

STATE OF NEW YORK
DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
POPULAR CLUB PLAN, INC. :
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 July 15, 1988 :
through December 31, 1988. : DETERMINATION
DTA NOS. 810667
AND 810668

In the Matter of the Petition :
of :
POPULAR SERVICES, INC. :
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 June 1, 1986 :
through February 28, 1989. :

Petitioner Popular Club Plan, Inc., P.O. Box 33, 226 Lincoln Place, Garfield, New Jersey 07026, filed a petition 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 July 15, 1988 through December 31, 1988.

Petitioner Popular Services, Inc., P.O. Box 33, 226 Lincoln Place, Garfield, New Jersey 07026, filed a petition 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 June 1, 1986 through February 28, 1989.

A consolidated hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York on April 27, 1993 at 1:15 P.M. Petitioners filed a brief on June 29, 1993. The Division of Taxation filed a brief on July 20, 1993. Petitioners filed a reply brief on August 13, 1993 which began the six-month statutory period for filing a determination.

Petitioners appeared by Leonard M. Polisar, Esq., William B. Randolph, Esq., and William H. Cox, Esq. The Division of Taxation appeared by William F. Collins, Esq. (James

Della Porta, Esq., of counsel).

ISSUES

I. Whether a Popular Club secretary's redemption of a reward credit for merchandise is a transaction subject to sales tax.

II. Whether, if the redemption of a reward credit is subject to sales tax, the amount of the receipt upon which the tax is imposed is equal to the face value of the credit.

FINDINGS OF FACT

As a result of a sales tax field audit, the Division of Taxation ("Division") issued to Popular Club Plan, Inc. a Notice of Determination and Demand for Payment of Sales and Use Taxes Due (notice number S901220132C) for the period July 15, 1988 through December 31, 1988, assessing sales tax in the amount of \$190,390.93, plus interest. The Division also issued a Notice of Determination and Demand for Payment of Sales and Use Taxes Due to Popular Services, Inc. (notice number S901220131C) for the period June 1, 1986 through February 28, 1989, assessing sales tax in the amount of \$894,619.64, plus interest.

Popular Club Plan was a division of Popular Services, Inc. On July 15, 1988, Popular Club Plan was incorporated as a wholly-owned subsidiary of Popular Services, Inc. The business audited by the Division was operated by Popular Club until July 15, 1988 and by Popular Club, Inc. thereafter. Popular Services, Inc. filed sales tax returns and reported sales made by Popular Club and Popular Club, Inc. The Division concedes that only one entity is liable for the tax assessed for the period July 15, 1988 through December 31, 1988. It explains the duplicative assessments by stating that it is unsure of which entity is liable for the tax, and, therefore, it has issued assessments to both. In this determination, "petitioner" refers to both Popular Club Plan, Inc. and Popular Club Services, Inc.

At hearing, the Division agreed that any tax payment made for the period July 15, 1988 through December 31, 1988 would be applied to reduce the liabilities assessed against both petitioners.

Petitioner is a mail-order house with its principal place of business in Garfield, New

Jersey. It has no offices, warehouses or other facilities in New York; however, it is a registered New York State sales tax vendor, and it collected and remitted sales tax on merchandise sold to New York customers.

Petitioner markets its goods through a unique system called the Popular Club Plan ("Popular Club"). According to its promotional materials, the range and quality of its merchandise is equivalent to that which would be found in a large department store. This merchandise is displayed for sale in the "big catalog". The Popular Club operates through Popular Club secretaries who perform a wide variety of tasks which are described by petitioner in a booklet entitled "Club Secretary Handbook" under the heading "A Business of Your Own".

"Each Popular Shopping Club is a small business, 'owned and operated' by its club Secretary.

"She enjoys the satisfaction and earnings of owning a small business, but without any investment or expense -- in return for just a few minutes a week of her spare time.

"Now you can do the same.

"What you do.

"As a club Secretary you make your catalog available to your customers. If you need an extra catalog we will send it. And we also send special-price Supplements and Bulletins.

"Your catalog is your store. You decide who can shop in it. And when it's open for business.

"As a club Secretary you do not go 'door-to-door' or contact strangers. Your customers are your own friends, co-workers, neighbors, relatives.

"You take orders and send them to us. We ship the goods directly to each customer.

"We send you a payment book for each order, and each week you collect the payments from your customers and remit a check to us.

"You can get additional customers, and more orders from the same customers, at any time.

* * *

"What you earn.

"Your Popular shopping club is a business that pays you well, with hundreds and even thousands of dollars worth of top-quality merchandise.

"The amount you earn depends only on you.

"You set your own goals.

"You decide how many customers you'll go for. And how often you'll help your customers to shop in your catalog.

"For each \$10 your customers purchase you earn a reward credit. And each reward credit is worth \$2.50 in goods from the catalog.

"It piles up fast.

"Most club Secretaries earn hundreds of dollars in reward credits in just a few weeks. Then more and more during subsequent weeks, months, and years."

One of the key aspects of the Popular Club is the award of dividend credits to members or customers. The award and use of these dividends is explained by petitioner in a booklet written for the Popular Club secretaries entitled "Making your club better".

"Each \$10 purchase in the big catalog earns one Dividend Credit valued at \$2. These credits can be used for merchandise in the big catalog.

"Member Dividend Credits help members stretch their budgets. These credits can be used to get free merchandise, and that means more money available for other family pleasures -- dinner out, dance lessons, a lot of things.

"Member Dividend/Dividend/Dividend Credit: All mean the same thing, one credit valued at \$2 is given to the member for each even \$10 purchased. The member can use these credits to get SuperStar Dividend merchandise or Dividend Certificates.

"SuperStar Dividend: This merchandise is found in a special section in the back of your catalog and is only available by using your Dividend Credits. You can redeem Dividend credits for this merchandise. Each SuperStar item requires a nominal dollar amount in addition to credits.

"A member orders SuperStar Dividend merchandise along with her regular order by listing the items on the Member Dividend section of the Member Order Form. They will be shipped along with her order.

"Dividend Certificate: If you don't order SuperStar merchandise, we'll automatically send you Dividend Certificates as pictured below. They will be attached to the Packing List.

"You can redeem certificates on a Dividend Certificate Redemption Order Form, or on a Member Order Form for SuperStar items."

On audit, the Division made the determination that the award and redemption of reward credits earned by Popular Club secretaries was a form of bartering, essentially the exchange of merchandise for services, taxable under Article 28 of the Tax Law. The amount subject to the

sales tax was calculated based upon the face value of the reward certificates redeemed in New York for merchandise. Member dividend credits were deemed to be a form of discount and were not held subject to sales tax. Petitioner took the position that the reward credits represented volume discounts not compensation for services, and, if the rewards were deemed to represent a taxable exchange, the reward credits should not be valued at face value.

Beginning in 1983, petitioner was required by the Internal Revenue Service to file a Form 1099 for every non-employee who received more than \$600.00 from petitioner. Petitioner was not required to report the value of member dividend credits. The value of the reward credits earned by the Popular Club secretaries was includable in amounts to be reported on the forms 1099. It was petitioner's opinion that each reward credit was worth less than its \$2.50 face value. The task of valuing the reward credits for Federal income tax purposes fell to William Von Klemperer, then petitioner's vice-president for finances, who described the valuation method he used.

Mr. Klemperer determined that by using a combination of dividend credits and reward credits a secretary could reduce the "cash price" of merchandise to 69% of the catalogue price. This assumes the use of a \$2.00 dividend credit (which secretaries received on their own purchases) and a \$2.50 reward credit (earned by making sales to other members) plus \$10.00 in cash to purchase a catalogue item valued at \$14.50. Thus, the use of the credits reduces the cash price of the merchandise to 69% of the catalogue price. Based on this analysis, Mr. Klemperer testified that the secretary's reward credit was worth no more than \$1.72, or 69% of \$2.50.

Mr. Klemperer then tried valuing the reward credits by taking a survey of the active secretaries. He knew that the cost to petitioner of merchandise with a catalogue price of \$2.50 was approximately \$1.05. He considered this to be the minimum worth of a reward credit. He considered \$1.72 to be "the theoretical maximum" worth of a \$2.50 reward credit. He selected a value of \$1.30 as being approximately half way between these maximum and minimum values. Mr. Klemperer then surveyed three groups of active secretaries and offered to exchange

the reward credits for cash. Petitioner offered secretaries in the first group \$1.00 for each reward credit, secretaries in the second group \$1.30 for each reward credit and secretaries in the third group \$1.72 for each reward credit. Based on the responses, petitioner determined that a substantial number of secretaries would be willing to make the exchange for \$1.30. Mr. Klemperer could not remember the exact number of secretaries in each group surveyed, although he thought it was between 20 and 50 people. He thought that between 40% and 70% of the secretaries in the second group showed an interest in exchanging a reward credit for \$1.30 in cash.

Mr. Klemperer testified that after taking the survey, he decided to initiate an actual exchange program. He explained the purpose of the exchange program as follows:

"I, as the financial officer, I didn't want and I had to issue 1099's quite soon, I didn't want to issue 1099's with \$1.30 value based only on a telephone conversation. What I wanted to do was get to secretaries and have some real transactions to say that beyond what someone happened to say at the moment when we telephoned them, that secretaries were really willing to part with their reward credit for that amount of cash. So, I was concerned with making sure some of them would really do it." (Tr., p. 49-50.)

In 1983, petitioner sent letters to 50 secretaries offering to redeem their reward credits for money instead of merchandise at the rate of \$1.30 per reward credit. Some of the secretaries took advantage of the offer, but the number doing so is not in the record. There is no evidence that the cash exchange offer was made to all Popular Club secretaries. The Club Secretary Handbook and the booklet entitled "Making your club better" do not mention a cash exchange program.

Petitioner offered in evidence (1) a memorandum written by Mr. Klemperer to his associates regarding certain aspects of the cash redemption program; (2) a copy of the letter sent to the secretaries who were offered a cash exchange; (3) a list of the 50 secretaries contacted; and (4) a suggested "script" for following up on the letter by telephone. Included in the script is the following hypothetical exchange:

"Why aren't you interested [in redeeming reward credits for cash]? What would it take to get you interested?"

* * *

" . . . I'm afraid I'll have to pay taxes if I receive cash.

"The IRS says you must report the fair market value of the merchandise you receive. You see, you pay taxes either way."

Prior to hearing, petitioner and the Division entered into a stipulation of facts. Those stipulated facts, modified by deleting references to exhibits, are as follows:

"1. The Division of Taxation is aware of the fact that department stores located in the State of New York, including the counties of Albany, New York and Westchester that are registered with the Department of Taxation and Finance ('the Department') to collect sales and use taxes, sell merchandise at a discount from their regular retail sales prices to employees. It is the policy of the Department not to assert or assess sales or use taxes against such department stores on the amount of the discount allowed to employees on their purchases when the discount is not conditioned on the employees' performance and the discount amount is not included as compensation on a 1099 or W-2 Form. That policy obtained in the Department with respect to the period June 1, 1986 through February 28, 1989.

"2. Petitioners' club secretaries were independent contractors, not employees.

"3. Petitioners filed with the United States Internal Revenue Service Forms 1099 reporting the redemption of reward certificates of club secretaries during the periods June 1, 1986 through February 28, 1989. The Forms 1099 as filed with respect to such redemptions were in the same form and contained the same information as the Forms 1099 filed by the petitioners with the United States Internal Revenue Service with respect to redemptions of Club Secretaries' rewards during the year 1992

"4. Petitioners debited cost of sales and credited reward liability on its books to record the cost of the reward certificates issued to club secretaries. The reward liability account was debited and inventory account was credited when a club secretary redeemed the certificates for merchandise."

As an exhibit to the stipulation, the parties offered in evidence examples of forms 1099 actually filed by petitioner in 1992. The exhibits establish that the value of the reward credits was reported as nonemployee compensation. The amount of compensation was calculated by multiplying the number of reward credits redeemed by \$1.30, whether the reward credits were redeemed for cash or merchandise.

A schedule attached to the stipulation shows that in 1992 four secretaries redeemed reward credits for either cash or a combination of cash and merchandise. The form 1099 filed for each of these secretaries shows nonemployee compensation equal to \$1.30 times the number of reward credits redeemed. The four secretaries who redeemed reward credits for cash are not

listed among the 50 secretaries who received letters explaining the cash exchange program in 1983.

It was petitioner's practice to give discounts to employees who purchased merchandise from petitioner. Employees were allowed a 40% discount on all items purchased from Popular Club catalogues. Twice a year, petitioner offered a two-thirds discount on clearance items.

Petitioner presented the testimony of Howard E. Hassler, presently a director of Brooks Fashion Stores and of Ames Department Stores. Mr. Hassler was qualified as an expert in the field of retail merchandising. He offered his expert opinion on the value of a reward credit. He stated his belief that a reward credit is worth less than its face value because it is not transferable and can only be used to obtain merchandise through Popular Club. He agreed with petitioner that the proper value of one reward credit is \$1.30. He testified that the average discount retail store operates at a markup of approximately 30%. Thus, a customer can purchase merchandise acquired by the discount store for \$1.00 at a price of \$1.30. Theoretically then, merchandise listed in the big catalog for \$2.50 could be purchased at a discount store for \$1.30. Based on this scenario, Mr. Hassler believes that a reward credit is properly valued at \$1.30. Finally, Mr. Hassler regarded as very significant the fact that some secretaries actually exchanged reward credits for \$1.30 apiece.

CONCLUSIONS OF LAW

A. The primary issue here is whether the redemption of reward credits for merchandise constitutes a retail sale under the Tax Law. Tax Law § 1101(b)(5) defines the terms "sale, selling or purchase" as:

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

The redemption of the reward credits for merchandise was a sale under this definition. Merchandise was transferred by petitioner to the secretaries in exchange for reward credits. The reward credits were earned by the secretaries and treated by the Internal Revenue Service as

income to the secretaries when they were redeemed. The Division characterizes the substance of the transactions between the secretaries and Popular Club as a bartering arrangement, the exchange of goods for services, and I agree with that characterization.

Petitioner's claim that the reward credits constituted "volume discounts" rather than sales has no merit. The evidence establishes that the reward credits were paid to the secretaries as compensation for their services and claims to the contrary are not convincing. The Club Secretary Handbook describes the reward credits as earnings. The Internal Revenue Service treated the redemption of reward credits as income to the secretaries, and petitioner reported the redemption of the reward credits whether for cash or merchandise as nonemployee compensation. The secretaries earned reward credits by making sales. They solicited customers, wrote up orders in an order book provided by petitioner, transmitted orders to Popular Club, collected money and submitted payment to Popular Club. Secretaries earned reward credits whether they made purchases from the Popular Club or not. The credits were based on their sales not their purchases.

Petitioner belittles the importance of the fact that it reported the redemption of credits on form 1099. In its brief, it states:

"Prizes and awards constitute taxable income under Section 74 of the Internal Revenue Code. Consequently, the fact that the Taxpayer reported the reward certificates on Forms 1099 did not establish that they constitute compensation, but only that the appropriate valuation constitutes taxable income to the Club Secretary." (Petitioner's Brief, p. 16.)

This argument is without any merit. As the Division notes in its brief, Treasury Regulation § 1.61-2(d)(1) provides that if services are paid for other than in cash, the fair market value of the property or services taken in payment must be included in income as compensation. The secretaries earned a right to income by soliciting sales for Popular Club. The income was recognized when the reward credits were redeemed for cash or merchandise. When the income (in the form of a credit) was exchanged for merchandise, a retail sale occurred.

Petitioner claims that there is no rational basis for treating the reward credits differently from an employee or other purchase discount. There are several reasons for doing so, the most

important one being that redemption of a reward credit was not a discount of any kind. As noted above, the reward credit was an item of value given to the secretaries in exchange for their services. Secretaries used the reward credits to obtain merchandise from petitioner. Thus, redemption of the reward credit was the equivalent of a payment, not a reduction in the purchase price. The IRS required that the reward credits be reported as income. They did not require that the employee discounts or member dividend credits be treated as income. Materials distributed by petitioner distinguish between the reward credit and the member dividend credits. The basis for awarding each is different, and the manner in which they can be used is different. At least to some extent, a reward credit could be exchanged for cash. A member dividend credit could not be. In short, all of the facts argue against treating a reward credit as if it were the same as an employee discount or a member dividend credit.

According to petitioner, the fact that the secretaries earned reward credits on their own purchases shows that the credits were discounts and not compensation. I disagree. The secretary earned two different kinds of credits in two different capacities. As a secretary rendering services to the Club, she or he earned reward credits. A secretary earned reward credits on all sales made, including sales made to himself or herself. As a Club member, the secretary earned dividend credits on his or her own purchases. The bases for earning the credits were different.

Finally, the regulation cited by petitioner does not apply to the situation at hand. It states that "[d]iscounts which represent a reduction in price, such as a trade discount, volume discount or cash and carry discount are deductible in computing receipts." (20 NYCRR 526.5[d][2].) This regulation offers no guidance in determining whether any item is a discount in the first place. The reward credits represented the secretary's earnings for services rendered to the Popular Club. The earned reward credits were exchanged for merchandise or, in some instances, cash. This transaction constituted a sale under Tax Law § 1101(b)(5). Accordingly, the regulations pertaining to discounts are not pertinent here.

B. Petitioner claims that if the reward credits are not treated as discounts, they are

properly regarded as promotional items distributed free to the Popular Club secretaries. This theory is not consistent with the facts. The reward credits were not given away for free. They were earned by the secretaries and given by petitioner to the secretaries in exchange for services.

C. The sales tax is imposed upon "receipts" from every retail sale (Tax Law § 1105[a]). Since the sales under consideration did not involve an exchange of cash, the amount of receipts subject to sales tax must be determined. For purposes of article 28, a receipt is defined as "[t]he amount of the sale price of any property . . . valued in money, whether received in money or otherwise" (Tax Law § 1101[b][3]; emphasis added). The Division takes the position that the \$2.50 face value of a reward credit is the "sale price" of the merchandise acquired with the credit. Petitioner offers several alternatives for determining the receipt subject to tax.

Petitioner proposes the theory that the receipts in question are subject to use tax (Tax Law § 1110) rather than sales tax. This rests on the proposition that the merchandise was purchased by petitioner as promotional items to be given away to the secretaries. Since I have already concluded that the merchandise was not given away as promotional items or for advertising, petitioner's use tax theory is baseless.

Alternatively, petitioner argues that the appropriate value of the reward credit is \$1.30, the amount for which a credit could be exchanged in cash. This theory is also rejected. An item advertised for sale in petitioner's catalogue for a sale price of \$20.00 could be purchased by the secretary by paying \$20.00 in cash, redeeming 8 reward credits with a face value of \$2.50 each, or paying some combination of cash and reward credits. Since the measure of receipts is the "sale price" of the merchandise "valued in money" (Tax Law § 1101[b][3]), the receipt subject to tax is \$20.00 whether the receipt is "received in money or otherwise" (Tax Law § 1101[b][3]).

The considerations petitioner brings to valuing the reward credits are immaterial for purposes of article 28. Petitioner notes that the credits were not transferable or assignable and could only be used to make purchases from the Popular Club "big catalog". Petitioner presented

evidence that an item with a catalogue sale price of \$2.50 could be purchased from a discount house for less than that. According to petitioner, this fact shows that the reward credit is worth \$1.30, the approximate discount house retail price of merchandise listed in the catalogue for \$2.50. Petitioner also claims that the fact that it paid secretaries who requested cash in lieu of merchandise \$1.30 for each reward credit further supports the \$1.30 value.¹

The redeemed reward credits are not being valued for income tax purposes. As a consequence, factors which might be relevant in determining the value of the credits to the secretaries when they recognized income from redeeming those credits are not necessarily relevant here. The sales tax is imposed on the receipt from the sale, not on the underlying value of the

item purchased. For sales tax purposes, it makes no difference whatsoever whether an item can be purchased for more or less in one store as opposed to another. The receipt upon which the tax is imposed is the sale price of the property valued in money, whether received in money or otherwise. The sale price of the merchandise purchased by a secretary was the catalogue sale price. In order to purchase an item with a listed price of \$2.50, the secretary was required to pay \$2.50 in cash or to redeem a credit with a face value of \$2.50. Accordingly, the receipts subject to tax were properly valued at \$2.50 for each reward credit redeemed.

D. The parties agree that only one of the two petitioners in this proceeding is liable for the tax assessed for the period July 15, 1988 through December 31, 1988. They apparently were unable to resolve the issue of which taxpayer is liable, although it must have been well within their means to do so. There is no evidence in the record which would enable me to determine

¹The evidence indicates that petitioner did have a cash exchange program of some kind, but the extent to which the program was made available is not known. The redemption of reward credits for cash would not be a taxable sale. Since petitioner failed to offer evidence of the amount of cash actually paid in exchange for the reward credits, it has not shown that it was inappropriate for the Division to treat all redemptions as sales.

which legal entity is liable for the tax assessed for this period. Consequently, I have no basis for cancelling either notice. At hearing, the Division assured petitioner that tax payments made for the period in question would reduce the liability of both Popular Club Plan, Inc. and Popular Services, Inc. Having failed to present evidence on this issue, petitioner will have to be content with that assurance.

E. The petitions of Popular Club Plan, Inc. and Popular Services, Inc. are denied, and the notices of determination and demands for payment of sales and use taxes due (notice numbers S901220131C and S901220132C) are sustained.

DATED: Troy, New York
January 27, 1994

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE