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In this installment of Noonan's Notes, the authors examine one of New York's form-over-substance rules and suggest some avenues to avoid running afoul of them.

We've said it before and we'll say it again: When it comes to sales tax, form usually wins over substance.[1] This principle can produce some harsh results, like a taxpayer having to pay sales tax on a transaction in which no cash changed hands.[2] Here at Noonan's Notes world headquarters, it's our job to keep our readers in the know about all these tough rules, and this edition will be no different. This month, we're tackling New York's "cheeseboard rule."

What Is the Cheeseboard Rule?

The cheeseboard rule is one of the more infamous form-over-substance rules. Under this rule, when taxable and nontaxable items are sold as a single unit, for a single charge, the entire amount of the charge is subject to sales tax.[3] Though the regulation applies only to bundled sales of tangible personal property, the tax department has often tried to apply it to bundled services as well.[4]

This rule gets its name from the example in the regulation from which it is derived:

> A vendor sells a package containing assorted cheeses, a cheese board and a knife for $15. He is required to collect tax on $15.[5]

There, a nontaxable item (cheese) becomes taxable because it is included with the charge of the taxable item (a board), with no separate line item for the cost of the cheese. If, instead of being bundled as one price, the charges for the cheese and board had been separately stated, only the board would be subject to sales tax. Thus, to avoid sales tax on the entire charge of a bundled price, the charges for the bundled items and services generally must be separately stated, must be for an amount reasonable in relation to the total charge, and must be able to be purchased individually.[6]

Let's go through a few examples in which the taxpayer bundled its goods and the entire charge ended up being taxable.

[1] *E.g.*, Timothy P. Noonan, "New Sales Tax Case Highlights 'Form Over Substance,'" Noonan's Notes blog (Mar. 7, 2017).

[2] *Matter of CLM Enterprises*, ALJ Determination, DTA No. 826735 (Feb. 23, 2017).

[3] 20 NYCRR 527.1(b).

[4] *See* TSB-A-91(43)S (May 15, 1997).

[5] 20 NYCRR 527.1(b), ex. 1.

[6] *See* TSB-A-03(6)S (Mar. 3, 2003).

Bundled and Bungled

In *Matter of Lake Grove Entertainment LLC*, the taxpayer operated an entertainment complex that offered ice skating, bowling, and rock climbing, among other activities.[7] The taxpayer sold party packages that included both the sale of food and beverages in addition to access to various activities, such as unlimited rides or use of the bowling or skating facilities for a specific amount of time. The price of the party package was on a per-person basis, and it depended on the number of items included in the package and the length of time, but the items were not separately stated. The taxpayer argued that since some of the items included in the party packages were properly subject to sales tax and others were not, the taxpayer should be required to remit tax only on those parts of the party package that were subject to sales tax. The judge disagreed. He noted that the taxpayer's party packages were offered as a single transaction and not in distinct taxable and nontaxable transactions, and the charge was not broken out on the invoice provided to the customer or on its advertising flyers. Thus, the entire charge was subject to sales tax. This decision was affirmed by the Tax Appeals Tribunal.[8]

Similarly, the Third Department rejected an answering service company's attempt to overturn an assessment based on its entire monthly fees to customers because a portion of the fee was for nontaxable "operator services."[9] Here, the taxpayer rented telephone answering equipment and provided related operator services. A monthly service charge of $25 covered the rental of the answering equipment and 40 "free" calls to the operator service. The invoices separately stated charges for operator services that exceeded the number of calls included in the basic service charge. The taxpayer collected sales tax only on the part of the service charge that it thought was attributable to equipment rental. The court found that "even assuming that, as petitioner contends, the operator services, *if charged separately*, would be exempt from sales tax taxpayer still had the burden of proof to overcome the assessment which was based on the single, unapportioned charge," which it failed to do.[10]

Finally, in a recent advisory opinion, the taxpayer sold software that provided interactive training to help the purchaser's employees learn about its products and culture, and this software was modified for each purchaser.[11] The software incorporated interactive quizzes, exercises, assessments, and videos. The taxpayer also provided the service of creating these videos and other media included in the training software. The tax department determined that when the taxpayer "charges a Retailer one price for both its sale of prewritten software and creation of its videos, the entire charge will be subject to New York State and local sales tax." Also, when the taxpayer did not separately state the charge for the customer modification of the pre-written software, the entire charge was subject to sales tax. This is a common refrain in many sales tax advisory opinions.

Credible Evidence?

Some courts have been more flexible when the taxpayer presents credible evidence of the amount that should, and should not, be exempt from sales tax. In *Matter of Locy Development Inc.*,[12] the auditor taxed the entire amount of "common charges" paid by individual owners of condominium units for services from a management company — here, the taxpayer. The taxpayer provided evidence of its actual expenditures for repair and maintenance services, which would be the only taxable portion of the charges. Even though the taxpayer did not separately state taxable maintenance services and other exempt services, the judge ruled that sufficient evidence had been presented for at least one of the audit periods to

[7] *Matter of Lake Grove Entertainment LLC*, ALJ Determination, DTA No. 821297 (Mar. 27, 2008).

[8] *Matter of Lake Grove Entertainment LLC*, Tax Appeals Tribunal, DTA No. 821297 (July 23, 2009).

[9] *Dynamic Telephone Answering Systems Inc. v. State Tax Commission*, 135 AD.2d 978 (3d Dept. 1987).

[10] *Id.* Emphasis in original.

[11] TSB-A-17(15)S (Aug. 1, 2017).

[12] *Matter of Locy Development Inc.*, ALJ Determination, DTA No. 802499 (Mar. 1, 1990).

show that only a portion of the fee was attributable to maintenance, and thus "[t]he balance of the monies drawn by petitioner from the common charges account did not constitute taxable receipts. It is therefore appropriate to recompute the additional taxable receipts in respect of the common charges as determined on audit." The Tribunal overturned the administrative law judge's determination on other grounds but did not question that an allocation of the charges would have been appropriate.[13]

This use of credible evidence also came up in *Matter of Pay TV of Greater New York Inc.*, in which the Tribunal was more lenient than the ALJ. In this case, the taxpayer sold TV signals that were transmitted by microwave to subscribers via a decoder box.[14] The taxpayer made payments to a firm known as Cooper Cable for the decoder boxes that it sent its signals to, and the taxpayer paid the firm $3 a month for the first box and $1.50 for each box after that. The $3 monthly charge that the taxpayer remitted to Cooper Cable included the cost for disconnecting sets and mailing bills in addition to other literature for the taxpayer. The charge also included the cost of answering and making phone calls to customers. The invoices were not itemized, and thus did not allocate the monthly charges for the decoder boxes. So the Division of Taxation included the $3 paid to Cooper Cable as taxable services. To determine the amount of tax due on the charges by Cooper Cable, the Division multiplied the number of decoder boxes by the rate charged by Cooper Cable to determine the total cost of the service.

The ALJ determined that the entire amount was subject to tax. The judge wrote:

> Petitioner has presented credible testimony and records from Cooper Cable to establish that only a small portion of the $3.00 monthly fee was used to repair equipment. Such evidence is pertinent because the Division should use a "fair sales price" as a basis for the asserted liability.

However, the judge found that despite being credible, the testimony "was not sufficient in the absence of supporting documentary evidence from Pay TV to establish the taxable portion of the charge." In the end, the judge relied on the old maxim of form over substance to determine that the entire charge was taxable.[15]

The Tribunal, on the other hand, found the taxpayer's evidence sufficient and overturned the ALJ's decision.[16] The Tribunal noted several occasions when its decisions had been overturned by the Third Department when the Tribunal held that testimony alone was insufficient. Thus, it determined that the correct rule was that "credible testimony that specifically establishes that the amount of tax imposed is incorrect may itself be sufficient to require a reduction to the assessment, without corroborating documentary evidence." The Tribunal found that testimony by the taxpayer's president that only 15 to 20 cents of the $3 monthly charge was attributable to repairs and maintenance was sufficient to prove an allocation was warranted: "We have specific, credible testimony that indicates that the amount of the assessment was erroneous and there is nothing in the record to controvert this testimony."[17]

But does it matter what side of the transaction you are on? In its decision, the Tribunal also noted that this case was distinguishable from *Dynamic Telephone Answering Systems* because the taxpayer was not a vendor, and thus it "did not create the unapportioned monthly charge." More importantly, the Tribunal also noted that the court in *Dynamic Telephone* did not say the taxpayer was *precluded* from overcoming an assessment without apportioned invoices or that it could not accept estimates. So this also appears

[13] *Matter of Locy Development Inc.*, Tax Appeals Tribunal, DTA No. 802499 (May 14, 1991).

[14] *Matter of Pay TV of Greater New York Inc.*, ALJ Determination, DTA No. 805298 (June 3, 1993).

[15] *Id.* ("The requirement that taxable and nontaxable items be separately stated on an invoice is not a mere technicality. The failure to follow this procedure makes it impossible on audit to determine whether the proper amount of tax is being collected.").

[16] *Matter of Pay TV of Greater New York Inc.*, Tax Appeals Tribunal, DTA No. 805298 (July 14, 1994).

[17] *Id.*

to open the door to those taxpayers who can demonstrate, with credible evidence, which part of the charge should and should not be subject to sales tax.

Perhaps because of cases like this, we've actually found the tax department to be refreshingly reasonable when stinky cheeseboard problems pop up in audits. While all auditors are aware of the cheeseboard rule, we've been able to navigate its pitfalls in audits when bundling issues arise, regardless of what side of the transaction our taxpayer is on. Indeed, in our experience, tax department auditors seem to recognize that while maybe they *can* try to collect additional taxes on sales of nontaxable items in a bundle, it is not something they *should* always strive to do. Let's look at a specific example to see this in action.

Investment Research: Cheeseboard in Real Life

One of the areas in which we have seen this issue come up repeatedly is the sale of investment research. New York state taxes the sale of information services, which generally include the provision of reports that are not personal or individual in nature, and in which the information presented is not included in reports available to other customers.[18] So when a company offers investment research personalized to its customer, that information can be provided without triggering a sales tax obligation. But when the information is more general in nature, it will likely be subject to sales tax.

We typically see this when a company provides several different products and services to its customers, such as generalized research reports, in addition to personal consulting and investment services. Since this includes both taxable and nontaxable components, when the items are bundled and provided for one price, the cheeseboard rule comes into play.

Let's use a semi-recent advisory opinion as an example. In it, the petitioners, PwC, provided a number of different products and services, including:

> (1) its advisory service, which included a subscription to its research notes, online research library, and other services such as presentations or on-site meetings with analysts, as well as access to its teleconferences;
>
> (2) teleforums;
>
> (3) reprints of published research notes;
>
> (4) in-person presentations on a topic determined by the client;
>
> (5) strategic management consulting services; and
>
> (6) white papers that offered in-depth analysis on products, technology, or issues and how they may affect the client.[19]

Now, some of these products and services would be taxable information services (potentially 1, 3, and 6, depending on how general the information) and others would not (2, 4, and 5). But as the advisory opinion makes clear, when:

> taxable and non-taxable items are bundled in a single transaction, the entire charge is subject to the tax unless charges for non-taxable items are separately stated on Company's bill or invoice, such charges are reasonable in relation to the total charges, and the services may be purchased separately.[20]

We've had to tackle situations almost exactly like this in many audits of both investment research providers and their clients. The typical service model is like that in the advisory opinion, with arguably taxable reports being bundled with clearly nontaxable services. And the billing conventions for these taxpayers are often unusual, with many clients paying on a discretionary basis, in an amount the client itself determines. In any event, the audit begins, and the tax department believes some portion of the taxpayer's sales — even if just a small one — is subject to New York sales tax. In a worst-case

[18] N.Y. Tax Law section 1105(c)(1).

[19] TSB-A-03(11)S (Mar. 25, 2003).

[20] *Id.*

scenario, the entire invoice cost for the taxpayer's New York clients could be taxed. But in all of these audits, the department, to its credit, has worked with us to unbundle the nontaxable products and services that were not originally separately stated, for purposes of resolving the audit. Then, however, auditors usually insist that thereafter, the taxpayer either unbundle the taxable and nontaxable items or charge tax on the total bundled price.

How do we determine the amount of the taxable charge? The methods vary. Sometimes we're able to identify what the taxpayer would charge for the taxable report on a stand-alone basis and use that as a base number. Or we use a least-common-denominator approach, basing the taxable amount per client on an amount equal to that paid by the cheapest client — on the assumption that this client gets nothing more than the reports. Or it is done on a percentage basis, and we work with the taxpayer to determine what the reports are really worth as a percentage of all the services provided.

We've even looked overseas in some cases to do this. For example, under Markets in Financial Instruments Directive 2014/65/EU, commonly referred to as MiFID II, investment firms are essentially required to unbundle their research and brokerage fees.[21] So when an investment service is offered with another product or service as a package, the firm must tell the customer that it can buy each component separately, the cost for each component, and a description of the component.[22] For firms subject to these MiFID requirements, looking to the unbundled amounts in these overseas transactions can also be a helpful marker.

Eyeing the 'Primary Function'

One final point here, relative specifically to investment research but also more generally to the cheeseboard rule. Sometimes — primarily in cases that involve the provision of significant services — these cheeseboard issues evolve into another interesting question: What was the primary purpose or "primary function" of the taxpayer's service? Under this concept, the inclusion of otherwise taxable products or services as components of a greater nontaxable service is permissible, so long as the primary function of the taxpayer's service offering was the service, and not the taxable goods or services.[23] For example, in one advisory opinion, the taxpayer sold integrated monitoring and management services in standard packages to its customers.[24] The services involved IT asset monitoring, IT asset management, and off-site data backup management, all of which were delivered to its customers via remote access. The tax department concluded that the primary function of the taxpayer's service was to assist customers in the operation and management of their IT system and that the sales were not taxable. If, however, the taxpayer sold portions of the service separately, the charges could be taxable if the services were taxable.

Lining this ruling up next to the cheeseboard rule, it could be viewed as a head-scratcher, right? In that opinion, the tax department seems to favor the bundling of charges, making clear that tax has to be charged *only* if certain otherwise taxable charges were unbundled. But the distinction lies in the primary function analysis. When someone buys a cheeseboard, they are buying two distinct items. The primary function of that sale is to give the customer a chunk of cheese and a board to put it on, and the vendor could just as easily have sold a piece of cheese or the board separately. But in the IT example from the advisory opinion, the vendor was providing a more comprehensive service, the primary function of which was to operate and manage the customer's IT needs. It did not and would not sell items piecemeal.

Consider another example, in the investment research context. In some cases, we've been able to successfully argue that when the taxpayer made, or was willing to make, its research reports available for free (for example, by making them accessible on its website), that was presumptive evidence that the primary function

[21] Directive 2014/65/EU of the European Parliament and European Council, article 24(11) (May 15, 2014).

[22] *Id.*

[23] *Matter of SSOV '81 Ltd.*, Tax Appeals Tribunal, DTA Nos. 810966 and 810967 (Jan. 19, 1995).

[24] TSB-A-10(14)S (Apr. 8, 2010).

was something other than the provision of taxable reports. The concept here is that the reports aren't a necessary, stand-alone component of the overall research and consulting service provided by the vendor since paying clients do not need to pay to get those reports; they must then be paying the vendor for something else. And as long as that "something else" is a nontaxable service, the overall charges to the client should not attract sales tax.

In any case, when navigating a "cheeseboard case," make sure to sniff out this primary function analysis too. ■