STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petitions of **RAFFOLER LTD. D/B/A TRENDS AND RBM, LTD.** for Revision of Determinations or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the period March 1, 1988 through August 31, 1991.	:	DECISION DTA NOS. 815435, 815436, 815437 815438, 815439 AND 815440
In the Matter of the Petitions of **JERRY WILLIAMS, OFFICER OF RAFFOLER LTD. D/B/A TRENDS AND RBM, LTD. AND STEPHEN BROWN, OFFICER OF RAFFOLER LTD. D/B/A TRENDS AND RBM, LTD.** for Revision of Determinations or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the period June 1, 1990 through August 31, 1991.[1]	:	

Petitioners Raffoler Ltd. d/b/a Trends, P.O. Box 85, 1200 Shames Drive, Westbury, New York 11590-0085, RBM, Ltd., 1200 Shames Drive, Westbury, New York 11590-0085, Jerry Williams as officer of Raffoler Ltd. d/b/a Trends and RBM, Ltd., 107 Lakeside Drive E.,

[1]The Division conceded that the officers of Raffoler and RBM, Jerry Williams and Stephen Brown, are not being held responsible for the first nine quarters of the audit period, which in its entirety covered the period from March 1, 1988 to August 31, 1991, since they were not assessed within the statute of limitations. Thus, the period for which the officers may be held responsible encompasses June 1, 1990 to August 31, 1991.

Lawrence, New York 11559-1718 and Stephen Brown as officer of Raffoler Ltd. d/b/a Trends and RBM, Ltd., 25 Briarcliff Drive, Merrick, L.I., New York 11566 and the Division of Taxation each filed an exception to the determination of the Administrative Law Judge issued on January 28, 1999. Petitioners appeared by Morrison & Foerster, LLP (Irwin M. Slomka, Esq., of counsel). The Division of Taxation appeared by Barbara G. Billet, Esq. (James DellaPorta, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioners filed a brief in support of their exception and in opposition to the Division of Taxation's exception. The Division of Taxation filed a brief in opposition to petitioners' exception and in reply. Petitioners filed a reply brief. Oral argument, at the request of both parties, was held on February 10, 2000 in New York, New York.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision. Commissioner DeWitt dissents for the reasons set forth in a separate opinion.

ISSUES

I. Whether petitioners, as vendors, may exclude charges to ship merchandise to customers from their taxable receipts subject to New York State and City sales tax.

II. Alternatively, if petitioners are not entitled to exclude the full amount of their shipping charges from taxable sales, whether petitioners are entitled to exclude their actual transportation costs from their taxable receipts.

III. Whether petitioners have established reasonable cause and the absence of willful neglect for abatement of penalties imposed in this case.

FINDINGS OF FACT

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

Raffoler Ltd. d/b/a Trends ("Raffoler"), incorporated in New York in 1982, conducted the business of selling low-priced merchandise by mail through direct mail consumer solicitation. RBM, Ltd. ("RBM"), incorporated in New York in 1986, marketed similar merchandise through space advertisements in newspapers and magazines throughout the country. Raffoler and RBM maintained their corporate headquarters in Westbury, New York, and shared warehouse facilities in Farmingdale, New York.

Raffoler and RBM sold a general line of merchandise that included toys, household products and clothing. They did not manufacture the products they sold, but rather purchased them directly from manufacturers or through intermediaries, such as importers and overseas vendors.

The marketing strategies of the two companies focused on being highly promotional and price sensitive. Many items sold occupied a price range between $5.00 and $20.00. For marketing purposes, Raffoler and RBM used trade names in their promotion of products. The trade names included Trends, CVP, National Historic MINT and GHR.

Raffoler, using direct-mail solicitation, reached potential customers by the mailing of promotional materials, such as sweepstakes offerings, with solicitation for Raffoler's products, along with an order form. The order form provided a place for the customer to separately state the sales price of the merchandise on one line and to insert on a separate line, marked "shipping" or "shipping charge," the separate additional charge for Raffoler to ship the merchandise to the

customer. RBM created advertisements that ran in various newspapers and magazines throughout the country, such as the freestanding inserts that appear in Sunday newspapers. RBM advertised in such publications as TV Guide, The New York Post, The National Enquirer, and American Legion. Along with the ad RBM included a coupon to fit the order or instructions on how and where to place the order. The coupon provided a place for the customer to separately state the sales price of the merchandise on one line and to insert on a separate line, marked "shipping" or "shipping charge," the separate additional charge for RBM to ship the merchandise to the customer.

On orders placed with both Raffoler and RBM, actual shipping charges were sometimes fixed, i.e., they did not vary with the size of the order, and at other times varied based on the size of the order. When establishing shipping charges, although Raffoler and RBM sometimes considered the anticipated weight of the item, the companies' primary concerns were with regard to marketing conditions and what was acceptable in the industry and to the consumer.

Both Raffoler and RBM shipped the ordered merchandise directly to a customer's home or business, and Raffoler and RBM charged their customers for this service. The customer was provided shipping information so that at the time of order placement, the customer knew the amount of the shipping fee. The shipping fee was separated from the price of the goods on the direct mail order forms and in the space ads. The fee was intended to cover the cost incurred by Raffoler and RBM to send the goods from the Farmingdale warehouse by carriers such as the United States Postal Service ("USPS") or UPS, to the home or business of the consumer.

The shipping fees that Raffoler received from customers were generally in excess of the actual shipping costs that it incurred to ship the goods by, for example, UPS or the USPS, to the

customer. Jerry Williams, who provided testimony on behalf of Raffoler and RBM in this matter, indicated that one of the problems with trying to set forth the actual cost of shipping on order forms is that the direct mail solicitations are being made throughout the 50 states and the cost to ship the merchandise will vary in accordance with the destination of the product.

Gross sales of Raffoler and RBM for the audit period as set forth in the Division's Field Audit Reports were $403,991,522.00 and $110,578,633.00, respectively. For the periods in issue, the actual shipping costs incurred by Raffoler and RBM amounted to $43,131,199.00, as compared to petitioners' claimed shipping receipts for the same period of nearly $92 million, comprised of $75,681,933.00 reported by Raffoler, and $16,168,179 reported by RBM.

When customers placed orders with Raffoler and RBM, the total of the check or the credit sale was recorded as a "sale" on the books of Raffoler and RBM, though such amount included components for shipping and sales tax. The orders were retained for only about three to six weeks because they were received in such volume and took up so much space to store. During the year, the volume of orders ranged from approximately 25,000 to 70,000 each day.

Although Raffoler and RBM were separate corporations, RBM did not maintain any separate records of its costs or expenses, including transportation costs. Petitioners did not submit records as to how transportation costs recorded on Raffoler's books should be allocated between it and RBM, but suggested in their brief, after the allocation issue was raised by the Division that such allocation of actual cost could reasonably be made based on reported gross receipts of each company to total receipts of both companies.

During an audit of Raffoler and RBM, conducted for the period September 1, 1985 through February 28, 1988 ("the prior audit"), the taxability of Raffoler and RBM's shipping charges first

arose. An analysis of incoming orders revealed that Raffoler and RBM had been overreporting sales by not recording an amount for the Tax Law former § 1101(b)(3) exclusion for shipping receipts which petitioners approximated at 20% of total receipts. Beginning March 1, 1988, Raffoler and RBM did not include in their taxable receipts reported on their New York State sales and use tax returns an amount equal to 20% of gross receipts, believing such amounts represented nontaxable shipping charges.

The prior audit was settled by the parties at a conciliation conference in 1990. Under the terms of a settlement, the Division permitted Raffoler and RBM to exclude from its receipts, as exempt from sales tax, an amount equal to 13% (not the 20%) of its gross receipts, which more closely represented petitioners' costs of shipping, a fact determined based on petitioners' records during the prior audit. Beginning June 1, 1990, petitioners reduced the exclusion for shipping charges reflected on their sales tax returns from 20% to 13% of their gross receipts. Petitioners never collected sales tax from customers on the shipping charges during either of the two audit periods.

The questions of what policy the Division was upholding in relation to the settlement of the prior audit, and what the parties discussed with respect to the Division's advice to petitioners was described in testimony by both Marsha Eisner, the Division's team leader for this audit, and David Welder, a former chief financial officer of Raffoler and RBM. The testimony by both was contentious and both failed to answer directly some pertinent questions posed to them.

Jerry Williams, chief executive officer of Raffoler and RBM, testified as to his duties and responsibilities with respect to the companies, their sales philosophies and marketing techniques.

Mr. Williams followed the sales tax advice of the companies' then tax advisor, Arthur Gelber, who represented Raffoler and RBM in the prior audit.

In July 1989, while the Division was conducting the prior audit, the Tax Appeals Tribunal rendered its decision in ***Matter of Spencer Gifts, Inc.*** (Tax Appeals Tribunal, July 27, 1989). In response to ***Spencer Gifts***, the Division issued audit guideline DOS-90-7, dated July 20, 1990, to its Central Office and District Office Sales Tax Personnel, which was "to be used as a guideline when auditing charges billed as postage, handling, shipping or other designation which represents the cost of transportation between a vendor and retail purchaser." Besides setting forth the provisions of 20 NYCRR 526.5(g), the audit guideline stated the following:

> The Tax Appeals Tribunal in the Matter of Spencer Gifts, Inc. concluded that charges designated as postage and handling on billings to retail purchasers were in fact charges for exempt transportation. This opinion was based on the following:
>
> (1) The petitioner offered uncontroverted testimony that the term "postage and handling" as used on its mail order form denoted a charge for delivery of merchandise from petitioner's warehouse to the purchaser.
>
> (2) This charge for "postage and handling" did not cover costs for handling.
>
> (3) The charges for "postage and handling" were more or less than the actual cost to petitioner for mailing and shipping; however, in the aggregate, the amounts collected by petitioner for postage and handling were less than its overall postage and shipping costs.
>
> As a result, it will now be Audit Policy to exempt charges billed as postage, handling, shipping or other designation if the aggregate receipts for the audit period are equal to or less than the vendor's actual cost of transportation. If the aggregate receipts for the audit period are more than the vendor's actual cost of transportation and charges are not separately stated in accordance with Regulation Section 526.5(g), the entire charge will be taxable.

> The actual cost of transportation to the vendor will be the actual out of pocket expense. For example, if the vendor obtains rebates from the transportation company, the rebates will be deducted from the amounts previously paid and the balance will be the actual cost of transportation.

Petitioners submitted as part of their evidence a binder of documents entitled "Comparison of Shipping Charges v. Industry," which petitioners compiled to compare petitioners' shipping charges against the shipping charges of other mail order vendors, whom petitioners identify as their competitors, during the tax periods in issue. Petitioners submitted 60 of what they identified as their actual order forms used during the tax periods in issue. Many of the forms indicate a printing date in one corner. Numerous forms contain the date 1988 or 1989. The form itself does not indicate in each case what year it was used. However, Charles Endy, petitioners' comptroller during the period in issue, established that the reference numbers on the order forms correspond to a particular mailing during a certain time frame. In addition to being able to place the mailing during a particular time frame, Raffoler and RBM were also able to measure the success or failure of a mailing by such reference code.

Also included in the binder were order forms of 12 other mail order vendors, identified as the following: Hanover House, Chef's Catalog, Gold Metal Products, Frederick's of Hollywood, Domestications, Hold Everything, Nature Company, Sturbridge Yankee Workshop, Tapestry, Williams Sonoma, Pottery Barn, and Nino's. These were the vendors petitioners identified as their competitors. Only one form contained a date, other than handwritten designations, to identify during what period the forms were in use. However, Charles Endy also established that the order forms of other mail order vendors chosen for comparison purposes were those that were

in existence during the period in issue. No information other than the order form from the mail order catalogs of the competitor vendors was provided.

Concerning industry rates, petitioner also submitted a schedule that summarized the comparison of shipping fees within the industry. Petitioners' average shipping fee for the orders it selected for the comparison was $3.46. This was contrasted with the $4.27 industry average cost of 12 companies that petitioners identify as competitors, for orders of the same dollar amount.

Ms. Eisner, the team leader of the audit, who testified for the Division with respect to the audit, stated that the Division never established what it considered reasonable rates for the mail order industry, and did not attempt to reduce petitioners' exclusion from approximately $92 million to its actual costs of approximately $43 million, which was established by petitioners during the hearing and accepted as valid by the Division.

Petitioners submitted as evidence two sales tax newsletters they received from the Division, dated September 1985 and March 1990, which outlined the sales tax rules for "postage and handling" charges. Both bulletins stated, in pertinent part:

> The charge for transportation of tangible personal property sold at retail is not subject to sales tax when:
>
> 1) the transportation costs are for delivery to either the purchaser or the purchaser's designee, and
>
> 2) the charges are separately stated in any written contract and on the bill given to the purchaser.
>
> Charges are deemed to be separately stated if they can be computed from information appearing on the bill.
>
> To qualify for the exclusion, transportation costs must be for the delivery of the tangible personal property to the purchaser or

> the purchaser's designee. Any charge made to a retail purchaser which represents the cost of transportation between a supplier, manufacturer, warehouse, catalogue or other distribution point and the seller's place of business is part of the receipt subject to tax, no matter what such cost is labeled.
>
> Postage, shipping or freight charges are all charges for transportation, and are not included in the receipts subject to sales tax when they meet the requirements stated above.
>
> Handling charges are costs which a supplier adds for servicing tangible personal property in preparing such property for shipping and mailing, and are subject to tax.
>
> If handling and transportation charges are combined and billed as one amount, the entire charge is subject to sales tax.

Raffoler and RBM separately filed New York state sales and use tax returns on a monthly or quarterly basis, as required, for the audit period, March 1, 1988 through August 31, 1991.

The Division issued notices of determination bearing the following dates and amounts, which relate to the Division's inclusion of Raffoler and RBM's shipping charges in taxable receipts:

Petitioner	Date of Notice	Tax	Interest	Penalty	Total
Raffoler	8/30/93	$364,586.80	$220,396.47	$109,376.03	$694,359.30
RBM	8/30/93	73,664.21	41,413.52	22,099.23	137,176.96
Williams, officer of Raffoler	9/9/93	364,586.80	222,322.57	109,376.03	696,285.40
Williams, officer of RBM	9/9/93	73,664.21	41,792.39	22,099.23	137,555.83
Brown, officer of Raffoler	9/9/93	364,586.80	222,322.57	109,376.03	696,285.40
Brown, officer of RBM	9/9/93	73,664.21	41,792.39	22,099.23	137,555.83

The additional tax due was calculated from petitioners' claimed shipping receipts as reported on the sales and use tax returns. The reported shipping receipts were multiplied by a New York State ratio to arrive at additional taxable sales, to which the effective sales tax rate was applied.

A conciliation conference was held on October 20, 1994 and conciliation orders were issued dated August 2, 1996 to Raffoler, RBM and Jerry Williams sustaining the notices of determination. Although it appears that a conciliation order was not issued for Stephen Brown, as officer of Raffoler and RBM, he was permitted to join the other petitioners in filing timely petitions. Petitioners Jerry Williams and Stephen Brown do not contest their personal liability as officers of Raffoler and RBM for any deficiency determined herein to be due, except as to the assessments for the periods that the Division has agreed are time-barred (***see,*** Footnote 1). The only issue that remains unresolved between the parties is that of the taxability of petitioners' shipping charges.

DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In her determination, the Administrative Law Judge concluded that there was no dispute that the cost of transportation (i.e., the shipping charges), as it appeared on the customer invoices, was separately stated in accordance with 20 NYCRR former 526.5(g)(1). After an exhaustive analysis of our decision in ***Matter of Spencer Gifts*** (Tax Appeals Tribunal, July 27, 1989) and a review of the Division's audit guideline memorandum DOS-90-7, the Administrative Law Judge held that the statute and regulations provided authority for an exclusion of shipping charges from taxable receipts and what a taxpayer needed to demonstrate in order to prove entitlement to the exclusion. Therefore, she dismissed the audit guidelines since, in her estimation, they

contradicted rather than interpreted the law and regulations. With respect to our decision in ***Spencer Gifts***, the Administrative Law Judge stated that we affirmed the analysis of the Administrative Law Judge in the determination rendered in ***Spencer Gifts*** and as such, she rejected the Division's argument that *cost* meant the amount actually incurred by the vendor to ship its goods to the customer rather than the amount charged by petitioners to the purchaser for transportation of the goods.

However, the Administrative Law Judge concluded that petitioners failed to establish that the amounts they charged for transportation were reasonable in relation to prevailing established rates (***see***, 20 NYCRR former 526.5[g][4]). Petitioners introduced into evidence order forms of 12 companies which petitioners identified as their competitors in an effort to show that the rates charged by petitioners were reasonable. The Administrative Law Judge determined that petitioners failed to provide sufficient information concerning these companies, e.g., sales information or type of merchandise sold, in order for her to conclude that petitioners' charges were reasonable in relation thereto. Thus, the Administrative Law Judge held that petitioners were not entitled to an exclusion from their taxable receipts to the extent of the $92 million collected by them during the audit period.

The Administrative Law Judge noted that where a taxpayer separately stated its cost of transportation as required by the regulations, and where such charge is entitled to exclusionary treatment, but for the fact that petitioner was unable to demonstrate the reasonableness of its rates, the Division had the discretion to reduce the claimed exclusion from taxable receipts by what it deemed to be excessive transportation charges. The Administrative Law Judge specifically found that the Division acted improperly by refusing to exercise its discretionary

power since it did not claim an inability to exercise its discretion nor did the Division argue that it chose not to make such a reduction for any other reason. As stated by the Administrative Law Judge, the Division claimed that petitioners were not entitled to any reduction because it was not provided with a breakdown of actual transportation costs as incurred by Raffoler and RBM, individually.

The Administrative Law Judge noted that the Division first raised this argument in its post-hearing brief. The Administrative Law Judge emphasized that although petitioners herein were assessed separately, during the hearing, the Division treated the two companies collectively for purposes of establishing their qualification for the exclusion. The Administrative Law Judge stated that although it was established at hearing that petitioners' records did not show a separation of actual transportation expenses between petitioners, the fact that they would be denied the exclusion if such costs could not be separated was never asserted. Therefore, the Administrative Law Judge accepted petitioners' suggestion as to allocation between petitioners based upon their respective ratios of gross sales of each to total sales of both entities combined. This resulted in the allowance of an exclusion equal to actual total transportation costs of $43,139,199.00 allocated approximately 78.5% to Raffoler and 21.5% to RBM.

With respect to the issue involving the imposition of penalty, the Administrative Law Judge determined that petitioners did not show that their failure to pay the sales tax due was reasonable and not due to willful neglect. The Administrative Law Judge noted that petitioners were previously audited on the same issue and should have known during the tax period herein to maintain the records required to keep the shipping receipts separate from sales as they were collected with the order forms from the purchasers and they did not. Rather, petitioners

continued to exclude from sales tax a percentage of its gross receipts when they knew they should only be excluding their actual shipping receipts.

ARGUMENTS ON EXCEPTION

In its exception, the Division argues that the statute and regulations confine transportation costs to the actual costs paid by a vendor. The Division maintains that the charges by petitioners were entitled to exclusion from taxable receipts only if the charges were separately stated and did not in the aggregate exceed transportation cost. Thus, the Division asserts that transportation charges are not properly excluded from receipts if such charges included a profit component as in this case. The Division states that its theory "that the exclusion for shipping charges is limited to the cost of transportation is consistent with the fundamental principle that all receipts representing expenses (except those expressly excluded) or profit incurred in making the sales are subject to sales tax" (Division's exception, Attachment B-1, ¶ 9). The Division continues to argue that its position on this point is supported by our decision in ***Matter of Spencer Gifts*** (***supra***).

Furthermore, the Division claims that it was justified in taxing all of petitioners' shipping charges since taxable and nontaxable items were billed as a single charge. However, *assuming arguendo*, that it was under a duty to exclude the actual cost of transportation from receipts subject to tax even when the vendor's shipping charges are substantially in excess of said costs, the Division states that it was under no obligation to exercise its discretion herein because it was not provided on audit with the necessary information to determine the actual shipping costs incurred by each petitioner. Therefore, it asserts that the Administrative Law Judge erred in her allocation of the shipping costs between petitioners herein. Lastly, the Division alleges that the

Administrative Law Judge's conclusion to reduce the additional receipts subject to sales tax based on an estimate of actual shipping costs for each petitioner is inconsistent with her conclusion that the actual cost of transportation is irrelevant to entitlement to the exclusion from sales tax.

In their exception, petitioners disagree with the Administrative Law Judge that they failed to meet their burden of proving that their shipping charges were reasonable in relation to prevailing established rates. Petitioners claim that since the Administrative Law Judge determined that the shipping charges were for the delivery of merchandise to their customers, that such charges were separately stated on their order forms and that the Division failed to establish reasonable shipping rates for mail order companies, the Administrative Law Judge erred by concluding that petitioners' shipping charges were taxable receipts.

Moreover, petitioners state that they did establish reasonable cause for failing to withhold and pay over to the Division the proper amount of sales tax on their shipping charges. Petitioners claim that their failure to maintain the exact amount of the transportation charges collected is irrelevant to whether their failure to collect and pay over the proper amount of tax on those charges was reasonable. Furthermore, petitioners disagree with the Administrative Law Judge to the extent that it was unreasonable for them to have excluded as shipping charges 20% of their gross receipts from March 1988 through May 1990 and, thereafter, based on the results of a settlement of a sales tax audit for the immediately preceding tax periods, to have excluded 13% of their gross receipts. Petitioners argue that they reasonably complied with the law and regulations in excluding from gross receipts shipping charges that they believed were reasonable

in relation to what others in the mail order industry were charging and they assert that there is no evidence that they willfully neglected to collect and pay the sales tax due on those charges.

OPINION

Tax Law § 1105(a) provides for a tax on the receipts from every retail sale of tangible personal property except as otherwise provided. Tax Law former § 1101(b)(3) defined receipt, in pertinent part, as follows:

> The amount of the sale price of any property and the charge for any service taxable under this article . . . excluding the cost of transportation of tangible personal property sold at retail where such cost is separately stated in the written contract, if any, and on the bill rendered to the purchaser.

The regulations which addressed the transportation exclusion, 20 NYCRR former 526.5(g), provided that:

> (1) The cost of transportation of tangible personal property, sold at retail, which is separately stated in the written contract, if any, and on the bill rendered to the purchaser is excluded from the receipts subject to the tax.
>
> (2) To qualify for the exclusion, transportation costs must be for the delivery of the tangible personal property to the purchaser. Any charge made to a retail purchaser, whether labeled transportation, handling or some other designation, which represents the cost of transportation between a supplier, manufacturer, warehouse, or catalog or other distribution point, and the vendor's place of business constitutes part of the receipts subject to tax.
>
> (3) Transportation charges shall be deemed to be separately stated if they can be computed from information appearing on the bill.
>
> (4) To qualify for the exclusion, transportation charges must be reasonable in relation to prevailing established rates. The bureau may establish reasonable charges for an industry, and reduce the exclusion for excessive transportation charges.

We begin by addressing the Division's argument that the phrase *cost of transportation* means the amount paid or expended by a vendor to transport goods to its customers. We are not persuaded that this phrase should be interpreted as narrowly as the Division urges. As outlined above, the regulations at 20 NYCRR former 526.5(g) provided guidance as to whether transportation charges were entitled to be excluded from taxable receipts. Primarily, the cost of the transportation had to be for the delivery of the merchandise to the purchaser and such cost could not encompass an amount charged by a vendor for any other transportation, or transportation-like, costs it may have incurred with any third party, e.g., supplier or manufacturer. In this case, there is no dispute that the actual amounts incurred by petitioners herein were for the delivery of their merchandise to their customers.[2] Moreover, the shipping charges were separately stated on the order forms completed by their customers. Therefore, the deciding factor for exclusion is whether the shipping charges were reasonable in relation to prevailing established rates.

We agree with the Administrative Law Judge that subsection (4) of the former regulation implied that the cost of transportation was something other than the actual amount expended for delivery. Otherwise the subsection would have been rendered meaningless. The regulation provided that the transportation charges must have been reasonable which contemplated that the charge was representative of more than just the actual amount incurred by the vendor for delivery. Furthermore, the regulations required that the charges be reasonable in relation to

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[2]The issue in this case involves whether the cost of transportation is limited to the amount expended by the vendor for delivery of their goods to the customer or whether any amount charged in excess of said amount for profit is an amount necessarily included as taxable receipts or whether, such amount, if reasonable in relation to prevailing establish rates, is entitled to exclusion from taxable receipts. To the extent that there is no dispute that the actual amounts expended by petitioners were charges incurred for the delivery of their merchandise to their customers, a discussion of ***Matter of Spencer Gifts*** (***supra***) is unwarranted.

prevailing established rates. Such statement implies that there was no exact formula for what constituted shipping charges entitled to exclusionary treatment. Accordingly, we refuse to adopt the Division's interpretation that cost in this case refers only to the actual amount expended for shipping.

The next question to be addressed is whether petitioners have demonstrated by clear and convincing evidence that their charges were reasonable. It is undisputed that petitioners claimed total shipping receipts of $92 million of which $43,131,199.00 represented the actual shipping costs incurred. Petitioners did not maintain records (source documentation) of their actual transportation costs charged to customers as required by law and regulation (***see***, Tax Law § 1135[a][1]; 20 NYCRR 533.2) or as admonished by the auditor during the prior audit (***see***, Hearing Tr., pp. 98-99). Therefore, it was impossible to decipher what petitioners had charged on their invoices and whether those charges were "reasonable in relation to prevailing established rates." Although it appears petitioners substantiated their $92 million dollar claim with fabricated percentages of gross receipts, there is absolutely no substantiation for this amount in their records.

In support of their position that their charges were reasonable, petitioners submitted into evidence a comparison of order forms used by them during the audit period with the order forms of 12 companies that petitioners characterized as their competitors. We agree with the Administrative Law Judge that petitioners have failed to provide enough information on the 12 companies in order for us to make a determination as to whether the rates as set by these companies were comparable to that charged by petitioners and how these 12 companies were chosen by petitioners as indicative of the prevailing rate in the industry. Therefore, petitioners

have not met their burden and, thus, are not entitled to the claimed $92 million exclusion from taxable receipts.

The Division's audit guideline memorandum DOS-90-7 states, in part, that the Division could exclude shipping and handling charges if the aggregate receipts for the audit period are equal to or less than the vendor's actual cost of transportation. The Division interprets this as meaning that any amount charged for shipping in excess of the actual shipping costs is excessive and grounds for denying petitioners any exclusion from tax for their shipping and handling charges.

We find such an interpretation unreasonable. Accordingly, while we find that petitioners have failed to prove entitlement to their entire claimed amount, it was reasonable for the Administrative Law Judge to find that petitioners are entitled at least to their actual shipping receipts incurred.

The Division argues that although allowing petitioners an exclusion for the actual shipping costs incurred sounds reasonable, it could not make such an adjustment due to the fact that petitioners did not maintain records such that the Division would be able to determine how much shipping expenses each corporation incurred individually. Therefore, it claims that no adjustment could be made.

While we recognize the inadequacy of petitioners' records, we uphold the allocation method as determined by the Administrative Law Judge. The Administrative Law Judge thoroughly discussed her reasons for employing a pro-rata allocation in this case and we sustain her conclusion for the reasons set forth therein. In doing so, however, we do not condone or excuse petitioners' failure to maintain required books and records even after being told to do so

by the auditor in their prior audit. As stated above, we cannot reach the issue of whether petitioners' charges were "reasonable" because they could not establish what they charged for shipping, i.e., they maintained no source documentation.

The last issue presented to us on this exception is whether penalty imposed pursuant to Tax Law § 1145(a)(1)(i) should be abated based upon reasonable cause and the absence of willful neglect on the part of petitioners. We agree with the Administrative Law Judge that petitioners have not proven that their failure to pay was due to reasonable cause and not due to willful neglect. The record reflects that in early 1988, petitioners began excluding from taxable receipts an amount equal to approximately 20% of such receipts as representative of their shipping charges. This practice was continued throughout 1988 to sometime in mid-1990 when the prior audit of petitioners was settled. After conclusion of the prior audit, petitioners continued to exclude from their taxable receipts a percentage of their gross receipts, rather than complying with the law and maintaining records which kept their shipping receipts separate from sales as such charges were collected. We find that petitioners' failure to adjust their record-keeping, especially in light of the fact that they had just completed an audit on the same issue and had been admonished to keep records, militates against a finding that their failure to pay the sales tax due and owing was based upon reasonable cause and not due to willful neglect. Therefore, we sustain the penalty imposed by the Division.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

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

2. The exception of Raffoler Ltd. d/b/a Trends, RBM, Ltd., Jerry Williams, as officer of Raffoler Ltd. d/b/a Trends and RBM, Ltd. and Stephen Brown, as officer of Raffoler Ltd. d/b/a Trends and RBM, Ltd. is denied;

3. The determination of the Administrative Law Judge is sustained;

4. The petitions of Raffoler Ltd. d/b/a Trends, RBM, Ltd., Jerry Williams, as officer of Raffoler Ltd. d/b/a Trends and RBM, Ltd. and Stephen Brown, as officer of Raffoler Ltd. d/b/a Trends and RBM, Ltd. are granted to the extent that the corporations' taxable receipts are entitled to be reduced by the amount of actual shipping receipts, but are otherwise denied; and

5. The Notices of Determination dated August 30, 1993 and September 9, 1993 are to be adjusted in accordance with paragraph "4" above and footnote "1," but otherwise are sustained.

DATED: Troy, New York
August 10, 2000

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

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

COMMISSIONER DeWITT dissenting:

I agree with the majority insofar as they conclude that the "cost of transportation" which may be excluded from taxable receipts pursuant to Tax Law former § 1101(b)(3) is not limited to the actual amount expended for delivery. However, I cannot agree with the majority's conclusion that petitioners have failed to meet their burden of proof to show that the transportation charges they collected from their customers were "reasonable in relation to prevailing established rates,"

as required by 20 NYCRR former 526.5(g)(4). In fact, by allowing only the actual costs of transportation expended by petitioners, the majority is tacitly approving the "reasonableness" standard maintained by the Division which it has explicitly rejected herein.

The difficulty in determining whether or not petitioners have met the standard of former 526.5(g)(4) is that neither Tax Law former § 1101(b)(3) nor the regulations provide any explanation of what "reasonable in relation to prevailing established rates" means. It is agreed that the Division could have established "reasonable charges for an industry" pursuant to former 526.5(g)(4) but it failed to do so. There are no guidelines as to how or when rates are to be "established," where such rates are to be "prevailing" or to what extent petitioners' rates may differ from such rates and still be considered reasonable.

The Division's auditor, in her audit report, noted that:

> PER THE SALES TAX REGULATIONS, SHIPPING RECEIPTS MUST BE COMPARABLE WITH PREVAILING RATES TO BE EXEMPT. AUDIT DIVISION POLICY IS TO USE THE COST OF SHIPPING TO DETERMINE PREVAILING RATES (Exhibit "FF," Field Audit Report - Audit Results, p. 10).
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> .

She further notes that catalogues of other mail order companies submitted by petitioners were rejected by the Division as proof of the charges for transportation by those other companies because it could not be determined if such charges included "handling" (despite this Tribunal's decision in ***Matter of Spencer Gifts, supra***, which allowed an exclusion as transportation cost for a charge labeled "postage and handling"). Thus, in order for petitioners' charges to be "reasonable" and entitled to exclusion, the Division would require petitioners to first show that the charges of their competitors were themselves entitled to exclusion (as per the Division's standards) and that petitioners' charges were reasonable in light thereof. This seems to be an

impossible task for petitioners and well beyond the requirements of the former statute and regulation which interpreted it.

In ***Matter of Spencer Gifts*** (***supra***), the reasonableness of petitioners' charges were not in issue. There this Tribunal found as a fact that:

> [t]he amounts Spencer charged its customers for postage and handling were established by its marketing division based on the prevailing rates charged in the mail order industry. The charges were imposed to enable Spencer to recover its own costs in transporting merchandise from its warehouses to the customer. The charges do not cover costs for handling the merchandise (***Matter of Spencer Gifts, supra***).

In the present case, the Administrative Law Judge made a similar finding of fact which states: "When establishing shipping charges, although Raffoler and RBM sometimes considered the anticipated weight of the item, the companies' primary concerns were with regard to marketing conditions and what was acceptable in the industry and to the consumer" (***see***, p. 4). No exception was taken to this finding by either party. Petitioners' CEO during the audit period reiterated several times during his testimony that petitioners' shipping charges were set by reference to market conditions, actual shipping costs and the charges made by petitioners' competitors. Since this is the standard found acceptable by this Tribunal in ***Spencer Gifts***, and with no evidence submitted by the Division to indicate that the charges were excessive in relation to what was charged by petitioners' competitors at the time or otherwise unreasonable in relation to prevailing rates in the mail order industry, the uncontroverted evidence indicates a policy of setting charges in this manner throughout the audit period.

I concur with the Administrative Law Judge's reluctance to place her faith in a report of transportation charge comparability prepared subsequent to the audit period. Such report needed

more explanation of why certain entities were considered to be comparable. In the recent decision of this Tribunal in ***Matter of Tropicana Prods. Sales*** (Tax Appeals Tribunal, June 12, 2000) we subjected an expert's report prepared in contemplation of litigation to just such a scrutiny as was done by the Administrative Law Judge in the present case. While I concur in the Administrative Law Judge's analysis of the validity of the cost report, I believe that petitioners provided ample uncontroverted evidence of the reasonableness of the methodology used to arrive at the transportation charges during the audit period without resort to this report. I submit that the Administrative Law Judge's aforementioned finding of fact supports this conclusion. Such charges were only unreasonable in light of the Division's standard that transportation charges were limited to actual costs, a position rejected by the majority herein. Therefore, I conclude that petitioners have met their burden of proof to show that their charges for shipping were "reasonable in relation to prevailing established rates" as required by 20 NYCRR former 526.5(g)(4). Based on that conclusion, petitioners were entitled to exclude their shipping charges from their taxable receipts. As a result, I would modify the Administrative Law Judge's determination and cancel the Notices of Determination at issue herein.

DATED: Troy, New York
August 10, 2000

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