STATE OF NEW YORK

DIVISION OF TAX APPEALS

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| In the Matter of the Petition | : | |
| of | : | |
| **HOUSE OF LLOYD, INC.** | : | DETERMINATION<br>DTA NO. 812039 |
| for Revision of a Determination or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period September 1, 1986 through February 28, 1990. | : | |

Petitioner, House of Lloyd, Inc., 11901 Grandview Road, Grandview, Missouri 64030, 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 September 1, 1986 through February 28, 1990.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on June 26, 1996 at 9:00 A.M., with all briefs to be submitted by December 2, 1996, which date began the six-month period for the issuance of this determination. Petitioner appeared by Morrison and Foerster, LLP (Hollis L. Hyans, Esq., and Harry R. Jacobs, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (James Della Porta, Esq., of counsel).

## *ISSUES*

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

II. Whether petitioner is entitled to a refund of sales tax paid with respect to demonstrator kits, premised on petitioner's estimate of a) the number of such kits returned to petitioner (i.e., sales returns) plus b) thenumber of such kits for which petitioner did not receive payment (i.e., uncollectible accounts).

III. Whether all or any portion of the penalties imposed against petitioner should be abated.

## *FINDINGS OF FACT*

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

2. Direct selling is a marketing method in which products are sold through personal explanation and demonstration, primarily in the home or office. Although the specific methods of direct selling vary, most companies in the direct selling industry market their products through networks of independent contractors commonly called "direct sellers," "consultants" or "demonstrators".

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

4. In general, the party plan is simply a method of selling products through personal explanation and demonstration. There is no one set definition of a "party". Testimony at hearing identified at least four different methods of selling utilized by petitioner's

demonstrators, each of which is considered to be "having a party", to wit, a social party, a catalog party, a single large-order party and a fund-raising party.

5. In a social party, a demonstrator seeks out a "hostess" or "host" who is willing to invite family members, friends, or co-workers into the hostess's home or office, where the demonstrator will show petitioner's merchandise.[1] A hostess is advised that if she has a party, and pays for an order, she will receive "hostess free goods" ("HFGs"). Petitioner's catalog states, in this regard, the following:

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

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

7. At a social party, a demonstrator brings a kit, known as a demonstrator kit, with sample merchandise and catalogs, and makes a sales presentation. The demonstrator distributes petitioner's product catalog, and the hostess and guests are asked to complete guest order forms indicating the products they wish to purchase. A demonstrator writes his or her name and telephone number on petitioner's catalogs that he or she distributes. A demonstrator also wears a name tag which designates him or her as a House of Lloyd salesperson. A hostess does not wear a name tag and does not place her name or address on catalogs. The guest order forms are

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

in triplicate. The hostess receives a copy, the demonstrator receives a copy, and the guest receives a copy. Copies of guest order forms are not sent to petitioner. In many instances, the order period is held open after the social party (for ten days to two weeks) to allow those who were unable to attend the party, or who simply wanted to order merchandise, to view petitioner's catalog and place an order.

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

9. Hostesses of catalog parties, single large-order parties, and fund-raising parties, like hostesses of social parties, receive HFGs. In this regard, while petitioner's catalog states that "[d]isplaying a catalog and taking orders from it is not considered a party," the catalog also states that "since all our salespeople are independent contractors who operate their own businesses, they may at times establish their own standards regarding the constitution of a party." Demonstrators decide when an order is a party, and when someone is entitled to HFGs. As a result, catalog parties are regularly treated as parties qualifying for the receipt of HFGs. Notwithstanding that they have not "hosted" anything, hostesses of catalog parties receive the same amounts of HFGs as hostesses at social parties, as long as they pay the same amount of cash to petitioner. Petitioner requires no particular services for a person to be designated a hostess and receive HFGs. Once a hostess's order has been received,

petitioner's only requirement for providing the HFGs is the receipt of the proper payment for the order and its subsequent shipment.

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

10. No matter what type of party is held, a cash payment, which in some instances may consist solely of a shipping and handling charge, must always be made before HFGs are sent. The minimum payment to obtain HFGs is $18.65, upon receipt of which petitioner will ship the minimum $40.00 of HFGs available even if no other merchandise is ordered from the catalog. That is, in order to receive the $40.00 of HFGs "just for having a party," payment of the required shipping charge ($17.50) and handling charge ($1.15), totalling $18.65, must be made to petitioner. Based on its own cost of merchandise purchased, petitioner calculates that it makes a profit of $5.05 on its transfer of $40.00 in catalog priced merchandise as HFGs to a hostess in return for the payment of $18.65. HFGs are never shipped to a hostess absent the correct cash payment. HFGs are often shared by the hostesses and guests. Petitioner maintains that HFGs provide an incentive for hostesses to sell additional merchandise.

11. After a party, however it is constituted, the demonstrator compiles orders into a "party order" using a ledger sheet called a "master order form". The master order form lists the total quantities of each item of merchandise ordered at a party. The master order form does not list the individual order of each person at a party, and petitioner does not know the identity of individual guests or the individual order of each guest.[3] The demonstrator mails the hostess's master order form to petitioner. Petitioner's initial use of this form is to confirm the existence of sufficient inventory (ordered or in-stock) as against incoming orders, and thereafter to use the information gleaned from incoming master order forms to issue advice to demonstrators as to the future availability of petitioner's merchandise.

12. Petitioner accepts orders from hostesses, and does not accept orders from individual guests. After the order is submitted, the hostess collects payments from the individual guests. Thereafter, the hostess sends in payment to petitioner for the entire party order, including sales tax. As in the previous three-guest, social party example, the hostess will remit $204.60 ($200.00 merchandise ordered plus four handling charges at $1.15 each) along with sales tax on

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

$204.60. There is no dispute that petitioner, a registered vendor for New York sales and use tax purposes, has remitted the sales tax on all merchandise sales, with the exception of tax calculated on HFGs. As with orders, petitioner accepts payments only from hostesses, and not from individual guests who instead make their payments to the hostess. Petitioner's catalog states, in this regard, the following:

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

13. Nothing is shipped by petitioner unless payment in full for the entire order is received. Payment must be made in the form of a money order or a cashier's check. After full payment is received from a hostess, petitioner prepares an invoice, known as a "pic tic," and fills the order. The cash received for the order is payment in full for the entire order, including any HFGs. In filling the order, petitioner does not know what services, if any, have been provided by the particular hostess. Petitioner has no way of knowing whether the sales arose from a social party, a catalog party, a single large-order party, or a fund-raising party, and the same dollar amount of HFGs is provided regardless of the activity undertaken by the hostess.[4] Thus, a hostess who holds a lavish party receives the same in HFGs as a hostess who simply places a large order, if both hostesses pay the same amount of cash. Hostesses do not report their expenses, and petitioner never reimburses hostesses for expenses.

14. Petitioner intends to make a profit on all merchandise that it sells, and calculates its catalog prices so that the cash it receives for an order pays for the cost of all merchandise sent to hostesses, including HFGs, and yields an overall profit on all of the merchandise transferred to the hostess including the HFGs. In this regard, petitioner candidly admits that the handling charge is in fact a means of adding profit as opposed to an amount specifically tied to the costs of "handling" goods. Petitioner's catalog prices could be lowered if petitioner did not offer HFGs with every paid and shipped order. Petitioner's overall merchandise cost is approximately

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

25 percent of the retail (catalog) price for such merchandise. More specifically, petitioner's cost for merchandise is, on average, 22 percent of the catalog price for such merchandise, while its merchandise packaging cost is, on average, three percent of the catalog price of the merchandise. The cost of HFGs is factored into petitioner's calculation of its retail (i.e., catalog) prices. Services provided by the hostesses (if any) are not factored into the calculation of petitioner's prices.

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

16. Petitioner does not directly engage the hostesses to act as agents for petitioner or to represent petitioner. A demonstrator is not authorized to appoint agents on behalf of petitioner. Petitioner does not direct or control the activities of a hostess, and generally does not have any contact with a hostess before receiving an order for merchandise. Petitioner has no agreement, either oral or written, with the hostess. Petitioner makes no attempt to monitor the hostess after the merchandise is delivered. A hostess is not required to make any reports to petitioner. A hostess is not required, or even requested, to provide the identity of her guests. Hostesses, unlike demonstrators, do not receive IRS forms 1099 from petitioner. Hostesses could, in theory, mark up the prices of the goods. However, it seems extremely unlikely that a hostess would, or could successfully, charge prices higher than those printed in petitioner's catalog.

17. It appears as though hostesses obtain title, as well as possession, of all merchandise in a party order. Once the merchandise is delivered to a hostess, petitioner does not have any control over it, and exercises no rights or powers with respect thereto. Petitioner assumes no responsibility to assist a guest if a hostess does not deliver merchandise ordered by a guest. If a guest contacts petitioner regarding a problem with a hostess, petitioner will send a form

telegram to the hostess warning the hostess that guests may contact the local authorities. Petitioner also sends a letter to the guest which directs the guest to contact the hostess, and if satisfaction is not received, to pursue the matter with local authorities.

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

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

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

21. Petitioner has a department, known as its "kit department," which records the inflow and outflow of demonstrator kits. Aside from the records kept by this department, petitioner does not record a formal entry in its books of account when a kit is initially provided to a demonstrator. The kit department notes a $75.00 charge in its records if a demonstrator has not generated $750.00 in sales by October, and thereafter records a second $75.00 charge if a

demonstrator has not generated $1,500.00 in sales by November. In turn, if a demonstrator generates $1,500.00 in sales by the end of the Christmas selling season, the $150.00 charge is reversed and nothing more is owed for the kit.

22. If a demonstrator fails to earn a kit by generating $1,500.00 in sales, and does not remit $150.00 or return the kit in salable condition, petitioner first undertakes in-house efforts to obtain a $150.00 payment for the kit. If petitioner's in-house efforts are unsuccessful, the debt is sent to a collection service. These collection efforts (in-house and collection service) span a time period of roughly one year. Petitioner considers an amount owed for a kit to be uncollectible if a collection agency reports that it is unable to recover the debt.

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

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

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

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

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

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

February 9, 1995, petitioner was found entitled to proceed to a hearing on the merits of its timely refund claim. These proceedings on the merits ensued.

***SUMMARY OF THE PARTIES' POSITIONS***

28. The Division maintains that sales tax is due on petitioner's sales of HFGs to the hostesses. Specifically, the Division argues that such merchandise is transferred to the hostesses in exchange for their services of hosting parties and promoting the sale of petitioner's merchandise, thus constituting a barter transaction properly subject to sales tax. The Division points out that the tax amount at issue represents tax on the cost of the HFGs to petitioner (in essence tax computed as a use tax), rather than tax on the retail (catalog) price of such goods. The Division's auditors based the tax on cost instead of retail prices because of the Division's letter advising that use tax (as opposed to sales tax) was due (see, Finding of Fact "23"). Further, the Division asserts that if it is concluded herein that a sales tax is not due, then a use tax is due upon the theory that petitioner's transfer of the HFGs to the hostesses represents a taxable use of the property in New York State akin to the provision of promotional materials to salespersons.

29. The Division also maintains that petitioner has failed to establish the amount of, or entitlement to, any refund for sales tax on demonstrator kits based on kit returns and on uncollectible amounts owed for such kits not returned. The Division maintains that petitioner did not make available to the auditors detailed records in substantiation of the claim that kits were kept but not paid for and that kits were returned (and thus not sold). On this issue, the Division maintains that the proof submitted consists only of the self-serving testimony of petitioner's vice-president for finance. In the context of the demonstrator kits and the HFGs, the Division also takes the position that it has no burden to establish the propriety of its audit results because petitioner consented and paid the tax and is seeking a refund. Thus, the Division argues that petitioner bears the heavy burden of establishing entitlement to a refund. Finally, the Division maintains that petitioner has not established reasonable cause warranting the abatement of penalties.

30. Petitioner, in contrast, argues that the HFGs were sold to the hostesses, that they were in fact a volume discount and a part of the overall merchandise ordered by the hostesses, and that sales tax was remitted on the full amount paid for every order including the HFGs. Petitioner likens the HFGs to a "buy three, get one free" offer, wherein the receipt for the merchandise subject to tax is the total amount paid for the merchandise received including the "free" item. Petitioner maintains that the hostesses are not "compensated" for providing any services to petitioner, that petitioner in fact has no idea what services are provided by any of the hostesses, and that there is no intent to barter services for goods. Petitioner further asserts that it neither maintains nor exercises any control over the goods once they are in transit and thereafter in the hands of the hostesses, and thus there is no use of the goods by petitioner in New York.

31. With respect to demonstrator kits, petitioner maintains that the Division's calculations are not supportable because they do not take into account kit returns and uncollectible amounts. On this score, petitioner maintains the auditors were made aware of the fact that a significant number of kits were unpaid or were returned, yet the auditors completely failed to take this information into account when calculating the amount of sales tax due on kits. Petitioner also argues that most of the specific information concerning kit returns and the success of collection efforts on kit debt for the period in issue was not complete or known at the time of the audit and thus was not available for presentation to the auditors. Petitioner also urges that penalties should be abated, noting that reasonable steps were taken to attempt to clarify the proper tax treatment of HFGs, including specifically the letter requests for guidance from the Division. In this context, petitioner points out that the Division itself was uncertain as to how to treat the HFGs, and that its initial advice in fact turned out to be incorrect. Finally, petitioner does not challenge the Division's claim that a double credit for tax was erroneously taken in the aggregate amount of $16,565.35 on its returns for the sales tax quarterly periods ended May 31, 1989 and August 31, 1989. Such amount, appearing on the second of the two

statements of proposed audit adjustments dated May 4, 1990 thus does not appear to be at issue, except to the extent of penalty imposed thereon.

32. With its brief, petitioner submitted proposed findings of fact numbered "1" through "38". Proposed findings "1" through "9", "11" through "14", "17" through "24", "28", "30", "32", "37" and "38" are accepted and have been incorporated herein. With respect to the balance of the proposed findings, the following rulings are made:

a) Proposed finding "10" is accepted and incorporated except for its second sentence which, while an accurate representation of testimony, is rejected as setting forth an ultimate finding of fact.

b) Proposed finding "15" is accepted and incorporated except for its seventh and eleventh sentences which are rejected as setting forth ultimate findings of fact.

c) Proposed finding "16" is accepted and incorporated except that its second sentence is changed to indicate that absent HFGs, petitioner's catalog prices could, as opposed to would, be lower. Without such change, the finding as proposed raises a hypothetical to the level of an affirmative fact.

d) Proposed finding "25" is accepted and incorporated except that the word "extensive" has been deleted from its first sentence.

e) Proposed finding "26" is accepted and incorporated except that its first two sentences have been rejected as conclusory.

f) Proposed finding "27" is accepted and incorporated, except that its second sentence has been clarified to reflect the record in proper context.

g) Proposed finding "29" is rejected as setting forth an ultimate finding of fact.

h) Proposed finding "31" is rejected as not supported by evidence in the record.

i) Proposed finding "33" is accepted and incorporated except for its last sentence which is rejected as irrelevant.

j) Proposed finding "34" is rejected as setting forth an ultimate finding of fact.

k) Proposed finding "35" is accepted and incorporated except for its first sentence which is rejected as setting forth an ultimate finding of fact.

l) Proposed finding "36" is accepted and incorporated except for its fifth sentence which is rejected as conclusory.

## *CONCLUSIONS OF LAW*

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

> "[a]ny transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume, . . . conditional or otherwise, in any manner or by any

> means whatsoever for a consideration, or any agreement therefor, including the rendering of any service, taxable under this article, for a consideration or any agreement therefor."

20 NYCRR 526.7(d) provides the following definition of barter: "the transfer of tangible property . . . to a person in consideration for . . . services received is a 'sale' under the Tax Law."

B. Tax Law § 1101(b)(3) defines receipt as:

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

C. Petitioner's shipment of HFGs to hostesses was not consideration given in exchange for services provided by the hostesses, and thus was not a barter transaction subject to sales tax. Instead, the HFGs represent additional goods the right to which was driven and secured solely by the dollar amount of merchandise ordered. That is, once a particular dollar amount of merchandise has been ordered, the person ordering (the hostess) becomes entitled to choose additional merchandise which will, upon payment of the particular dollar amount, be included and shipped to the hostess at no additional cost. Thus, the HFGs constitute a merchandise discount based on the dollar volume of merchandise ordered. While the HFGs are denominated "free", and may be properly viewed as bonus items available based on the dollar amount of the underlying order, the point that emerges most clearly is that nothing shipped by petitioner is free to the recipient. The fact is, such "free" items are simply built into petitioner's overall pricing structure, and are merely labelled "free" as part of petitioner's marketing strategy aimed at increasing sales. While such a marketing strategy obviously appeals to the desire to get something for nothing (or something more for the same amount of money), the nomenclature "free" merely masks the fact that the cost of all of the merchandise received by a hostess is built into the pricing structure and is, in fact, paid for. On this score, petitioner explained that it

intends to make a profit on every transaction, including the "free gifts just for hosting a party", where a payment of $18.65 is required and results in a profit to petitioner of $5.05, or nearly 27 percent.[5]

D. Perhaps the best example showing that the HFGs are simply included in the cost of the order in accordance with petitioner's marketing method, as opposed to representing compensation to hostesses bartered in exchange for services, is the single large-order party. In the single large-order party, the guest and the hostess are one and the same. The guest/hostess is entitled to choose and receive additional merchandise over and above the catalog price of her order based simply on the dollar amount of her order. Clearly no services are provided by the guest/hostess, and petitioner's receipt for the merchandise shipped is the basic dollar amount of the order. The fact that such basic dollar amount entitles the guest/hostess to choose additional merchandise does not result in any change to the amount of petitioner's receipt. Although the catalog priced value of the total amount of merchandise shipped (including HFGs) exceeds the basic dollar amount paid, the receipt to petitioner remains unchanged. Thus, the additional merchandise is included in the order as part of the price paid for the order. No services are performed, no additional consideration is given, and the amount subject to tax is the amount remitted by the guest/hostess to petitioner.

E. Petitioner's customer is the hostess. Whether a hostess simply receives an additional volume of merchandise due to the size of her own individual order (as in the single large-order party), or receives an additional volume of merchandise due to the cumulative volume of a group order (as a benefit of submitting payment for and thereafter distributing such group order), it remains that the volume of merchandise included in the order and shipped in either case is dependent only on the dollar amount of the receipt tendered to petitioner. Petitioner does not know what level of "hosting" services, if any, were performed in either instance.

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[5]Petitioner calculates its merchandise cost plus packaging cost as 25 percent (on average) of the retail price of its merchandise. In this case, $40.00 of retail priced merchandise costs petitioner $10.00. Petitioner then adds its average shipping cost to New York ($3.60) to arrive at total cost of $13.60. Comparing this cost figure to the required payment of $18.65 results in a profit of $5.05 to petitioner on allegedly "free" goods.

F. In sum, the level of "services" provided by the "hosting" party is of little or no importance to petitioner. Rather, petitioner's primary concern is the dollar amount of merchandise ordered. Labelling merchandise as "free" only promotes merchandise sales by serving as an incentive to buyers to "order up" to a certain level, the result of which is to increase the overall amount of goods which will be received. Stated differently, the lure of a merchandise discount based on volume begets more volume. If no payment is made, no goods (including HFGs) are shipped. From petitioner's perspective, the amount of goods delivered is based and driven entirely by the amount of dollars actually paid. The volume of HFGs to which a hostess is entitled simply increases in direct relation to the dollar amount of the order, irrespective of the type or level of "services" provided. Thus, the HFGs represent a volume discount, and the amount of money actually paid to petitioner is the receipt subject to tax (see, 20 NYCRR 526.5[d][2]). Since the orders received and shipped by petitioner included HFGs, and since there is no dispute that petitioner remitted tax on all of its receipts for such orders, it follows that petitioner is entitled to a refund of the additional tax on HFGs as calculated on audit and paid thereafter (under protest) by petitioner.

G. In counterpart to Tax Law § 1105, Tax Law § 1110(a) imposes a compensating use tax on tangible personal property and certain enumerated services, except that such tax does not apply where the property or services have been or will be subjected to the sales tax. In light of the foregoing conclusion that the HFGs were paid for and were included as part of the orders shipped by petitioner, and that petitioner has remitted sales tax on the receipts for such orders, it follows that use tax would not be payable on the HFGs. In fact, the parties have focused their arguments on the premise that sales tax is at issue, and have essentially narrowed their disagreement to the question of consideration for the HFGs. The Division has argued that the HFGs were sold in a barter transaction in exchange for hostesses' services (i.e., such services represented additional sales taxable consideration over and above the dollar amount of the underlying order). Petitioner, in contrast, has argued that the HFGs were sold for cash consideration (i.e., as volume discounted merchandise paid for as part of the payment remitted

for the order). Under either of these arguments, sales tax has been or will be paid, and thus use tax under Tax Law § 1110(a) would not apply. Furthermore, the facts bear out that petitioner exercised no rights or control over the merchandise in New York and thus did not make a taxable use of the merchandise in New York (Tax Law § 1101[b][7]; see, Matter of Bennett Brothers, Inc. v. State Tax Commn., 62 AD2d 614, 405 NYS2d 803).

H. Turning to the issue of tax on demonstrator kits, petitioner's claim rests on its argument that a percentage of kits was returned and that an even larger percentage of kits was never paid for. Thus petitioner seeks to reduce the tax calculated as due on demonstrator kit sales by allowances for sales returns and uncollectible accounts. Petitioner's argument on this issue is twofold, to wit: a) that the Division's failure to make any allowance on audit for kit returns and uncollectible accounts renders the audit method and result unreasonable and b) that in any event the evidence supports a reduction to the amount of tax computed on audit and thus should result in a refund of a portion of the tax paid by petitioner. The Division argues that since petitioner consented to an assessment and now seeks a refund, the Division has no obligation to establish the reasonableness of its audit method and that petitioner bears the burden of establishing entitlement to the refund it claims.

I. As to the burden of proof issue concerning the reasonableness of the audit method, it is true that petitioner is seeking a refund of tax (plus penalty and interest) paid. However, the context of this case is not a "first instance" claim for refund, but rather involves petitioner's consent to an assessment, payment thereof to stop the accrual of penalty and interest and, as contemplated under Tax Law § 1139(c), protest to the assessment in the form of a claim for refund. Thus, petitioner is not simply seeking a refund of taxes overpaid, but is contesting the Division's audit-calculated assessment of tax due. In short, petitioner is challenging the results of an audit. Petitioner's consent and payment to stop interest and penalty accrual merely converted an impending assessment into a claim for refund. To accept the Division's argument that the reasonableness of the audit method, upon which the amount at issue is based, is immune from scrutiny under these procedural circumstances (the consent and payment with

accompanying right to protest as specifically allowed under Tax Law § 1139[c]), is clearly not consistent with the aim of Tax Law § 1139(c).

J. Petitioner's position with respect to the audit calculations concerning tax on demonstrator kits amounts essentially to a claim that the Division's auditors were made aware of the fact that demonstrator kits were sold on credit, and thus "must have known" that kits were returned and/or not paid for. More specifically, it appears that the subject of returned kits was at least mentioned on audit, and that the Division requested detailed records in connection therewith, although the extent of discussion on the subject is not entirely clear from the record. It does not appear that the issue of uncollectible kit accounts (essentially bad debts) was discussed during the audit. In turn, both topics were mentioned by petitioner at the time of the auditors' closing conference with petitioner, in response to which the Division requested detailed records in support of kit returns and uncollectible accounts. However, petitioner did not furnish such records. Given this set of circumstances, it cannot be concluded that the Division's calculations of tax due on kit sales was irrational or unreasonable, notwithstanding that there was no estimate and allowance given to reflect returned kits or bad debts. In this regard, Tax Law § 1132(c) presumes that receipts from all sales shall be subject to tax unless and until the contrary is established, and a mere claim that there were sales returns and/or bad debts, unsubstantiated by records specifically requested to establish such claim, is insufficient to rebut the presumption of taxability. While it is reasonable to assume that there could be returns and bad debts, the failure to provide any records as requested to establish the same overrides such assumption. Accordingly, the Division's audit calculation of tax due on kit sales must be viewed as reasonable.

K. In turn, as to the question of any refund on kit sales, petitioner's evidence consisted only of the testimony of its vice-president for finance, together with a one-page document summarizing his testimony that 15.6 percent of kits are returned and 32.4 percent of kits are not paid for, and certain form letters used by petitioner as part of its in-house collection efforts. While the summary percentages listed are allegedly taken from records maintained by

petitioner's kit department and its credit department, it remains that no records were presented, despite requests therefor, at or even after the time of audit. Without more, the evidence submitted does not warrant concluding that nearly half (48 percent) of petitioner's kit sales ended up as sales returns and uncollectible debts. Accordingly, petitioner's request for refund of a portion of the tax calculated as due on kit sales is denied.

L. Given the conclusion that tax has been paid with respect to HFGs (i.e., that HFGs were additional items constituting a volume discount included as part of the receipt for the entire order), the penalty calculated in connection therewith is no longer in issue. Moreover, even if tax were due on HFGs, it would be appropriate to abate penalty thereon. In this regard, the question of the proper tax treatment of HFGs was far from clear cut. Petitioner, for its part, attempted to ascertain its proper tax responsibility in this area by requesting advice from the Division. In turn, petitioner received advice which ultimately proved to be incorrect. In any event, petitioner took steps and made reasonable efforts to meet its tax obligations vis-a-vis HFGs, thereby supporting abatement of any penalty on this issue. However, penalty imposed with respect to the tax due on demonstrator kits is sustained. On this score, petitioner collected no tax on demonstrator kits for a portion of the period at issue, and for the balance of the audit period collected only the statewide portion but not the local portion of the sales tax. Petitioner's failure to collect the local sales tax was apparently based on its conclusion that it would be too cumbersome to do so. There appears to be no claim that petitioner held any belief that tax was not due on demonstrator kits. Accordingly, penalty abatement is not warranted. Finally, petitioner has raised no challenge and conceded to the portion of the audit which disclosed that petitioner claimed a credit in the amount of $16,565.35 twice (see, Finding of Fact "30"). No basis warranting abatement of penalty resulting from such overstated credit has been established and therefore penalty on this aspect of the audit is sustained.

M. The petition of House of Lloyd, Inc. is granted to the extent indicated in Conclusions of Law "F" and "L", and petitioner is entitled to a refund of tax, penalty and interest consistent therewith, but the petition is otherwise denied.

DATED: Troy, New York
May 29, 1997

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE