STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
MICHAEL D. BUTTON AND JAMES F. BUTTON	:	DECISION
	:	DTA NO. 817034
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 October 7, 1997 through November 8, 1997.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on October 12, 2000 with respect to the petition of Michael D. Button and James F. Button, 702 Reese Road, Frankfort New York 13340. Petitioners appeared by Thomas G. Jackson, Esq. The Division of Taxation appeared by Barbara G. Billet, Esq. (Michael B. Infantino, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioners filed a brief in opposition and the Division of Taxation filed a reply brief. Oral argument, at both the Division of Taxation's and petitioners' request, was heard on July 26, 2001 in Troy, 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 were prevented from exercising their authority as corporate officers by the actions of Marine Midland Bank such that they cannot be held liable for the taxes owed by the corporation for the period in issue.

II. Whether, if petitioners had the authority to pay the taxes due from the corporation, their failure to pay those taxes was due to reasonable cause and not to willful neglect.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for finding of fact "9" which has been modified. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

Petitioner Michael D. Button is the former president of Herkimer Wholesale Company, Inc. ("Herkimer"), a wholesale supplier of groceries, candy, cigarettes and other sundries. His brother, James F. Button, is the former vice-president of Herkimer. The Button family purchased Herkimer in 1968 and operated the business for almost 30 years from its main office in Utica, New York.

Herkimer was licensed as a cigarette agent by the Division of Taxation ("Division"). In this capacity, Herkimer was required to advance and pay the cigarette tax imposed under Tax Law § 471. As of September 1, 1995, Herkimer was also required to prepay on account of sales taxes imposed by articles 28 and 29 of the Tax Law. Herkimer advanced and prepaid the cigarette and sales taxes by purchase of cigarette tax stamps from Fleet Bank acting as an agent of New York State. The tax stamps were affixed to packages of cigarettes sold by Herkimer in New York State as evidence that the taxes had been paid.

Herkimer filed a credit bond with the Division and was permitted to purchase tax stamps on credit and to pay for them 30 days later. By late 1997, the amount of Herkimer's credit bond was $2.2 million. The surety was National Union Fire Insurance Company of Pittsburgh, Pennsylvania.

To pay for the tax stamps purchased on 30-day credit, Herkimer filed an authorization for Automatic Clearing House ("ACH") debits which authorized Fleet Bank to use ACH procedures to debit a designated account that Herkimer maintained with a branch of Marine Midland Bank ("Marine") in Utica, New York for the amount of tax owed.

During the entire time that it was owned by members of the Button family, Herkimer's sole banking relationship was with Marine where it maintained checking accounts and received mortgages, demand loans and installment loans. Herkimer's receipts grew from $2 million per year in 1968 to almost $125 million per year in 1996. During that time, Herkimer's borrowings from Marine also grew to almost $12 million.

By arrangement with Marine, all of Herkimer's receipts were deposited daily into operating accounts maintained at Marine. Overdrafts on Herkimer's checking accounts routinely occurred in the course of Herkimer's business. Since large deposits of cash were being made by Herkimer on a daily basis, Marine permitted the overdrafts which were repaid on days when Herkimer had deposits in amounts large enough to cover them, and Marine charged Herkimer interest on the daily average outstanding amount.

From the beginning of its relationship with Marine, Herkimer had never been late in making payments on any mortgage, note or interest expense. However, its total indebtedness to Marine grew.

On Friday, September 24, 1996, representatives of Marine required Herkimer's officers to attend a meeting at Marine's offices. At that meeting, Herkimer was informed that Marine was altering its methodology for computing Herkimer's borrowing base (i.e., the amount of collateral maintained by Herkimer to support its loans). From that date forward, Marine eliminated the value of affixed and unaffixed tax stamps, cigarette coupons, cigarette coupon receivables and manufacturer's receivables to determine the loan amounts for which Herkimer qualified. As a result of this change, Herkimer was placed in default of its collateral obligations under the Marine loans.

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

> On October 25, 1996, Herkimer and Marine entered into a Loan and Security Agreement (the "Loan Agreement") which consolidated and restructured certain of Herkimer's pre-existing debt to Marine. As pertinent here, Marine agreed to make available $250,000.00 to cover short term overdrafts in Herkimer's operating accounts with advances being repaid within five business days provided that the sum of the aggregate principal not exceed $8,850,000.00.
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> In the Loan and Security Agreement, Herkimer, by its officers, specifically granted Marine a security interest in and lien on all its accounts wherever located, among other items. Further, the agreement specifies that if Herkimer defaulted, Marine could declare the indebtedness due and payable without further notice to Herkimer.
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> Herkimer executed an amendment to the Loan and Security Agreement, "Amendment No. 4," dated September 24, 1997, in which Herkimer agreed to provide evidence satisfactory to Marine of a prospective purchaser of the business by October 31, 1997. The Amendment provided that if Herkimer failed to produce such evidence they would be in default under the security agreement and Marine would be entitled to take immediate possession of the collateral, including all Herkimer's accounts. This provision was

> incorporated into the Loan and Security Agreement of October 25, 1996 as section 12.1(p).[1]

Herkimer's financial condition at the end of 1996 is summarized in an independent auditor's report issued by Pasquale & Bowers, Certified Public Accountants, on April 24, 1997.

> [Herkimer] incurred a substantial net loss for the period ended December 31, 1996. In addition, at December 31, 1996, [Herkimer] has a working capital deficit of approximately $4,400,000 and total liabilities exceed total assets by approximately $4,600,000. The loss included approximately $3,800,000 in trade and nontrade receivable allowances and write-offs and other significant increases in operating costs that management has deemed to be nonrecurring. These factors raise substantial doubt about [Herkimer's] ability to continue as a going concern. [Herkimer's] ability to establish favorable bank terms and maintain bonding and account drafting arrangements with cigarette manufacturers factor heavily into its ability to continue as a going concern. Management has met with representatives from its bank in an attempt to restructure debt and secure the bank's continuing support. The bank previously amended its loan agreement and provided an extension of the line through June 30, 1997.
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> During the last quarter of calendar 1996, management retained a group of industry consultants to assist in restructuring [Herkimer's] operations. . . . The new management team has analyzed operations and is focusing on increasing efficiency, profitability and cash flow through inventory management and reduced operating costs. Management is confident it is taking the steps necessary to enable [Herkimer] to return to profitability.
>
> It is not possible, however, to predict at this time the success of management's efforts. The financial statements do not include any adjustments relating to the recoverability and classification of recorded assets, or the amounts and classification of liabilities that might be necessary in the event [Herkimer] cannot continue in existence.

As a condition of extending Herkimer's loans, Marine required Herkimer to seek a buyer for its business. Herkimer's principals entered negotiations with another New York State cigarette agent, A.D. Bedell, about the possibility of that agent's purchasing Herkimer's assets and inventory and assuming some of Herkimer's debt. The negotiations between Herkimer and

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[1]We modified finding of fact "9" of the Administrative Law Judge's determination to better reflect the record.

the potential buyer broke down on November 5, 1997, and Bedell withdrew from further negotiations.

On Thursday, November 6, 1997, Herkimer received faxed copies of two letters from Marine's attorneys, Hancock & Estabrook, each dated November 6, 1997. The first letter notified Herkimer of Marine's demand for immediate repayment of all indebtedness owing under the Loan Agreement and for overdrafts existing in Herkimer's operating accounts plus interest, costs and expenses. In addition, Marine demanded all inventory, equipment, accounts, general intangibles and chattel paper of Herkimer and of a related company (Button Leasing Co.). Marine also demanded that Herkimer "hold in trust for the benefit of, and immediately turnover to Marine any proceeds of any of the Collateral now or hereafter in possession of the Borrower." Herkimer was warned that failure to turn over any proceeds might be deemed a criminal conversion. Finally, Herkimer was informed that Marine would be returning all items submitted for payment to it, adding: "Borrowers' accounts are, as you are aware, currently overdrawn." The second letter dated November 6, 1997 corrected several amounts stated in the first letter. According to the letters, Herkimer's indebtedness under the Loan Agreement amounted to $9,750,000.00, and, Herkimer's overdrafts amounted to $1,234,495.04.

On the morning of Friday, November 7, 1997, Herkimer's principals learned that its operating accounts had been frozen as of November 5, 1997, and all monies in Herkimer's payroll account and operating account had been used by Marine to reduce Herkimer's debt. This included deposits of $148,897.66 made directly into a Marine account by Herkimer's sales personnel. As a result, an ACH debit submitted by Fleet Bank on November 5, 1997 for cigarette stamps purchased 30 days earlier was returned by Marine for insufficient funds.

At approximately 5:00 P.M. on November 7, 1997, Marine served Herkimer with a restraining order issued by the New York State Supreme Court of Onondaga County which prevented Herkimer from using or transferring any of the collateral (essentially all cash and assets owned by Herkimer and related corporations wherever located). This effectively prevented Herkimer from doing business.

On Monday, November 10, 1997, an involuntary petition under Chapter 7 of the Bankruptcy Code was filed against Herkimer in the United States Bankruptcy Court, Northern District of New York (the "Bankruptcy Court") and served on Herkimer on the same day. The petitioners were Geri Button, a sister of petitioners, A.E. Austin-Brown Associates, Inc. and Scott Brown & Co. The total amount of the petitioners' claims was $107,100.00.

On November 12, 1997, Marine moved in the Bankruptcy Court for an injunction enjoining Herkimer from using or otherwise disposing of certain collateral and cash collateral described in the affidavit of Steven F. Ricca, a vice-president of Marine, and for an order prohibiting Herkimer's continued use of Marine's cash collateral during the pendency of the bankruptcy proceeding, among other things. In his affidavit, Mr. Ricca asserted that Herkimer's daily deposits ranged between $70,000.00 and $900,000.00 and that its deposits for the seven business days beginning November 6, 1997 through November 14, 1997 should have amounted to $2,175,000.00. Marine accused Herkimer of diverting this collateral since no deposits had been made into Marine accounts after November 6, 1997.

Honorable Stephen D. Gerling, Chief Judge of the Bankruptcy Court, issued an Order to Show Cause and Temporary Restraining Order on November 12, 1997 which, as pertinent here, states:

> **ORDERED,** that pursuant to § 303(f)[2] and pending the hearing and determination of the subject motion, the Debtor be and hereby is enjoined and restrained from using, transferring, selling, pledging, assigning, hypothecating or otherwise disposing of subject collateral other than in the usual and ordinary course of its business, and shall deposit any and all proceeds of the collateral collected since November 5, 1997 in a separate checking account to be established at Marine, except for the sum of $100,000 or such other amount as may be agreed to by the parties, currently on deposit at Albank, in order to cover payroll obligations for the weeks of Nov. 3rd and Nov. 16, 1997, pursuant to Rule 7065 of the Federal Bankruptcy Rules of Procedure, Rule 65(b) of the Federal Rules of Civil Procedure and Local Rule 913,2; and it is further
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> **ORDERED**, that at least one business day prior to said hearing, the Debtor shall provide Marine and its counsel with a detailed accounting with respect to the Debtor and its affiliates conduct with respect to the disposition of the collateral since November 5, 1997; along with copies of invoices and receivables listings reflecting all outstanding receivables as of November 12, 1997.

On November 26, 1997, Judge Gerling issued an order granting Herkimer's motion to convert the case to a Chapter 11 proceeding, and on December 10, 1997, Herkimer and Marine entered into a cash collateral stipulation, approved by the Bankruptcy Court, that allowed Herkimer access to the cash collateral subject to the terms of the stipulation. The stipulation was placed on the record of the hearing held on December 10, 1997. Stephen A. Donato, Esq., and James Canfield, Esq., appeared on behalf of Marine. The pertinent portions of the stipulation are as follows:

> Mr. Canfield: The debtor's use of cash in the cash collateral account on a given day is going to be limited to the extent that the inventory borrowing basis and receivable borrowing basis, and those are calculated per the October 25, 1996 Loan and Security Agreement, and collected funds in the cash collateral account exceed, then we have the following provisions: One is $6,552,900 as of December 11, 1997. That's defined as the base. That base is increased by $50,000 each day on Friday, December 12, Monday, December 15th, Tuesday, December 16th, Wednesday, December 17th and for Thursday, December 18th.

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[2] Subsection (f) permits the debtor to continue to operate any business of the debtor and to dispose of property the same as if the case had not been commenced. However, the court is permitted to control the debtor's powers to prevent the debtor from disposing of assets to the detriment of the creditors. Judge Gerling did just this.

That bases or the floor, as I call it, must be $6,758,000. That is essentially what Marine's collateral position was as of the date of the Petition.

In determining the borrowing bases, we are going to allow the debtor to include pre-paid inventory, which is in transit in the formula in determining those bases.

* * *

Mr. Donato: The debtor shall and has already opened up a debtor-in-possession account at Marine Midland Bank. During the terms of the stipulation the debtor shall comply with all terms and conditions of the Loan Agreement, except as modified herein, excluding known defaults as of today. *This includes compliance with Section 7 of the Loan Agreement requiring the deposit of all cash collateral and proceeds in the same medium in which received within 24 hours of receipt into the bank account at Marine Midland.*

The debtor shall not engage in any transactions outside the ordinary course of business. The bank's collateral shall only be used in the ordinary course of the debtor's business. No other sale or disposition of the collateral shall be made by the debtor without further order of the Court.

The cash collateral account shall be held under the joint control of the debtor, subject to the lien of the bank. *The debtor will not attempt to draw any checks against or initiate any wire transfer from the cash collateral account and hereby authorizes the bank to place a hold on the cash collateral account to ensure the prevention of same.*

The debtor intends to use the cash collateral on a daily basis in varying amounts . . . on each day of the week in which the stipulation is in effect. And after receipt by the bank of a duly completed and verified cash collateral certificate for each particular date, . . . the bank shall transfer, from the debtor's cash collateral account to the [debtor-in-possession] account, the amount authorized in the cash collateral account, and to the extent of such funds, the debtor may use such funds in the ordinary course of business.

* * *

Mr. Donato: The bank will have no obligation to make any transfer from the cash collateral account to the debtor's [debtor-in-possession] account at the bank if the debtor is in default of any term or provision of this stipulation or any other loan document, except for known defaults as of today.

> *Further, any transfers by the bank from the cash collateral account to the [debtor-in-possession] account, other than authorized by this agreement, will be subject to the bank's sole and absolute discretion.*

The collateral stipulation was approved by Order of the Bankruptcy Court.

When the ACH debit submitted by Fleet Bank was returned for insufficient funds, a representative of Fleet Bank notified Christine Bowen, a Tax Technician in the Division's Commodities Audit Unit. She was able to speak with Michael Button after making several phone calls to Herkimer over a period of a few days. He informed her of the bankruptcy proceeding and asked if Herkimer would be allowed to continue purchasing stamps. Ms. Bowen initially told Mr. Button that Herkimer would not be able to purchase stamps until Herkimer satisfied the outstanding balance of tax due on the prior purchases. After receiving the bankruptcy documents she had requested and discussing the matter with her supervisors, Ms. Bowen informed Mr. Button that Herkimer would be allowed to continue purchasing stamps; however, Herkimer was required to wire transfer payment for all stamps at the time they were ordered.

On December 8, 1997, the Division issued to Herkimer a Notice and Demand for payment of sales and use taxes due for the period ended November 8, 1997 in the amount of $427,560.00 plus interest of $6,490.38 and penalty of $46,963.80 for a total due of $481,014.18 (assessment number L-014466172-5). The prepaid sales tax liability relates to stamps ordered by Herkimer in the period October 6, 1997 through November 7, 1997. Under the terms of the 30-day credit agreement, payments for those stamps would have come due from November 5, 1997 through December 7, 1997. ACH transactions were initiated by Fleet Bank on November 5, 1997, November 6, 1997, November 7, 1997, November 13, 1997 and November 14, 1997. These

were returned by Marine for insufficient funds or because the operating account was frozen. When these ACH debits were returned by Marine, the Division accelerated the remaining payments due; thus, the Notice and Demand is for the period ended November 8, 1997, the last date of stamp purchase rather than the date the last payment was due, December 5, 1997. The Division filed a Proof of Claim in the bankruptcy proceeding on December 19, 1997 listing the December 8, 1997 sales tax assessment as well as claims for cigarette tax and highway use tax.

On January 26, 1998, the Division issued identical notices of determination to petitioners, assessing sales tax of $427,560.00 plus penalty and interest for the period October 7, 1997 through November 8, 1997. The notices state: "This notice is issued because you are liable as an Officer/Responsible Person for taxes determined to be due in accordance with sections 1138(a), 1131(1), and 1133 of the New York State Tax Law." The parties agree that the assessments were improperly drawn and should have been issued as a penalty equal to the tax due from Herkimer plus penalty and interest pursuant to Tax Law § 1145(e).

From December 10, 1997 through February 24, 1998, Herkimer continued to do business as a wholesale supplier of cigarettes and other products. During that time, it was able to purchase limited amounts of inventory and to make payroll payments to a small number of employees. It continued to purchase tax stamps but was required to directly wire transfer payment for the stamps. On February 24, 1998, Herkimer ceased all operations, and the Bankruptcy Court issued an order permitting Marine to enforce the terms of the Stipulation and foreclose on all of the collateral securing Herkimer's indebtedness to Marine.

By letter dated February 25, 1998, R. John Clark, as the attorney for Marine, informed the Division that Herkimer, a licensed cigarette agent had surrendered possession of all of its

inventory to Marine as a secured creditor and that Marine intended to sell the cigarettes and other tobacco product to a licensed wholesaler or wholesalers. The letter goes on to state:

> We are assuming that Marine's taking possession of the inventory of the Licensee and subsequent sale as the secured creditor to a licensed dealer would be deemed an "isolated circumstance" and that your Department would allow Marine to do such without obtaining an agent's license pursuant to Section 331.1(a)(5) and 332.1(a)(3) of the Regulations adopted under Article 20 of the New York State Tax Law.
>
> Assuming such is the case, we would request written confirmation from your Department that Marine is authorized to act in the capacity of an agent without obtaining an agent's license for the purpose of liquidating the inventory of Licensee. If Marine intends to dispose of any of the tobacco inventory other than to a licensed wholesaler, Marine will advise you accordingly.

Peter Spitzer who was then an auditor in the Division's Registration and Bond Unit responded with a letter to Robert Markowski in Marine's Syracuse office, dated March 3, 1998. In that letter, the Division granted Marine authorization to act in the capacity of a cigarette agent and wholesale dealer, subject to certain conditions: (1) within three days after authorization was granted, and prior to any sales, the Division was to be allowed access to the premises to conduct an inventory of all cigarettes and tobacco products and any unaffixed New York State cigarette stamps; (2) all unaffixed tax stamps were to be returned to the Division at the time the inventory was conducted and "upon receipt of a properly completed Claim for Redemption/Refund of Cigarette Tax Stamps and Prepaid Sales Tax (CG-114), the refund claim will be processed and paid pursuant to law;" all stamped cigarettes were to be sold only to licensed agents, wholesale dealers or retailers; (4) cigarettes were to be sold in accordance with the Cigarette Marketing Standards Act; tobacco products were to be sold tax free to a licensed distributor who would then be responsible for remitting the tax due; and (5) Marine was to submit a separate accounting of all cigarette and tobacco product sales providing the following information for each transaction

entered into: customer name, address, license number, product type, brand, quantity sold, denomination of affixed tax stamps, selling price per unit without tax and total selling price per unit including tax if any.

On March 6, 1998, Mr. Spitzer received a second letter from Marine's attorneys referring to a conversation had the preceding day between Mr. Spitzer and one of Marine's attorneys, Mr. Clark. The letter asks Mr. Spitzer to state whether the Division would authorize a check to be issued payable directly to Marine or a two-party check to Marine and Herkimer in payment of a refund for unaffixed tax stamps in Herkimer's inventory. There is no evidence that Mr. Spitzer replied to the letter, nor is there evidence that Marine ever filed a claim for refund for tax stamps purchased by Herkimer.

Employees from the Division's Syracuse District Office conducted an audit of the Herkimer inventory which was completed on or before April 1, 1998. These employees removed unaffixed New York State tax stamps and tax stamps from other jurisdictions from the premises at this time.

Marine Midland retained American Industrial Auctioneering Co. of Buffalo, New York (the "Auctioneer") to dispose of Herkimer's inventory. Much of the cigarette inventory consisted of stale or otherwise unsalable cigarettes with tax stamps affixed. The entire Herkimer inventory was transferred to Tripifoods, Inc., a Buffalo cigarette agent, which tendered the best offer in response to an offer to bid on the inventory. The inventory purchased by Tripifoods, included both stamped and unstamped cigarettes and sellable and unsaleable cigarettes.

The Bureau of Conciliation and Mediation Services issued identical conciliation orders to petitioners, each dated March 5, 1999. In those orders, the Division sustained the amount of tax

assessed in the notices of determination but canceled the penalties assessed and ordered that the interest be recomputed at the applicable rate.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In her determination, the Administrative Law Judge noted that a valid assessment document is a prerequisite to the jurisdiction of the Division of Tax Appeals. The Administrative Law Judge noted, however, that the parties to this proceeding were agreed that the notices of determination issued to petitioners were incorrectly drawn.

The Administrative Law Judge, reviewing the definition of "persons required to collect tax" provided by Tax Law § 1131(1), concluded that petitioners were under a duty to act for Herkimer in complying with all requirements of Article 28, despite the fact that the prepaid sales tax imposed on cigarettes under Tax Law § 1103 is not directly collected from the consumer. As such, petitioners were subject to personal liability for the prepaid sales tax on cigarettes and appeared to have been properly assessed as responsible officers pursuant to Tax Law §§ 1131(1), 1133(a) and 1138(a).

The Administrative Law Judge noted that pursuant to Tax Law § 1145(e), any officer or employee of a corporation under a duty to act for such corporation which fails to pay the prepaid sales tax on cigarettes is liable for a penalty equal to the total amount of the tax not paid, plus penalties and interest. To preclude the imposition of penalty pursuant to Tax Law § 1145(e) as well as an identical amount of tax, penalty and interest under Tax Law § 1133(a), Tax Law § 1145(e) provides that the penalty imposed by that section shall not be imposed if such person is liable for the prepaid sales tax on cigarettes pursuant to Tax Law § 1103(b). That section, in turn, applies all the provisions of Tax Law Article 28 relating to the administration, collection

and disposition of tax to the prepaid cigarette tax, with such modifications as may be necessary. The Administrative Law Judge concluded that a modification to Article 28 is necessary to prevent a person from being found liable under both Tax Law § 1133(a) and Tax Law § 1145(e).

The Administrative Law Judge noted that where the Legislature enacts a specific provision directed at a particular class and a more general provision in the same statute which appears to encompass that class, the specific provision will be applied. Therefore, inasmuch as the penalty provision of Tax Law § 1145(e) was the more specific provision, the Administrative Law Judge determined that it should be applied except in those instances where it is totally inappropriate. Accordingly, the Administrative Law Judge found that petitioners should have been assessed a penalty equal to the tax not paid, plus, penalty and interest pursuant to Tax Law § 1145(e). The Administrative Law Judge determined, however, that there was no evidence that petitioners were misled or prejudiced in any way by the manner in which the notices were drafted. Both Tax Law §§ 1131(1) and 1133(a) and the penalty provisions of Tax Law § 1145(e) place liability upon petitioners as a result of their status as corporate officers under a duty to act for Herkimer in complying with the Tax Law. Petitioners were informed of their rights to protest the assessments and availed themselves of those rights. The issues to be addressed are similar, if not identical, despite whether the amount owed was assessed as a tax or a penalty and the amount of liability assessed would be the same. Therefore, the Administrative Law Judge deemed the notices of determination issued to petitioners, as modified by the conciliation orders, to be notices of determination of a penalty equal to the amount of prepaid sales tax not paid by Herkimer, plus interest, pursuant to Tax Law § 1145(e).

The Administrative Law Judge also concluded that cancellation of penalties by the conciliation orders did not cancel the underlying assessments in their entirety. The conciliation orders sustained the tax amount of $427,560.00 but canceled penalties imposed on that amount. The Administrative Law Judge determined that the conciliation orders simply followed the form of the notices and were intended to merely cancel the penalty imposed on the amount of the unpaid sales tax.

The Administrative Law Judge found that as liability under Tax Law § 1145(e) was identical with the liability under Tax Law § 1133(a), case law construing Tax Law § 1133(a) was helpful in determining whether petitioners were liable as responsible officers pursuant to section 1145(e).

The Administrative Law Judge accepted petitioners' argument that although they were corporate officers and had both a duty to act for Herkimer and authority to do so during most of the time during which the corporation existed, they were not liable for the penalty assessed against them because they were precluded from paying these specific taxes by the actions of Marine.

The Administrative Law Judge reviewed the course of conduct engaged in by Herkimer, the Division and Marine. The Administrative Law Judge found that Herkimer and the Division had entered into an agreement whereby Herkimer was allowed to purchase tax stamps on a 30-day credit. Pursuant to that agreement, payment for tax stamps purchased by Herkimer was debited from its operating accounts 30 days after the purchase. The notices of determination issued to petitioners were for unpaid sales tax on stamps purchased during the period October 7, 1997 through November 8, 1997. Pursuant to the arrangement between Herkimer and the

Division, payment for stamps purchased on October 6, 1997 came due on November 5, 1997; payment for stamps purchased on October 7, 1997 came due on November 6, 1997; and so forth. Herkimer acquired no debt for prepaid sales taxes after November 8, 1997.

The Administrative Law Judge found that:

> Before November 5, 1997, the ACH debits submitted by Fleet Bank on behalf of the Division were paid. Pursuant to its loan agreements with Marine, overdrafts on Herkimer's operating account were routine and did not result in the return of items drawn on that account. Furthermore, on November 5, 1997, Herkimer's operating account had sufficient funds in it to satisfy the ACH debit submitted by Fleet Bank. On that date, Marine froze Herkimer's operating account without notice to petitioners and applied approximately $148,800.00 in deposits then existing in that account to Herkimer's outstanding loan balances. Marine did not inform petitioners of this action until November 7, 1997. As a result of Marine's actions, all ACH debits issued by Fleet Bank on November 5, 6 and 7, 1997 were returned unpaid. On November 7, 1997, Marine served Herkimer with a restraining order issued by the State Supreme Court which prohibited Herkimer from using or transferring any of Marine's collateral (essentially all of the assets and cash of Herkimer wherever located). From this point forward, petitioners had no authority to pay any bills or use any funds of the corporation. (Determination, conclusion of law "D").

Although payments from customers continued to be received by Herkimer after its Marine accounts were frozen, the Administrative Law Judge found no evidence that Herkimer hid deposits from Marine or attempted to divert receipts. Rather, any monies deposited in Herkimer's Albank account were subject to the authority of the Bankruptcy Court and could only be expended by order of that court. The Administrative Law Judge found Mr. Ricca's claim that Herkimer deposited over $380,000.00 in its Albank account between November 5 and November 7, 1997 to be pure speculation.

The Administrative Law Judge concluded that petitioners never regained the authority to pay the outstanding tax liabilities after November 5, 1997. Herkimer was required to deposit all receipts in a Marine collateral account from which monies were transferred to the debtor-in-

possession account subject to Marine's approval of each expenditure on a daily basis. Herkimer was restrained by the order of the Bankruptcy Court and the stipulation from using Marine's cash collateral for any transactions "outside the ordinary course of business." Petitioners were subject to the restraining order of the State Supreme Court until the involuntary petition in bankruptcy was filed on November 10, 1997. At that point, Herkimer became subject to the authority of the Bankruptcy Court. As a result of the bankruptcy proceeding, the Administrative Law Judge noted that Herkimer was prohibited from paying any pre-petition debt, including tax debts incurred prior to the filing of the petition in bankruptcy.

The Administrative Law Judge found no evidence that any tax liabilities at issue herein were incurred during any period of time when petitioners were in control of Herkimer's finances. No taxes owed by Herkimer went unpaid until Marine froze Herkimer's accounts on November 5, 1997. No further liabilities were incurred after Herkimer resumed operation of its business as a debtor-in-possession. The Administrative Law Judge concluded that Herkimer's tax liability was coextensive with that period of time during which petitioners were prevented from exercising their duty to pay the taxes. The Administrative Law Judge concluded that petitioners' authority to pay the $427,560.00 in prepaid sales tax in issue was extinguished before the due dates for payment of the tax, November 5, 1997 through November 8, 1997, due to the freezing of Herkimer's operating account by Marine on November 5, 1997; the State Supreme Court temporary restraining order filed on November 7, 1997; the order of Judge Gerling issued on November 12, 1997; and the stipulation between Herkimer and Marine which was made an order of the Bankruptcy Court on December 10, 1997.

As petitioners lacked the authority to see that the prepaid sales tax was paid when payment came due, the Administrative Law Judge concluded that they were not under a "duty to act" for Herkimer with respect to the payment of those taxes. Based on this, the Administrative Law Judge did not address whether there was reasonable cause for failure to pay the tax or whether the Division had any obligation to seek return of the stamps or payment for them from Marine.

ARGUMENTS ON EXCEPTION

On exception, the Division argues that Herkimer's liability for payment of the purchase price of the cigarette tax stamps was fixed at the time that the stamps were purchased and received. Since, pursuant to Tax Law §§ 1131(1) and 1133(a) responsible persons are jointly liable for the tax due, and since petitioners have not challenged their status as responsible officers, they are each liable for the tax evidenced by the stamps purchased and received by Herkimer.

The Division asserts that the Administrative Law Judge incorrectly concluded that the tax due upon the purchase of the stamps did not exist as a tax liability until the close of the discretionary 30-day credit period. The Division maintains that if the tax was not due upon the purchase of the stamps, there would be no need to extend credit for payment for 30 days nor would there have been a basis on which Herkimer, as a licensed cigarette agent, could receive a commission as provided by Tax Law § 472(1). Further, if the tax was not fixed and due as of the date of purchase, the Division alleges that the indebtedness for such tax could not have been a pre-petition debt in bankruptcy.

The Division also argues that the tax at issue was due no later than November 7, 1997. As a result, petitioners were not precluded from acting to pay the prepaid sales tax on behalf of

Herkimer until November 10, 1997, the date on which an involuntary petition in bankruptcy was filed against Herkimer.

The Division maintains that the earlier orders of the Supreme Court precluded only Herkimer's use of Marine's collateral but did not preclude petitioners from acting to prepay the sales tax and should not allow them to be relieved of their liability to do so. The Division urges that petitioners placed themselves in this relationship with Marine by refusing to segregate prepaid sales tax in order to keep it beyond the reach of Marine. In doing so, petitioners allowed a private creditor (Marine) to be elevated over the Division in its right to receive trust funds of the State. Further, despite their financial difficulties, petitioners chose to place themselves at risk by continuing to purchase stamps on credit. The Division asserts that the Administrative Law Judge's conclusion that petitioners were not liable due to the actions of Marine is premised on a misunderstanding of the moment when liability occurred and ignores petitioner's complicity in the risky behavior they undertook.

The Division believes that the liability of petitioners is independent of the obligation of the corporation to pay the tax. Herkimer and its officers, not Marine, owed a duty of good faith and cooperation to the Division. The Division maintains that petitioners made no effort to compel their corporation to pay the debt owed to the Division while the corporation was in bankruptcy. The Division, however, asserts that it did all that it was required to do by filing a Proof of Claim in bankruptcy. The Division could not refuse to sell stamps to Herkimer for cash until the pre-petition debt was paid. The Division alleges it was not obligated to seek the return of the stamps attached to the cigarette inventory seized by Marine on February 24, 1998. The Division argues that the record does not support a conclusion that the stamps for which Herkimer had failed to

pay were the same stamps attached to the cigarette inventory seized by Marine in February 1998. According to the Division, the issues of the Division's obligation to seek payment for the stamps attached to the seized collateral and the Division's obligation to seek to collect the tax at issue from Herkimer's estate in bankruptcy are irrelevant to the issue of petitioners' liability herein.

The Division also argues that the Order of the Administrative Law Judge of October 14, 1999 incorrectly directed the Division to furnish petitioners with a Further Bill of Particulars.

Petitioners, in opposition to the exception of the Division, argue that the Division's position fails to consider the steps taken by Herkimer to return its business to a profitable status. Further, neither Herkimer nor petitioners was under a duty to segregate prepaid sales tax. However, both the Tax Law and the Division's regulations permit agents to purchase cigarettes on credit, subject to the Commissioner's discretion, and the risk that an agent might not possess the necessary funds to make payment for stamps 30 days after their purchase is the very reason that any agent purchasing stamps on credit is required to maintain a credit bond in excess of the amount of stamps purchased - which Herkimer did throughout the period in issue.

Additionally, petitioners maintain that the prepaid sales tax can only be collected when the inventory to which stamps are affixed is sold and paid for, which, in the wholesale cigarette industry, is on average greater than the 30-day period of credit extended by the Division. Thus, petitioners assert that they did not neglect an obligation to the State to segregate the prepaid sales tax money from Herkimer's operating receipts nor did they agree to give the State's trust fund taxes to a private creditor. Rather, Herkimer prepaid the sales tax imposed on consumers from its own operating funds which represented the proceeds from Marine's collateral and passed the amount of the tax on to consumers. Petitioners urge that this is in accord with the intent of

Article 20 of the Tax Law, which provides that the ultimate incidence of and liability for the cigarette tax is upon the consumer of the cigarettes.

According to petitioners, if the Legislature had imposed an obligation on agents to segregate a portion of its own operating funds in a tax accrual account in the amount of its daily tax stamp purchases on the day that the stamps were purchased, there would be no purpose for providing a 30-day period of credit before requiring an agent to pay for such stamps. The Division acknowledges this in its brief by stating that the purpose of the 30-day credit provisions is to allow an agent to recoup its investment in inventory before being required to pay for the stamps. Petitioners argue that it was not the absence of an accrual account that placed petitioners at risk or deprived the Division of its ability to collect the amounts at issue from Marine. Rather, it was the Division's failure to follow controlling law as set forth in ***Lincoln First Commercial Corp. v. New York State Tax Commn.*** (136 Misc 2d 478, 518 NYS2d 904) and the opinion of the Division's Counsel that, as a matter of law, Marine could never acquire a secured interest in cigarette tax stamps whether affixed to packages of cigarettes or not. Petitioners disagree with the Division's assertion that petitioners were not precluded from paying the prepaid sales tax at issue until November 10, 1997 when an involuntary petition in bankruptcy was filed against Herkimer. Petitioners believe that this argument ignores the actions by Marine in freezing Herkimer's accounts on November 5, 1997 and the Supreme Court's restraining order filed on November 7, 1997. As the Administrative Law Judge found, that order effectively prevented Herkimer from doing business.

Petitioners dispute the Division's position that the Division could not have asserted its rights in the affixed and unaffixed stamps. Petitioners disagree with the Division's assertion that

there is nothing in the record to show that the stamps seized by Marine were the unpaid-for stamps purchased during the period in issue. In fact, petitioners argue, the unsalable cigarettes that had been inventoried and packaged by Herkimer for return to the cigarette manufacturers were still in Herkimer's inventory at the time that it was closed. That inventory was transferred to Tripifoods which, in turn, returned it to the manufacturers and received a refund for the value of the stamps affixed thereto.

Petitioners also maintain that the October 14, 1999 Order of the Administrative Law Judge granting petitioners' demand for a further bill of particulars was appropriately granted.

OPINION

The Administrative Law Judge considered the validity of the notices of determination issued to petitioners and deemed them to have been properly issued pursuant to Tax Law § 1145(e) rather than pursuant to Tax Law §§ 1131(1), 1133(a) and 1138(a). Neither party has taken an exception to this conclusion. Therefore, we begin our analysis by looking to Tax Law §1145(e). That section provides, in applicable part, that:

> any officer, director, shareholder or employee of a corporation . . . who, as such officer . . . is under a duty to act for such corporation . . . in complying with any requirement of [Article 28 of the Tax Law] . . . which fails to pay the tax required to be prepaid by . . . [Tax Law § 1103, Prepayment of sales tax on cigarettes] shall. . . be liable for a penalty equal to the total amount of the tax not paid, plus penalties and interest. . . . If the commissioner determines that such failure was due to reasonable cause and not due to willful neglect, the commissioner shall remit all or part of such penalty imposed under this subdivision. [The penalty imposed by 1145(e)] shall be determined, assessed, collected and paid in the same manner as the tax required to be prepaid by section . . . eleven hundred three. . . .

The threshold issue for our consideration is whether petitioners are officers of Herkimer who were under a duty to act for Herkimer in complying with any requirement of Article 28 of the Tax Law. In considering this issue, we look to Tax Law § 1131(1), which sets forth the

definition of "Persons required to collect tax." In applicable part, this definition includes "any officer, director or employee of a corporation . . . who as such officer, director, employee or manager is under a duty to act for such corporation . . . in complying with any requirement of [Article 28]." Further, Tax Law § 1133(a) places personal liability for "the tax imposed, collected or required to be collected" on "every person required to collect any tax imposed by this article." Thus, as the Administrative Law Judge found, the liability placed on officers pursuant to Tax Law §1145(e) is identical to the liability placed on corporate officers pursuant to Tax Law § 1133(a). Therefore, it is instructive to look at decisions by this Tribunal concerning the imposition of responsible officer liability under Tax Law § 1133(a).

Whether an individual is under a duty to act for a corporation in complying with its responsibilities pursuant to Article 28 so that the individual would have personal liability for the taxes imposed, collected or required to be collected depends on the particular facts of the case (***Matter of Cohen v. State Tax Commn***., l28 AD2d l022, 5l3 NYS2d 564).

The question to be resolved in any particular case is whether the individual had or could have had sufficient authority and control over the affairs of the corporation to be considered a responsible officer or employee. Although the holding of corporate office is not in and of itself a sufficient basis upon which to impose personal liability for sales taxes found owing by a corporation (***Chevlowe v. Koerner***, 95 Misc 2d 388, 407 NYS2d 427), case law and the decisions of the Tax Appeals Tribunal have identified a variety of factors as indicia of responsibility: the individual's status as an officer, director, or shareholder; authorization to write checks on behalf of the corporation; the individual's knowledge of and control over the financial affairs of the corporation; authorization to hire and fire employees; whether the

individual signed tax returns for the corporation; and the individual's economic interests in the corporation (***see, Matter of Martin v. Commr. of Taxation & Fin.***, 162 AD2d 890, 558 NYS2d 239; ***Matter of Cohen v. State Tax Commn***., ***supra***; ***Matter of Blodnick v. New York State Tax Commn***., l24 AD2d 437, 507 NYS2d 536; ***Vogel v. New York State Dept. of Taxation & Fin.***, 98 Misc 2d 222, 4l3 NYS2d 862; ***Chevlowe v. Koerner, supra***; ***Matter of Constantino***, Tax Appeals Tribunal, September 27, 1990).

In most instances, a corporate officer with an economic stake in the corporation will be found to be under such a duty to act (***see***, ***e.g.***, ***Matter of Martin v. Commr. of Tax & Fin***., ***supra***; ***Matter of LaPenna***, Tax Appeals Tribunal, March 14, 1991). Exceptions have been found where the facts establish that the corporate officer has been precluded from acting on behalf of the corporation with regard to payment of sales taxes (***e.g.***, ***Matter of Constantino***, ***supra*** [where a majority stockholder prevented the petitioner from acting with regard to the financial and management activities of the corporation]; ***Matter of Stern***, Tax Appeals Tribunal, September 1, 1988 [where the corporation's assets, including all of its financial records, were seized by a creditor]). While we have held, generally, that liability for taxes is fixed from the time the taxes are to be collected and not from the time that the return was due to be filed and payment remitted, we have also held that where the responsible officer is prevented from carrying out his responsibilities to see to it that the taxes so collected are properly remitted to the State, such liability does not lie (***Matter of Kadish***, Tax Appeals Tribunal, November 15, 1990).

Here, petitioners claim that, although they were corporate officers (the former president and former vice-president, respectively, of Herkimer) and had both a duty to act for Herkimer and authority to do so during most of the time during which the corporation existed, they are not

liable for the assessed penalty because they were precluded from paying these specific taxes by the actions of Marine.

Tax Law § 1103(a)(2) provides that the prepaid sales tax on cigarettes shall "be paid at the same time and in the same manner as the tax imposed by such article twenty with respect to cigarettes. The commissioner may, in the commissioner's discretion, permit an agent to pay the tax imposed under this section at the same time that the agent pays for cigarette tax stamps under article twenty of this chapter . . . ." As relevant here, Tax Law § 472(1) provides that "The commissioner may, in his discretion, permit an agent to pay for such [cigarette tax] stamps within thirty days after the date of purchase and may require any such agent to file with the department of taxation and finance a bond . . . ." In this case, there was an agreement between the Division and Herkimer that Herkimer could purchase stamps on credit with payment to be remitted thirty days later. Despite the credit arrangement between Herkimer and the Division, however, the sales tax on cigarettes was still "prepaid" as required by statute in that it was intended to be remitted to the Division by an agent purchasing the stamps prior to its collection from customers following a retail sale.

We do not disagree with the Division's argument that liability for this prepaid sales tax on cigarettes was incurred by Herkimer at the time that the stamps were purchased by Herkimer. As stated above, liability for taxes is generally fixed from the time the taxes are to be collected, and not from the time that the return was due to be filed and payment remitted. Therefore, Herkimer and petitioners incurred liability for sales and use tax on purchases (at time of purchase) up to the involuntary petition in bankruptcy filed on November 10, 1997. The petitioners' debt was not accelerated – it already existed because the taxes were self-assessed, fixed and final debts

upon purchase. Petitioners made 25 separate purchases of tax stamps between October 7, 1997 and November 8, 1997 and the taxes thereon were fixed and due on receipt of the stamps purchased (Tax Law §§ 471, 472 and 1103).

However, the focus of our concern herein is whether petitioners were under a duty to act for Herkimer in complying with the requirement of Article 28 that the prepaid sales taxes on cigarettes be paid, as required by Tax Law § 1103.

Given the circumstances present in this matter, it cannot be said that petitioners were precluded from exercising their authority to pay the outstanding tax liabilities. We find it critical that petitioners voluntarily created the scenario which led to their inability to pay the cigarette and sales and use taxes due. In the Loan and Security Agreement, dated October 25, 1996, between Herkimer Wholesale Company, Inc. and Button Brothers, Inc. as Debtors and Marine Midland Bank as the secured party, Herkimer specifically agreed to grant Marine a security interest in and lien on, among other items, all its *accounts*, wherever located (section 3.1). In addition, the agreement specifies that, in the event of default (including where Marine believed the prospect of payment was impaired), Marine could declare the indebtedness due and payable without presentation, demand, or further notice to Herkimer.

On November 6, 1997, Marine did declare the indebtedness due and payable due to Herkimer's default under the Loan and Security Agreement and the Amendment No. 4 thereto, dated September 24, 1997, in which Herkimer agreed to repay the advances and overdrafts in excess of its borrowing capacity on its accounts and also in failing to provide evidence satisfactory to Marine of a prospective purchaser of the assets of the business by October 31, 1997 (the latter provision found in paragraph "4" of the Amendment and made a part of the Loan

and Security Agreement [§ 12.1(p)]). The events of default entitled Marine to immediate possession of the collateral, which included all of Herkimer's accounts.

Given Herkimer's voluntary agreement to the terms of these agreements, its officers, who executed the agreements and took the risks necessary to keep Herkimer in business, cannot now shield themselves from liability for the cigarette and sales and use taxes due by claiming to be surprised by the actions of Marine on the business's default. Petitioners did not seek the Division's approval in placing it at risk with the business fortunes of Herkimer, and Herkimer's (and petitioners') failure to provide enough security for the taxes to be paid in the event of default (i.e., the credit bond) cannot provide a basis for releasing the officers from liability for the taxes. It may very well be that petitioners believed the Division's interests were ultimately protected by the bond thus justifying their agreement to allow Marine to take their accounts without notice on default, but their error in judgment does not translate into the Division sharing in the risks they chose to take in running their business enterprise. Any preclusion from action by these petitioners was of their own creation, with full appreciation of the possible tax ramifications if the business operations failed. In our opinion, this conclusion disposes of the issue of whether there was reasonable cause for the failure to pay the tax.

However, we believe that there must be a discussion of whether the Division had an obligation to seek return of the stamps or payment for them from Marine and a determination of the amount of credit due, if any.

Since the Administrative Law Judge declined to discuss these issues given her finding on the issue of liability, we remand this case to the Administrative Law Judge for determination of only this issue. A remand will allow the issue to be fully developed through the two stages of

our tax appeals process. As we stated in ***Matter of Air Flex Custom Furniture*** (Tax Appeals Tribunal, September 12, 1991):

> If the matter returns for our review, we will have the benefit of the Administrative Law Judge's analysis as well as the parties' responses to the Administrative Law Judge and to each other. Although we believe it is important to allow the two stage process to perform this function, we are also concerned that the remand will delay the resolution of this case.

Accordingly, the Administrative Law Judge is requested to issue a determination within 60 days of the date of this decision without the submission of further briefs or evidence. Any further submissions by the parties will be at the discretion of this Tribunal on exception, if any.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is granted to the extent that petitioners are liable for the sales and use taxes of Herkimer Wholesale Company, Inc. and that reasonable cause does not exist for the failure of Herkimer Wholesale Company, Inc. or petitioners to pay the taxes owed;

2. The determination of the Administrative Law Judge is modified in that the Administrative Law Judge's determination with regard to the issue of officer liability for the sales and use taxes due from Herkimer Wholesale Company, Inc. is reversed;

3. The case is remanded to the Administrative Law Judge for issuance of a determination on the existing record within 60 days of the date of this decision, as to whether the Division of Taxation had an obligation to seek return of the stamps or payment for them from Marine Midland Bank and a determination of the amount of credit due, if any;

4. The petition of Michael D. Button and James F. Button is denied, in part, consistent with this decision; and

5. The two notices of determination, dated January 26, 1998, are sustained, subject to modification by the Administrative Law Judge and further review by this Tribunal.

DATED: Troy, New York
January 28, 2002

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

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

COMMISSIONER DeWITT dissenting:

I respectfully disagree with the opinion of the majority in this matter and I would affirm the determination of the Administrative Law Judge. Herkimer, as a licensed cigarette agent, was permitted by the Division's regulations to purchase cigarette tax stamps on a credit basis, with payment to be made "within 30 days after the date of purchase, provided a credit bond or other acceptable security has been filed or deposited with the department . . ." (20 NYCRR 74.2[c][1][ii][b]). "Purchases must be placed directly with the fiscal agent or agent bank and must be effectuated in accordance with the terms and conditions prescribed in the written agreement entered into by the fiscal agent or agent bank with the State" (20 NYCRR 74.2[c][1]). Although the terms of the agreement between Fleet Bank and the Division are not in the record, we must assume that Fleet was operating pursuant to that agreement in its relationship with Herkimer.

I disagree with the majority's reasoning that petitioners are liable for the prepaid sales tax due on cigarettes because they voluntarily created the scenario which led to their inability to pay the tax when it came due. If the majority is correct, then petitioners became personally liable for any and all taxes which might become due in the future at such time as they entered into the Loan and Security Agreement with Marine on October 25, 1996. I find no support in the Tax Law for the imposition of liability on this basis. By entering into the Loan and Security Agreement, petitioners did not fail to perform their duty to act on behalf of Herkimer in complying with the provisions of Article 28 of the Tax Law.

An examination of the manner in which payment of the prepaid sales tax was effected by Herkimer prior to November 5, 1997 discloses that it was Marine, not petitioners, that caused the default in payment of tax money to the Division on November 5, 1997 and thereafter. Herkimer deposited its receipts into its Marine deposit account on a daily basis. Marine then transferred amounts from Herkimer's deposit account to the payroll account and operating account, in such amounts as were necessary to meets Herkimer's needs. It is undisputed that an amount in excess of that needed to meet the payment obligation of Herkimer to the Division on November 5, 1997 had been deposited directly into a Marine account by Herkimer's sales personnel. It was Marine which decided, unilaterally and without notice to Herkimer, to retain that deposit and failed to transfer it to the operating account. Further, Marine unilaterally and without notice to Herkimer, refused to allow an overdraft to the operating account, contrary to the course of conduct existing between Marine and Herkimer upon which Herkimer had come to rely. As a result, the ACH debits submitted by Fleet Bank on November 5, 1997 and thereafter for cigarette stamps purchased 30 days earlier were all returned by Marine for insufficient funds.

There is no question that the Division had given permission to Herkimer to avail itself of the 30-day credit provisions provided by the Tax Law and the Commissioner's regulations in paying for its cigarette tax stamps. There is likewise no question that until November 5, 1997, Herkimer was in compliance with its tax obligations to the Division. Until November 6, 1997, Herkimer had no actual notice that Marine intended to withhold funding of Herkimer's operating account as of November 5, 1997 and divert Herkimer's deposits to itself. From the record, it appears that on the same day that Marine seized Herkimer's assets and froze its accounts, Herkimer was cooperating with Marine in attempting to find a purchaser for its business, as Marine demanded. It was on the very day that negotiations "broke down" with a prospective purchaser that Marine acted so as to make it impossible for Herkimer to continue conducting business as usual. The actions by Marine did not relieve Herkimer of its liability to the Division for the amount necessary to pay for the stamps it purchased on credit. However, the record discloses that because of the actions of Marine, it was not possible for petitioners to have acted on behalf of Herkimer to pay for the stamps as payment fell due on November 5th or thereafter.

On exception, the Division argues that Herkimer should have maintained an account to safeguard trust funds consisting of sales tax collected on the sale of cigarettes and which belonged to the State. Tax Law § 1103(b) provides that:

> All the provisions of [article 28] relating to or applicable to the administration, collection and disposition of the taxes imposed by such sections shall apply to the tax required to be prepaid under this section so far as such provisions can be made applicable to such prepayments of tax with such limitations as set forth in [article 28] and such modifications as may be necessary in order to adapt such language to the tax so imposed. . . . Such provisions shall apply with the same force and effect as if the language of those provisions had been set forth in full in this section except to the extent that any provision is either inconsistent with a provision

> of this section or is not relevant to the tax required to be prepaid by this section.

In this regard, I find the provisions of section 1137(e)(3) applicable to the prepaid sales tax on cigarettes. That section provides, in applicable part, that:

> whenever any person fails to collect, truthfully account for, pay over the tax, or file returns of the tax as required in this article, the [commissioner], in [his] discretion where [he] deems necessary to protect the revenues to be obtained under this article, may give notice requiring such person to collect taxes which become collectible after the giving of such notice, to deposit such taxes in any banking institution approved by the [commissioner] and located in this state . . . in a separate account, in trust for and payable to the [commissioner], and to keep the amount of such tax in such account until payment over to the [commissioner].

Further, 20 NYCRR 533.4(d) provides that when the conditions specified in the statute exist, "[i]f the department finds in writing that the financial condition of such a person may impair his ability to pay over the tax, the department may give notice requiring this person to establish such a trust account for the deposit of any taxes collected or collectible after the giving of such notice."

There is no evidence in the record that any condition existed prior to November 5, 1997 which would have provided the Division with a basis on which to give notice to Herkimer or petitioners that they would thereafter be required to establish a trust account into which they would deposit sales tax revenues. To the contrary, there is no challenge to the Administrative Law Judge's conclusion that prior to the time that Marine froze Herkimer's accounts on November 5, 1997, "no taxes owed by Herkimer went unpaid." While neither Herkimer nor petitioners were precluded from having established a trust account on their own initiative, they cannot be found to have breached any duty or obligation to the Division by their failure to have

opened such an account prior to November 5, 1997. Since no trust account had been established, Herkimer's funds on deposit with Marine were not, nor were they required to be, held in trust for and payable to the State. Thus, there was no impropriety in Marine holding a security interest in these funds while on deposit with Marine.

The majority implies that petitioners should have maintained an account free of the security interest of Marine with deposits made therein to be used to pay the prepaid sales tax on cigarettes as it came due. While there is no statutory or regulatory obligation for Herkimer to have done this, hindsight indicates that it would have been prudent to have done so. However, even if such an account had been established, Herkimer's (and petitioners') ability to pay for the stamps it purchased thirty days prior would not have continued past the filing of an involuntary petition of bankruptcy on November 10, 1997. Thus, even under the stringent liability imposed by the majority, petitioners would only be liable for payments of sales and use tax demanded by Fleet and not made on November 5, 6 and 7, 1997.

The focus of our concern herein is to determine whether petitioners were prevented from acting to see to it that Herkimer paid its sales tax on cigarettes when payment was due. We must recognize that petitioners never abandoned, delegated or sought to disregard their duty to pay taxes on behalf of Herkimer and, until Marine seized Herkimer's accounts, they always fulfilled their obligation to pay taxes when due. While there was undoubtedly a risk that Herkimer might one day fail to have sufficient assets on hand to meet its payment obligations, there is no indication that the existence of risk rises to the level of a dereliction of petitioners' duty to see to it that Herkimer complied with the requirements of Article 28 of the Tax Law. In addition, to offset the risk involved, Herkimer maintained a bond as required by the Division and which was

held by the Division to insure that the corporations's obligation was always secured. If entering into a security agreement with a banking institution constitutes a breach of petitioners' statutory duty, then the majority has established a stricter standard of liability to be met by all "persons required to collect tax" than has heretofore been found to exist.

In short, petitioners were the owners and operators of a failing business. Perhaps Herkimer was already destined to fail as a going concern when it entered into the Loan and Security Agreement on October 25, 1996. It may be that its failure was more predictable when it agreed to Amendment No. 4 to that Agreement on September 24, 1997 . However, despite Herkimer's lagging fortunes, Herkimer never once failed to meet its obligation to pay its taxes to the Division as payments came due until Marine precluded it from doing so on November 5, 1997. Liability of responsible officers for the failure of their corporation to pay its taxes when due is often characterized by the diversion of tax money collected and held in trust for the State. Here, no such situation was present. Sufficient funds were on hand to pay their debt to the Division as it came due on November 5, 1997. I do not find that petitioners breached any statutory duty to the Division by entering into an agreement with a lending institution that encompassed a security interest in non-trust fund accounts and I would hold that, as a result of the actions of Marine, petitioners were prevented from acting to fulfill their duty to see to it that the prepaid sales tax due and owing on and after November 5, 1997 by Herkimer was paid to the Division. Thus, I would find, as did the Administrative Law Judge, that petitioners were not

under a "duty to act" for Herkimer with respect to the payment of sales tax on cigarettes on and after November 5, 1997.

DATED: Troy, New York
January 28, 2002

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