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In this installment of Noonan's Notes, the authors discuss a New York Tax Appeals Tribunal ruling that Apple incorrectly charged tax on its 2011 and 2012 back-to-school promotions in its retail stores.

There's been a lot of buzz in New York tax circles about how sales tax vendors are supposed to navigate the world of discounts and price reductions. We've covered similar issues in this column in the past, detailing how New York sales tax was supposed to work in the Groupon environment¹ and reporting on a great victory by a group of hotel chains that dealt with sales taxes on hotel reward point programs.² But more recently, things have taken a more distressing turn for taxpayers. A couple months ago, for instance, a New York administrative law judge found the reimbursement mechanism of a fuel rewards

program to be akin to a manufacturer's coupon, which created a sales tax liability for gas stations that used the program to sell discounted gas.³ According to the ALJ, the gas stations should have collected tax based on the undiscounted price of the gas rather than the discounted price paid by the customers. There's also been action in the false claims area, with the New York attorney general bringing an action against a large retailer with claims that the retailer took fraudulent steps to under-collect sales tax on a coupon program.⁴

And recently, New York's Tax Appeals Tribunal jumped into the fray with a ruling against the behemoth Apple Inc. in a sales tax case involving gift cards and promotional deals. Specifically, in *Matter of Apple Inc.*, the tribunal held that Apple incorrectly charged tax on its 2011 and 2012 back-to-school (BTS) promotions in its retail stores.⁵ The case covers the gamut of sales tax issues, including structuring, burden of proof, audit method, and compliance in New York's broader tax enforcement climate. Here at Noonan's Notes, we love ourselves some meaty sales tax — so here goes.

The Case

The Apple case involves a discount promotion that, unfortunately for Apple, contained significant ambiguity. In 2011 the Mac App Store was launched. To raise awareness of the Mac App Store, Apple offered a BTS promotion during 2011 and 2012. Under the terms and conditions of the BTS promotion, "qualified education individuals" (basically K-12 school employees and higher

¹Timothy P. Noonan and Lance E. Rothenberg, "Taxing Groupon-Type Coupons: New York Tax Department Guidance," *State Tax Notes*, Oct. 17, 2011, p. 171.

²Noonan, "Hotels Win Big on Taxation of Loyalty Programs," *State Tax Notes*, Mar. 29, 2010, p. 983.

³*Matter of GRJH Inc.*, DTA No. 827617 (N.Y. State Div. of Tax App. Dec. 19, 2019).

⁴*State of New York v. B&H Photo and Electronics Corp.*, NYS Attorney General Summons and Superseding Complaint.

⁵*Matter of Apple Inc.*, DTA No. 827287 (N.Y. State Div. of Tax App. Dec. 24, 2019).

education institution employees, students, and parents of students) who purchased a qualifying Apple computer or iPad during a specific timeframe could receive “a Back to School Gift Card . . . that [could] be used at the Mac App Store, the iTunes Store, the App Store, and the iBookstore.”

A BTS gift card received by the customer in connection with the BTS promotion had a value of either \$100 or \$50, depending on the qualifying product purchased. The question in the case was whether the customer purchased: (1) discounted hardware and a full-price gift card, or (2) full-price hardware and a free gift card. In other words, where was the discount — on the hardware or on the gift card? One might think that this is a relatively easy question to answer — simply look at the terms and conditions of the program and the receipt given to the customer and the issue will answer itself, right? Well, not exactly. As discussed below, Apple ran into problems because of ambiguity in the underlying facts. Some facts pointed to discounted hardware, while other facts pointed to full-price hardware and a free gift card.

The presiding ALJ, and ultimately the tribunal, decided that Apple was selling full-price hardware and giving away free gift cards. In other words, Apple did not sell the gift cards. Rather, Apple gave the gift cards away as part of the BTS promotion. This meant that Apple should have charged tax on the full price of the hardware rather than the discounted price. The ALJ and tribunal based their conclusions on the fact that if a customer declined the BTS gift card, the full price of the qualifying device with applicable tax would have been charged. Moreover, Apple’s invoicing indicated that the gift cards could not be returned separately. Finally, to support its conclusion that the gift cards were free, the tribunal cited one of Apple’s online promotional FAQs that stated “equivalent discount amount to cancel out the charge for the [gift] card” would appear on the invoice or receipt so that the total invoice amount “will amount to the cost of the Mac or iPad only.”

Structuring Issues

One of the first issues that arises in the case gets into the guts of the promotion itself. As

described above, in accordance with Apple’s promotions, customers who purchased qualifying Apple computers or iPads received gift cards for either \$100 or \$50, depending on the product purchased. Let’s say I paid \$1,000 for an iPad. Under the BTS promotion, I received the iPad and a \$100 gift card. The question in this case is whether I paid for a discounted iPad (that is, a \$900 iPad and a \$100 gift card) or a full-price iPad and a free gift card. As the tribunal noted, these factually distinct scenarios have very different tax consequences. In the former, sales tax is due on only the \$900 iPad, while in the latter, sales tax is due on the full \$1,000.

The tribunal concluded that, based on the facts of the transactions at issue, tax was due on the full \$1,000 and upheld the ALJ determination. But what’s crucial to recognize here is that Apple could have easily accomplished its goal of selling discounted hardware and full-price gift cards if it just made the facts surrounding the transaction clearer. For example, it would have helped if, on the receipts given to customers, Apple simply applied the BTS discount directly to the line that contained the hardware. The tribunal noted that a customer’s invoice “shows the itemized charges for the qualifying device and gift card, among other items, but does not indicate whether the BTS discount was applied against the qualifying device or, in the alternative, the gift card.” This was different from how Apple documented other discounts, such as its “individual educator” discounts. The tribunal noted that “an individual educator discount appears on the same line as the device on the invoice, but the BTS discount is included on the invoice as its own separate item.” This simple structural change in how the transaction was documented to the customer likely had a significant effect on the analysis and outcome of the case. Indeed, the tribunal noted, “ultimately, the invoices did not clearly indicate whether the BTS promotional discount was applied against the qualifying device or against the gift card.”

And that’s why sales tax is a particularly persnickety tax. Taxpayers are stuck with the forms of the transactions they create and the tax consequences that flow from them. Structure properly and you can reduce your tax liability.

Structure poorly or ambiguously and you might be hit with a hefty and unexpected tax bill.

Burden of Proof

But did Apple really structure poorly here? That seems a bit harsh. Certainly, the company could have made the underlying facts clearer to leave the auditors with no basis for an assessment. But some facts supported its position and the tribunal acknowledged this. For example, Apple treated the revenue from the gift cards for accounting purposes as deferred revenue — in other words, there was, in fact, a sale of the gift card. Moreover, when hardware was returned by the customer, Apple required the contemporaneous return of the unused gift card, otherwise only the discounted price of the hardware would be refunded. Apple never used the word “free” when referring to the gift card and its point-of-sale system was not capable of discounting the price of the gift card. The only way the promotion would work in the company’s point-of-sale system would be to apply the discount to the hardware. These seem like pretty important facts.

But, as discussed above, there were also unhelpful facts for Apple — the most damaging of which seems to be that Apple’s online sales of these promotions correctly (in the auditors’ view) charged tax on the full \$1,000. Moreover, if a customer declined the BTS gift card, the full price of the qualifying device with applicable tax would have been charged, and the company’s online FAQs supported that there was no charge for the gift card.

What’s important to recognize here is that the applicable burden of proof puts taxpayers at a severe disadvantage when confronted with competing factual scenarios. Unfortunately for Apple, it had the burden of proving, by clear and convincing evidence, that its position was correct. It had numerous helpful facts, and from where we sit, it appears that a preponderance of the facts supported Apple’s position. But a preponderance is not necessarily clear and convincing; if an auditor can make a reasonable argument under the applicable facts, a taxpayer is going to have a heavy lift, indeed, winning its case. Taxpayers should recognize that the rules of the game are tilted heavily in favor of the government, as borne

out annually in the published statistics from the Division of Tax Appeals.⁶

Audit Method

Just a quick note on the sales and use tax audit method. Many taxpayers forget that sales and use tax audits examine three distinct areas:

1. Did the taxpayer collect the proper amount of sales tax on its sales?
2. Did the taxpayer pay the proper amount of tax on its purchases (capital and expense)?
3. Do the taxpayer’s numbers reconcile?

This last point, which usually occurs first in an audit, was central in this case. Had the auditor not thoroughly reviewed Apple’s sales and tax figures, it’s likely that this issue would not have been spotted on audit. Auditors are instructed to review the taxpayer’s taxable sales figures and confirm that they reconcile with the amount of tax paid to the state. Similarly, auditors are instructed to review the amount of tax collected by the taxpayer from customers to confirm that it reconciles to the amount of tax actually paid to the state.

In this case, the liability resulted from a one-day test period wherein customer invoices from Apple’s retail stores were reviewed, with the subtotal on the invoice being multiplied by the applicable tax rate. This review led to a discrepancy between the amount of tax the auditors determined should have been collected and the amount actually collected by Apple for sales subject to the BTS promotion. Again, this issue could have easily been missed by less diligent auditors and it’s a warning to taxpayers to conduct internal reconciliations of their numbers before meeting with auditors. Surprises are great for birthday parties and Christmas gifts, not so much for sales tax audits.

Conclusion

Not that anyone will play the violin here, but Apple did get somewhat of a raw deal. As noted above, it could have structured those transactions to clearly avoid this result. Instead, it ended up

⁶ See New York State Tax Appeals Tribunal, “Annual Report Fiscal Year 2018-2019”; N.Y. Tax Law section 2006(13); see also Noonan and Ariele R. Doolittle, “Checking in on New York’s Division of Tax Appeals,” *State Tax Notes*, Oct. 8, 2018, p. 121.

getting stuck with additional taxes that it otherwise would have collected from its customers. It's particularly startling to see the amount of effort Apple exerted to get these promotions right. The tribunal details how Apple's point-of-sale, tax, accounting, and legal teams all worked on the promotions.

If a behemoth like Apple can't get it right, with all its resources and expertise, what hope does a little mom-and-pop retailer have of correctly navigating New York's confusing and counterintuitive sales tax laws? In fact, at one point in the decision, the tribunal notes that an Apple employee voiced concern about over-collecting tax, which, she posited, could happen if Apple gave the gift card away for free (charging full tax on the full charge for the hardware) and then charged tax again when the gift card was redeemed for taxable products. The tribunal noted that Apple has been subject to over-collection suits in the past. Though hindsight is always 20/20, you can imagine the uncertainty that Apple faced in the moment. This uncertainty was accompanied by particularly high risks in New York, because it is one of the few states that allow tax issues to form the basis of whistleblower claims. These claims have led to harsh allegations, invasive investigations, and massive liabilities, as most recently demonstrated in the *B&H Photo* case referenced above.

Indeed, sales tax vendors are often put in a "heads they win, tails you lose" position when navigating sales taxes, particularly in the discount and promotional space. And with the advent of *Wayfair* and nexus everywhere, it's even tougher to keep up. While such a compliance environment does make practitioners more important than ever (every cloud has a silver lining), it underscores the critical importance of getting sales taxes right the first time. ■

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