in error, and that the Division's advice that the tax is due from the demonstrator, as well as its advice that use tax is due, was incorrect. At the time of audit, the Division advised petitioner, by letter, that its prior advice was revoked. This letter, dated April 26, 1990, advises petitioner of the Division's position that sales tax is due on the retail value of HFGs, and referenced Tax Law § 1101(b)(3),(5) and 20 NYCRR 526.7(d) in support of its theory that the HFGs were sold in a barter transaction. The Division's auditor, in testimony, explained that "[t]his was an unusual case" and that the Division was "unsure" of how to classify the tax (sales or use) on HFGs. The Division's counsel noted, in closing comments, his "understanding" of why petitioner did not collect sales tax on HFGs, although not accepting that petitioner's failure to remit any tax (i.e., use tax) was reasonable.

We modify finding of fact "24" of the Administrative Law Judge's determination to read as follows:

> The Division conducted an audit of petitioner's sales and use tax returns for the period September 1, 1986 through February 28, 1990. Following the audit, the Division issued to petitioner four statements of proposed audit adjustment (Form AU-3), setting forth the amounts of tax, interest and penalty calculated as due by the Division pursuant to its audit findings. Two of such statements are dated May 4, 1990, while the other two are dated May 7, 1990. The May 4, 1990 statements indicate tax due in the amounts of $443,972.53 and $16,565.35, respectively, plus penalty and interest in each case, thus resulting in total amounts due of $700,647.16 and $22,009.27, respectively. The May 7, 1990 statements indicate the imposition of omnibus penalties (only) in the respective amounts of $1,426.28 and $44.87. It is undisputed that records made available upon audit were not sufficient to enable a detailed review with respect to HFGs or with respect to returned and

> uncollectible demonstrator kits. The Division's auditors requested "detailed information/records with actual $ amounts," pertaining to hostess free goods and demonstrator kits, but did not specifically request information from which estimates of kit returns and bad debts could have been prepared. The Division was informed that such information was not available. Although petitioner claimed on audit that most of the demonstrator kits were returned, it provided no substantiation of same.[8]

The dollar amount of tax on HFGs ($336,387.72), although calculated based on extrapolation from a review of information for a three-month period (September 1989 through November 1989), is not specifically at issue. Rather, petitioner maintains that no additional tax is due, because the appropriate amount of tax was remitted on the entire receipt for all merchandise shipped. Similarly, the dollar amount of demonstrator kit sales, and the tax thereon ($107,584.81), was estimated. In turn, petitioner makes no claim to have had kit sales, returns and uncollectible debts records for the audit period available at the time of audit, and makes no specific challenge to the dollar amount of tax calculated as due on kit sales. Instead, petitioner argues that a portion of such kit sales was later returned, and that payment was not received on other kit sales, and that therefore sales tax on such sales should not have been imposed. Moreover, petitioner argues that the demonstrator kit segment of the audit was not reasonable because the auditors knew that demonstrator kits were provided on credit, that many kits were returned and many went unreturned and unpaid, yet the auditors did not take this information into account in calculating the tax due on kits.

Petitioner has paid the amounts due as set forth above, including penalties and interest. The context of such payment was that petitioner consented to the amounts prior to the Division's

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[8]We modified this finding of fact to more accurately reflect the record.

issuance of formal assessments (notices of determination), tendered payment, and also simultaneously noted that such payment was made under protest. On June 29, 1990, the Division issued to petitioner four notices of determination and demands for payment of sales and use taxes due. These notices reflected the same amounts assessed as were set forth on the statements of proposed audit adjustment, and also showed that because of the payments made by petitioner, no amount was due. Petitioner did not challenge the notices by filing a request for conference or a petition within 90 days after issuance of the notices. Instead, petitioner filed an application for refund within two years of the date of its payment, seeking a return of the amounts paid. The Division initially denied petitioner's claim on the basis that petitioner had failed to timely protest the notices of determination and thus was not entitled to proceed via a refund claim. A hearing was held on this procedural issue and, by a determination dated February 9, 1995, petitioner was found entitled to proceed to a hearing on the merits of its timely refund claim. These proceedings on the merits ensued.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge determined that the transfer of HFGs to hostesses was not consideration for services rendered by the hostesses and, therefore, was not a barter transaction (20 NYCRR 526.7[d]). The Administrative Law Judge found that the HFGs constituted a merchandise discount based on the dollar volume of merchandise ordered. The Administrative Law Judge accepted petitioner's explanation that the cost of the HFGs were "built into petitioner's overall pricing structure" (Determination, conclusion of law "C") and that said goods were part of a marketing strategy aimed at increasing sales. Therefore, the Administrative Law Judge concluded that the sales prices set forth on the receipt for the goods ordered included the

cost of the HFGs, that the HFGs represented a "volume discount" (20 NYCRR 526.5[d][2]) and that no services were performed or additional consideration given by the hostesses. On the basis of these conclusions, the Administrative Law Judge found that petitioner was entitled to a refund of the additional tax on HFGs.

The Administrative Law Judge found that use tax did not apply given the analysis set forth above and that the focus of both parties was on the sale transaction not petitioner's exercise of any rights to or control over the merchandise in New York.

Petitioner supplied its demonstrators with "demonstrator kits" which were free to the demonstrators as long as they accounted for a certain level of sales. If the level was not attained, the demonstrator either returned the kit or was charged for it. Petitioner argued that the audit methodology was flawed because it made no allowance for kit returns and uncollectible accounts and was contrary to the evidence presented. The Division argued that petitioner had no right to challenge the reasonableness of the audit since it had consented to the tax due prior to the issuance of a notice of determination and then applied for a refund. The Administrative Law Judge held that petitioner did have the right to challenge the basis of the tax in issue "with the aim of Tax Law § 1139(c)" (Determination, conclusion of law "I"). However, the Administrative Law Judge found that petitioner furnished no substantiation of its claims although requested to do so on more than one occasion, and was not entitled to an allowance for refunds given on returned kits or uncollectible accounts.

Finally, the Administrative Law Judge canceled the penalties assessed on the HFGs sales, consistent with his holding that sales and use tax was not due on the transfer of the HFGs.

However, the Administrative Law Judge sustained the penalties assessed on the additional tax on the sales of demonstrator kits.

ARGUMENTS ON EXCEPTION

The Division of Taxation contends that the transactions between hostesses and petitioner were barter transactions. It points out that the HFGs were exchanged for non-cash consideration, i.e., holding a party and getting others to do the same. The Division claims no sales tax was collected when HFGs were transferred in such transactions. Further, since the refund claim by petitioner did not take the aforementioned situations into account, said claims were not precise and, therefore, must be denied for lack of specificity.

The Division rejects the position that hostesses transferred the HFGs to their guests, citing a lack of proof. The Division maintains that tax included by customers could not have included tax due on HFGs because customers never purchased those goods.

The Division continues to argue that there was a use of the property by petitioner within New York. It bases its contention on the statutory change in 1989 (L 1989, ch 61, § 242) which broadened the definition of use to include the distribution of tangible personal property, such as promotional materials. The Division concedes that the change in the statute would only affect the last two quarters of the audit period.

With respect to penalty, the Division contends that no additional tax would have been owed if petitioner had complied with the instructions in the letters from the Division. Further, the Division points out that regardless of whether petitioner was confused as to whether it should collect tax on the cost or retail price of the HFGs, such confusion is not an excuse for paying nothing and failing to inquire further as to its tax liability.

Petitioner contends that the Division's argument that there was a barter transaction between petitioner and the hostess is without merit since there was always cash consideration for said HFGs. It argues that the Division can point to only two circumstances where the HFGs were exchanged for services - - where there were no sales at the party and where three other guests held parties within three weeks. Petitioner points out that cash consideration was given in the former and the latter were "booking gifts" which were never in issue on audit.

Petitioner raises an objection to what it characterizes as the Division's argument that it is making sales for resale to the hostesses, collecting sales tax and then including the tax on its own returns as a convenience to the hostesses. Petitioner claims this argument raises new factual issues never presented below.

Petitioner maintains that the Administrative Law Judge correctly determined that abatement of penalties was proper on the issue of HFGs sales because of the confusion caused by the letters sent from the Division in response to petitioner's sincere inquiry as to the proper treatment of said sales. Petitioner urges that even if the Administrative Law Judge's determination on the issue is reversed, the reasoning for abatement of penalties should prevail. Finally, petitioner believes that its entire reporting history is not germane to the HFGs issue, and that the failure to pay tax on demonstrator kits should be ignored.

On its own exception to the determination, petitioner argues that the Division's audit methodology regarding the tax assessment on demonstrator kits was flawed because the auditor made no allowance for uncollectible accounts or returned kits. Petitioner contends that the Division did not accept its estimates of such accounts and that it could have provided other data but it did not believe the Division would accept it.

The Division responded to petitioner's brief in support by stating that petitioner had consented to the tax and never raised an argument as to the audit's rationality or the failure to consider uncollectible accounts or returns of demonstrator kits. Since petitioner is petitioning the denial of a refund application, it was incumbent upon it to prove that the tax due on the kits was less than fixed by the statements of proposed audit adjustment or that petitioner was not obligated to collect and report the agreed upon amount of tax.

In the alternative, the Division contends that the audit methodology was reasonable and that petitioner has not established its rights to the uncollectible accounts or kit returns.

Petitioner argues that it has the right to challenge the audit methodology, as determined by the Administrative Law Judge, and highlights the fact that the Division has cited no authority for its position to the contrary.

OPINION

We reverse the Administrative Law Judge's conclusion that the transfers of HFGs were not barters within the definition of retail sale.

Sales tax is imposed, *inter alia*, on the receipts from every retail sale of tangible personal property (Tax Law § 1105[a]).

Tax Law § 1101(b)(5) defines "sale, selling or purchase" as:

> [a]ny transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume, . . . conditional or otherwise, in any manner or by any means whatsoever for a consideration, or any agreement therefor, including the rendering of any service, taxable under this article, for a consideration or any agreement therefor.

20 NYCRR 526.7(d) provides the following definition of barter: "[t]he transfer of tangible property . . . to a person in consideration for . . . services received is a 'sale' under the Tax Law." Tax Law § 1101(b)(3) defines receipt as:

> [t]he amount of the sale price of any property and the charge for any service taxable under this article, valued in money, whether received in money or otherwise, including any amount for which credit is allowed by the vendor to the purchaser, without any deduction for expenses or early payment discounts and also including any charges by the vendor to the purchaser for shipping or delivery regardless of whether such charges are separately stated in the written contract, if any, or on the bill rendered to such purchaser and regardless of whether such shipping or delivery is provided by such vendor or a third party, but excluding any credit for tangible personal property accepted in part payment and intended for resale. For special rules governing computation of receipts, see section eleven hundred eleven.

Consistent with the definition of barter under the Commissioner's regulations, we find the transaction between petitioner and the hostesses to be a barter within the definition of sale (Tax Law § 1101[b][5]). Despite petitioner's arguments to the contrary, the parties intended to create a contractual relationship as evidenced by their words and deeds.

> In determining whether the parties entered into a contractual agreement . . . it is necessary to look, rather, to the objective manifestations of the intent of the parties as gathered by their expressed words and deeds (***Brown Bros. Elec. Contrs. v. Beam Constr. Corp.***, 41 NY2d 397, 393 NYS2d 350, 352).

Petitioner promised to transfer $40.00 in HFGs from its catalog in exchange for the hostess's promise to host a party. There was unmistakable intent by both parties to form this relationship and the evidence of services being rendered by the hostess and petitioner compensating therefor confirms its execution. As the hostess increased her sales volume,

petitioner increased the credits for catalog gifts in accordance with its promise/contractual obligation.

The determination did not adequately explain the situation where no sales were made at a party but HFGs were earned just the same. In that instance, the hostess received merchandise in exchange for the services she provided, i.e., holding a party. Although required to pay the shipping and handling for the $40.00 in goods, she was not required to pay for the goods themselves or even the sales tax on handling, which was customary. Further, although petitioner boasted of profiting on this exchange, its profit margin was much less than half of what they made on standard sales (the profit to gross sales ratio was only 27% on the zero dollar sales compared with approximately 60% on standard sales where purchases were made). Petitioner was foregoing a considerable profit on these transactions, constituting the consideration supporting their contractual promise to pay for the services of the hostess. Therefore, it is concluded that the HFGs were exchanged for services.

Petitioner's marketing strategy is heavily dependent on hostesses having parties with several guests, enabling current sales and ensuring future parties. The fact that a hostess received bonus dollar value credits for parties hosted by her guests ("booking gifts") indicates the importance placed on numbers of guests and "pyramiding" by petitioner. Petitioner's contention and the Administrative Law Judge's conclusion that "the best example showing that the HFGs are simply included in the cost of the order . . . is the single large-order party" (Determination, conclusion of law "D") is contrary to petitioner's marketing strategy as testified to by their own witness, who stated that "[w]e suggest the demonstrator get a hostess home party; and the hostess would invite guests to that party" (Hearing Tr., p. 183). When asked if there were other types of

parties than ones with guests, Mr. Saul Kass, petitioner's Vice President of Finance, stated that there were others but the one with guests is the "desired method" (Hearing Tr., p. 184). The fact that the majority of "parties" are ones with guests further supports the intended marketing strategy. The party plan is not predicated on having one person at a "party." The party plan works like a pyramid, i.e., guests beget more hostesses who beget more guests who all make purchases and profits for the company. As guests see the hostess earn credit for free goods, they realize the benefit of holding parties themselves. Single parties, regardless of the size of their orders, will not create a larger market in the long run and the hostess of a single party will not earn her HFGs on the sales of her guests. The same impetus which motivates one to earn HFGs on the sales of others, will encourage others to host parties as well.

Along the same line of reasoning, the company knows this same motivation will prevent thousands of individuals from holding a "party of one" and sending in $18.65 for $40.00 in HFGs when the "one" refuses to purchase any goods from the catalog. The company appears very certain of this since it is willing to reduce its profit to gross sales ratio from 60% to 27% on such transactions.

However, one should not become mired in petitioner's profit margins.

Each party held by a hostess earns the minimum $40.00 bonus. However, as set forth in the facts, the hostess earns credit towards additional purchases from petitioner's catalog as sales increase. The Administrative Law Judge characterized these credits for HFGs as a percentage discount. However, a percentage discount is a stated reduction in the retail price of an item for reasons such as trade, volume or cash and carry (20 NYCRR 526.5[d]). Therefore, the Administrative Law Judge's characterization is not an accurate depiction of the instant

transaction, where all goods were valued at retail and exchanged for services (holding a party) and sales volume (more sales, more retail value of HFGs earned).

Hostesses were the linchpin of petitioner's party plan. They agreed to host parties in exchange for HFGs regardless of whether or not they made sales. Providing this incentive was good for business since it was unlikely a hostess would hold another party or encourage others to do likewise if they got nothing in return for their efforts.

The issue is whether the transfer of the HFGs to hostesses was a taxable event where the value of the goods received in exchange for the services of the hostesses was the retail value of the goods in the catalog. Since petitioner exchanged credits spendable in its catalog for specific sales volume, and the hostesses performed services with the expectation of receiving the credits which they believed to be redeemable towards the retail price of the catalog goods, it is clear that both parties to the contract intended that the retail value was the consideration offered. Therefore, when petitioner transferred $200.00 in catalog merchandise and $70.00 in additional catalog goods, denominated HFGs, it was exchanging $270.00 in merchandise for services and a commission redeemable in HFGs. The hostesses received the HFGs credit based upon their services and the sales volume. Hostesses did not need to buy even one catalog item to earn substantial credits for free goods.

We found a similar "marketing strategy" constituted a barter sale transaction in ***Matter of Popular Club Plan*** (Tax Appeals Tribunal, May 11, 1995) where "secretaries" earned redeemable credits for merchandise based upon taking catalog orders, collecting the payment for the orders and sending the funds to the company. There, the "secretaries" earned reward credits redeemable for merchandise in a catalog in exchange for their services. The more sales

generated, the more credits for merchandise they received. Although the transaction in ***Popular Club Plan*** was less compact than here, and in some instances the credits were redeemable for cash, the essence of the transaction was identical. House of Lloyd hostesses held a party, took catalog orders, forwarded the orders to petitioner through the demonstrator, collected the payment for the items, remitted payment to petitioner and distributed the goods to the purchasers when received from the company. All services were performed in exchange for credits redeemable at retail price in the House of Lloyd catalog.

Additionally, as in ***Popular Club Plan***, we reject the Administrative Law Judge's characterization of the free goods as analogous to discount sales. The dollars for free goods were specific items of value given to the hostesses in exchange for their services, while discounts are reductions in price and result in amounts not being paid. The two concepts are distinct and receive different tax treatment (***see***, 20 NYCRR 526.5[d][2]).

The next issue is whether petitioner is entitled to a refund of sales tax paid with respect to demonstrator kits based on returns and uncollectible accounts. Although we agree with the Administrative Law Judge's conclusion that the Division correctly denied the refund application because petitioner failed to meet its burden of proof, we disagree with the Administrative Law Judge's conclusion that petitioner had the right to challenge the rationality of the audit methodology after signing a consent to the taxes found due and set forth on a statement of proposed audit adjustment. The Administrative Law Judge had reasoned that petitioner's consent and payment to stop interest and penalty accrual merely converted an impending assessment into a claim for refund and was consistent with the aim of Tax Law § 1139(c) (Determination, conclusion of law "I").

In ***Matter of SICA Elec. & Maintenance Corp.*** (Tax Appeals Tribunal, February 26, 1998), we stated:

> In addition, the above provisions also provide for a taxpayer to agree and consent to the amount of a tax liability (sections 1138[c] and former 1139[c]), thereby obviating the requirements of the issuance of a notice of determination and the 90-day protest waiting period thereafter, i.e., a taxpayer may consent to an assessment as was done in this matter. By agreeing to the amount of tax and consenting to an assessment, a taxpayer gives up its right to protest such assessment, except as provided by Tax Law former § 1139(c); to wit, the taxpayer may protest by payment of the amount assessed and by filing a claim for refund of any such amount so paid within two years of the date of payment thereof.
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> * * *
>
> We conclude that the signature on the consent to tax rendered the use tax fixed and final (***Matter of BAP Appliance Corp***., Tax Appeals Tribunal, May 28, 1992; ***Matter of Rosemellia***, Tax Appeals Tribunal, March 12, 1992) and established the rational basis for the assessment. Having signed the consent, the audit method and audit computation ceased being an issue. Further, the threshold issue of "rational basis" that might otherwise be present in an audit case under Tax Law § 1138(a) was no longer present. The Division was relieved of the burden of showing a rational basis because petitioner's signature on the consent established that there was a rational basis.

We agree with the Administrative Law Judge that petitioner, even after signing the consent and paying the tax, still has the opportunity to prove it is entitled to a refund. However, in order to be entitled to a refund, petitioner must demonstrate by clear and convincing evidence that the tax asserted is erroneous (***Matter of Surface Line Operators Fraternal Org. v. Tully***, 85 AD2d 858, 446 NYS2d 451), i.e., petitioner's actual tax liability was less than that set forth in the signed consent (***Matter of Philipp Bros.***, Tax Appeals Tribunal, June 4, 1992; ***Matter of BAP Appliance Corp.***, ***supra; Matter of Rosemellia, supra***).

Once a taxpayer or a taxpayer's representative is provided an opportunity to review the audit papers and proposed consent to tax and, thereafter, signs a section 1138(c) consent, the burden of going forward and of proving that the tax is erroneous and a refund is due shifts to the taxpayer. A petitioner, under the facts here, can prevail upon a refund claim only by proof that the correct amount of tax is less than the amount set forth in the consent to tax.

As noted above, we agree with the Administrative Law Judge's conclusion that the taxpayer did not meet its burden of proving the returns or uncollectible accounts and, therefore, its entitlement to a refund. In short, petitioner has not established that the actual tax due was less than that set forth in the consent.

Finally, we affirm the Administrative Law Judge on the issue of penalties. The facts leave no doubt that there was substantial confusion on the part of the Division as to who was liable for the tax and even whether it was use or sales tax. Petitioner had been collecting sales tax prior to its inquiry in 1985 and indicated its desire to properly comply with sales tax collections. The Division did not clearly respond to this inquiry until April 26, 1990, when the Division revoked all previous advice given to petitioner and clearly stated what tax was to be collected and by whom. Although it was rather aggressive of petitioner to take the position that it did not owe any tax under the circumstances, it remains that the conflicting advice received from the Division at least forms the basis for abating penalties (Tax Law § 1145[a][1][iii]). The regulation at 20 NYCRR 536.5(c)(5) provides that any cause for delinquency which clearly indicates an absence of willful neglect may be determined to be reasonable cause for the abatement of penalty. We conclude that the confusion raised by the Division between the time of petitioner's inquiry in 1985 and its unequivocal revocation of prior advice in 1990 constitutes such reasonable cause

and we direct that penalty be abated for the audit period with regard to the failure to remit tax on the HFGs exchanged for the services and cash of hostesses.

Additionally, we do not find convincing the Division's reliance on our decision in ***Dominion Textile, (USA)*** (Tax Appeals Tribunal, April 10, 1997). In ***Dominion***, we said that the ambiguity concerning the definition of stock options was never a reason for not filing returns and paying the tax at the time prescribed by the statute and the theory was never raised as a viable argument until after the conciliation conference. In the instant case, the Division did not clarify its theory of taxation until 1990 and, unlike ***Dominion,*** petitioner did take steps to inform itself about whether it had liability for sales tax. Hence, if of any precedential value, ***Dominion*** would support petitioner's course of action herein.

With regard to penalty asserted with respect to the demonstrator kits, the Administrative Law Judge correctly and completely addressed the issues, which remain unchanged before us, and we affirm his determination in sustaining the penalties for the reasons set forth therein.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of House of Lloyd, Inc. is denied;

2. The exception of the Division of Taxation is granted to the extent that its assessment of sales tax on sales of HFGs is sustained, but is otherwise denied;

3. The determination of the Administrative Law Judge is reversed in accordance with paragraph "2" above, but is otherwise affirmed; and

4. The petition of House of Lloyd, Inc. is granted to the extent that penalty assessed on sales of HFGs is cancelled, but in all other respects the petition is denied.

DATED: Troy, New York
November 13, 1998

/s/Donald C. DeWitt
Donald C. DeWitt
President

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner

/s/Joseph W. Pinto, Jr.
Joseph W. Pinto, Jr.
Commissioner