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In this edition of Noonan's Notes, the authors discuss New York's renewed sales and use tax enforcement efforts on artwork and luxury goods.

States' struggles to recoup lost sales tax revenue have been well documented in the fight over remote sales taxation. But while that drama unfolds nationally, New York state has been waging its own battle to reclaim lost sales tax revenue — namely on untaxed artwork and other big-ticket luxury items. For many years, the New York State Department of Taxation and Finance focused on yachts and airplanes, targeting taxpayers attempting to skirt sales and use tax on those items. But after the State Legislature in 2015 limited the taxability of boats and eliminated tax on aircraft altogether, the department has had to turn elsewhere to go big-game hunting. This article explores New York's renewed enforcement focus on artwork and luxury goods and the interesting sales and use tax issues that have accompanied it.

Use Tax 101

First, it's helpful to know the playing field. In New York the sales tax is consistently reaffirmed as a form-over-substance tax, so the department regularly holds taxpayers to the (sometimes unintended) sales tax consequences of how they do business.[1] By the same token, taxpayers can structure their transactions to avoid or reduce sales and use tax. The simplest case in point involves transactions between related entities; they're respected for sales and use tax purposes. That can lead to unintended sales tax consequences but can also allow for creative structuring to minimize tax. We'll see a bit later how these structures have been developed by taxpayers (and countered by the department) in the context of art and luxury goods.

In New York, vendors are required to collect and remit the tax on sales made within the state. However, the sales tax is ultimately a tax on the consumer, and New York is entitled to collect the tax directly from the customer if not collected by the vendor — which is when the compensating use tax comes into play. It's designed to ensure that New York residents who purchase taxable items for use in New York have paid tax on those items — even if tax was not charged at the time of sale (for example, because the purchase was out of state or because the seller lacked nexus with New York). The national debate on remote sellers shined renewed light on the use tax issue, and made clear that just because a vendor does not charge tax doesn't mean tax isn't due. Likewise,

[1] *See, e.g.*, *107 Delaware Associates*, 64 N.Y.2d 935 (1985). One entity's payroll reimbursement for use of a related entity's maintenance employees was held subject to sales tax on maintenance services. Exemption for maintenance services performed by a person's own employees didn't apply, even though both entities were nearly 100 percent related and shared personnel.

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traveling across state lines to purchase an item at a lower tax rate doesn't eliminate exposure for use tax on the difference when a resident brings the item home.

"Home," by the way, is a critical concept when it comes to use tax. New York only imposes use tax on items purchased by someone who was a New York resident at the time of purchase.[2] For example, a Delaware resident who comes to New York for a camping vacation does not owe use tax on his Delaware-purchased camping gear when he enters New York. Notably, however, residency for use tax purposes is not the same as residency for income tax purposes in New York. For individuals, all it takes to become a resident for use tax purposes is to maintain a "permanent place of abode" in the state, regardless of how much time the individual is in the state.[3] Thus, if our Delaware camper happened to also have a vacation home in the Adirondacks, then his camping gear is technically subject to the New York use tax.[4] For a business entity, use tax residency is established merely by "doing business" within the state.[5] All of those concepts become relevant in discussing New York's saga with taxing luxury goods.

The Battle for Boats and Planes

Planes and luxury yachts are expensive, yet many New York residents own and use them in the state. And since sales and use tax generally applied in full force to both items before 2015, the sales and use tax tag made those items enticing targets for enforcement by New York (and creative tax planning by taxpayers). Case law and rulings suggested that even temporary or sporadic use of a vessel or aircraft in New York could trigger use tax on the craft's full value — to the extent sales tax had not been paid in New York or elsewhere.[6] To avoid New York tax, residents developed two tactics that — at least until the Legislature stepped in — worked to allow use in New York without use tax exposure.

One tactic took advantage of the use tax exclusion for purchases made by a nonresident of New York. Under that method, a New York resident could set up a non-New York (nonresident) entity (typically a single-member LLC (SMLLC) disregarded for income tax purposes) to purchase a boat or plane. Since New York — in keeping with its form-over-substance treatment — recognizes business entities, including SMLLCs, as taxpayers separate from their owners for sales and use tax purposes, the entity could bring the boat or plane into New York without triggering use tax, since it was purchased by a nonresident.

The second tactic for boats and planes involved the sales tax exemption for commercial aircraft and vessels. Since the exemption required only that the plane or boat was used primarily to transport persons or property "for hire,"[7] a plane could be purchased by a newly created entity that would transport the company's owners for hire. And since fees charged for such transportation are nontaxable, sales tax could be averted altogether on both the purchase and use of the plane.

The Legislature finally stepped in and closed those perceived loopholes in 2009 with amendments that effectively "looked through" those transactions. If the persons using the boat or plane in either scenario were New York state residents, then the structures were ineffective for sales and use tax purposes. Specifically, the legislation amended the use tax exemption for nonresidents so that it no longer covered vessels, aircraft, or motor vehicles purchased primarily to transport owners, members, officers, etc., of the purchaser who were residents of New York. The

[2] *See* N.Y. Tax Law section 1118(2).

[3] 20 NYCRR section 526.15(a).

[4] New York would allow a credit for tax already paid to another jurisdiction; however, in this example, no tax would have been paid in Delaware, since Delaware does not impose sales or use tax.

[5] 20 NYCRR section 526.15(b).

[6] *See, e.g., Sunshine Developers Inc. v. Tax Commission*, 132 A.D.2d 752 (3rd Department 1987) (although a vessel temporarily moored in New York as a stopover en route to another destination would not constitute a use, seasonal use would trigger use tax). *George Sexton*, TSB-A-90(31)S (June 29, 1990) (an emergency landing of a plane in New York would not constitute a use, but three overnight stays are sufficient to trigger use tax for the plane's resident owner).

[7] N.Y. Tax Law sections 1101(b)(16), (17).

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commercial aircraft exemption was also amended so that for-hire transportation no longer included transporting resident owners, members, officers, etc. of the purchaser. With those planning structures off the table, our firm saw a healthy stream of use tax audits involving aircraft and vessels used in New York. Renewed enforcement efforts such as marina sweeps by the department generated many of those cases, and the agency maintained the position that virtually any presence in New York other than for emergencies or repairs constituted a taxable use.

When use tax was unavoidable, there were still arguments to reduce the tax. In *Matter of Xerox v. State Tax Commission*,[8] the appellate division held that local taxing jurisdictions were prohibited from imposing use tax on airplanes hangared outside — and used only occasionally in — the jurisdiction. Several administrative rulings extended the *Xerox* rationale to planes hangared outside New York and used only occasionally in the state, holding that use tax could be imposed at the statewide rate, but no additional county tax could be applied.[9] In audits, we also argued that the use of a boat in a county where the owner was not a resident could not trigger county-level use tax, since the local use tax (like the state-level tax) is imposed on county residents only.[10] The department's view — which we still question — was that the rules were different for boats and motor vehicles, and that use tax was due at the rate in the county where the owner resided, regardless of where the use occurred.

But in 2014, perhaps prompted by aviation industry lobbying and other factors, New York's taste for taxing boats and planes dried up. Amendments effective in mid-2015 effectively eliminated sales and use tax on aircraft and substantially limited the tax on vessels. First, the Legislature added an exemption for "general aviation" aircraft to the existing exemption for commercial aircraft, meaning even aircraft for personal use are now exempt.[11] And for vessels, the 2015 legislation capped sales tax on purchases (only the first $230,000 is now subject to tax) and eliminated use tax on boats used in New York for less than 90 consecutive days — effectively allowing boats purchased out of state to come and go freely, even seasonally, without triggering use tax.[12]

Artful Dodging on Artwork

While New York can no longer count on the tax generated by a $3 million Cessna, it still expects tax on a $10 million Cézanne. As with vessels and aircraft, the taxation of artwork has been something of a cat-and-mouse game between the department, tax practitioners, dealers, and collectors. New York's recent efforts to enforce sales tax on high-end artwork have been well publicized. In 2016 the state attorney general announced a $4.3 million settlement with Gagosian Gallery, one of New York City's most recognized art dealers, after an investigation regarding failure to collect and remit sales tax.[13] Also, the well-known art collector and real estate developer Michael Shvo pleaded guilty this past April to evading sales tax on purchases of artwork and other luxury goods, relating to an indictment dating back to 2016.[14]

One issue in the Gagosian matter involved purchased artwork shipped outside New York at the purchaser's request. Over the past few years, the department has taken an aggressive position regarding out-of-state sales of artwork. New York sales tax is levied based on destination, meaning that "the point of delivery or point at which possession is transferred by the vendor to the purchaser, or the purchaser's designee" controls where the sale takes place for sales tax purposes.[15] The department's position is that if a vendor is

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[8] *Matter of Xerox v. State Tax Commission*, 71 A.D.2d 177 (3d Department 1979).

[9] *See Matter of Lipman*, Admin. Law Judge Determination (Feb. 17, 2000); and *Matter of Knight*, Admin. Law Judge Determination (Aug. 30, 1990).

[10] This treatment was confirmed in two State Tax Commission decisions involving racehorses brought to a county in which the owner was not a resident. *See Matter of Dana Irving*, State Tax Commission (Feb. 18, 1986); and *Matter of Dana Irving*, State Tax Commission (Nov. 7, 1986) (involving the same taxpayer but a different horse).

[11] *See* TSB-M-15(3)S (July 24, 2015).

[12] *See* TSB-M-15(2)S (July 24, 2015).

[13] *See* press release, "A.G. Schneiderman Announces $4.28 Million Settlement With International Art Dealer Gagosian Gallery for Failure to Collect and Remit New York Sales Tax," July 19, 2016.

[14] *See* Eileen Kinsella, "Art Collector Michael Shvo Pleads Guilty to Tax Evasion, But Avoids Jail Time," *Artnet News* (Apr. 27, 2018).

[15] 20 NYCRR section 525.2(a)(3).

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obligated to ship purchased property outside New York, the property is delivered when it reaches the purchaser out of state.[16] However, when an out-of-state purchaser arranges for shipping, the department deems delivery to occur within New York if the purchaser hires anything but a common carrier to pick up the item. The idea is that a private or contract carrier hired by the purchaser takes possession of the property within New York as an agent or designee of the purchaser.[17]

The problem with that common versus contract carrier issue is that neither term is defined for sales tax purposes. And despite some common law attempts to delineate between the two, very little pragmatic guidance exists to make such determinations. A common carrier is generally understood as one that holds itself out as a carrier and "for a specified compensation, agree[s] to transport personal property from one place to another 'for all persons that may see fit to employ [it].'"[18] By contrast, a contract or private carrier is "one that carries for some particular person under some particular arrangement, but makes no public profession that it will carry for all who apply, nor is it required to."[19]

The department has taken the position — at least with artwork — that specialized art shippers can't be common carriers, but it has not articulated why in any published guidance. Nor is that issue confined just to disputes over artwork sales. We have also seen it come up in practice in the context of other high-end goods such as rare wine.

Of course, many New York residents who purchase artwork don't want it shipped out of state and are purchasing it for use in the state. As with vessels and aircraft, creative planning techniques have sprung up in New York to avoid or at least defer sales tax on those big-ticket purchases. The techniques have not gone unnoticed by the state, and legislation over the past two years has aimed to shut them down. One such planning structure involved the same use of the nonresident exclusion used in boat and plane purchases. The aforementioned 2009 amendments were effective to stop persons from exploiting the exclusion for boats, aircraft, and motor vehicles, but the amendments didn't cover other high-end property. Thus, one planning technique for art purchases involved setting up an out-of-state entity (a nonresident) to make the purchase out of state. When the entity itself brought the artwork into New York in its name, the nonresident exclusion prevented use tax from being triggered. However, legislation enacted in 2017 targeted that structure by adding a requirement that business entities would not qualify as nonresidents regarding property brought into New York unless they had been actively doing business outside New York for at least six months before the property entered the state. Thus, a Delaware LLC whose only business outside New York was owning artwork likely could no longer meet the exclusion.

Another planning technique for artwork (also on the department's radar) focused on New York's "resale" exclusion. As with any tangible personal property, if an item is purchased exclusively "for resale . . . as such," no sales tax is due on the transaction; rather, tax will be due when the property is later resold at retail.[20] A vendor who accepts a resale certificate in good faith is relieved entirely of any burden of later proving the sale was exempt.[21] Understandably in the art world, the desire to avoid the upfront sales tax hit on six- and seven-figure price tags has made resale certificates a common currency.

But case law makes it clear that a mere collector or investor cannot rely on the resale exclusion merely because she may sell the art at some point in the future. Such was the case for former *Penthouse* publisher Bob Guccione. In *Matter of P-H Fine Arts*,[22] a corporate entity acquired various works of art tax free, claiming the resale exclusion, and later displayed them in a townhouse Guccione used both as corporate offices and his private residence. New York's Appellate Division held that even though some

[16] *See Crowe Chizek & Company LLC*, TSB-A-08(53)S (Dec. 15, 2008).

[17] *Id.*

[18] *Matter of Yellow Book of New York Inc.*, 75 A.D.3d 931, 933 (3d Department 2010) (internal citations omitted).

[19] *Id.*

[20] 20 NYCRR section 526.3.

[21] 20 NYCRR section 532.4(b)(2).

[22] 227 A.D.2d 683 (3d Department 1996).

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works were indeed resold, the artwork was not purchased exclusively for resale, but rather partly for general display and personal use.

But what if a business entity does purchase artwork exclusively for resale . . . to its owner? One structure that previously allowed the sales tax hit on artwork to be deferred (albeit not avoided) involved creating an SMLLC whose business was to acquire and lease out works of art. Since New York acknowledges the separate existence of an SMLLC and its sole member for sales tax purposes, the SMLLC could purchase artwork tax free, based on the resale exclusion, and later lease out the art to its member. While sales tax would be due on the lease payments between the SMLLC and its member (leases are considered taxable sales, with tax due on the lease payments as they become due), the effect was to defer the sales tax hit over many years as opposed to an upfront burden. And because the SMLLC was disregarded for income tax purposes, the internal payments also had no income tax consequences.

Considering that the department had blessed the use of transactions using SMLLCs for other purposes in several advisory opinions, there seemed to be little justification for looking through the structure.[23] But like the nonresident structure, that structure did not escape the department's eye. After a previously unsuccessful attempt at legislation targeting that structure in 2014, the Legislature amended the resale exclusion in 2016 so that purchases by an SMLLC for purposes of resale to its member no longer qualified for resale treatment.[24] The legislation also extended the treatment to apply to purchases by a partnership for resale to its partners and a trust for resale to its beneficiaries. None of those transactions now qualify for the resale exclusion.

Recent Enforcement Initiatives

The timing between the 2016 and 2017 sales and use tax amendments and the recent criminal enforcement actions is not a coincidence. The department has been aggressive in the past few years in ensuring luxury goods in New York don't escape tax. Our office has seen numerous cases recently in which U.S. customs records have triggered a use tax inquiry on imported items such as watches, jewelry, and artwork coming into New York through customs. Those notices from the department's "casual sales" unit essentially assert full use tax due on the item until proven otherwise — for example, proof that tax was paid to another jurisdiction or that the item was transported out of New York via common carrier with no intervening use in New York.

It is clear from those notices that the department has easy access to customs records and is looking for high-value items that may have eluded tax. The wave of activity has prompted many New Yorkers who have purchased art or other goods abroad to consider coming forward under the state's Voluntary Disclosure and Compliance Program, which allows taxpayers with liability to voluntarily disclose and pay that liability without civil or criminal penalties and, in most cases, limits the lookback period to three years.[25] Taxpayers are only eligible to participate if they are not already under audit or have not already been informed by the department of liability for the tax years in question.

Do Luxury Items Have a Domicile?

Given New York's prominent place in the art and auction world, the temporary presence and sale of art within the state is common. That can raise tricky income tax issues when works are sold. Nonresidents of New York are subject to tax only on income "derived from or connected with New York sources."[26] But that includes income attributable to "the ownership of any interest in real or tangible personal property in this state."[27] In *Matter of Ittleson*,[28] the Tax Appeals Tribunal acknowledged that the temporary presence of property in New York — for instance, artwork

[23] *See, e.g.*, Arthur Andersen LLP, TSB-A-99(7)S (Jan. 28, 1999) (SMLLC could purchase hotel furniture and fixtures for resale (lease) to its sole member); and M Ventures LLC, TSB-A-04(11)S (Apr. 4, 2004) (SMLLC could purchase aircraft tax free for re-lease to another SMLLC owned by same member).

[24] Tax Law section 1101(b)(4)(v).

[25] *See* New York State Department of Taxation and Finance, "Voluntary Disclosure and Compliance Program."

[26] Tax Law section 631(a)(1).

[27] Tax Law section 631(b)(1)(A).

[28] N.Y. Tax Appeals Trib. (Aug. 25, 2005).

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consigned for sale at auction — would not trigger New York source income for a nonresident on a sale occurring while in the state. That did not help the taxpayers in the case, though.

The issue involved a Modigliani painting the couple hung in their New York City apartment for 11 years. In the process of selling their apartment and moving to South Carolina, they consigned the painting to Sotheby's for sale. While the painting was exhibited by Sotheby's in various locations (Tokyo, Paris, London, and Zurich), the couple officially became nonresidents of New York. Finally, after a month back in New York, the painting sold at auction. The couple claimed the painting was only temporarily in the state. However, the tribunal found that the entire 11-year period was relevant in determining whether the painting's presence was temporary, not just the period beginning when the couple became nonresidents.

Although *Ittleson* itself involved a quirky set of facts, the tribunal's reasoning has implications — such as whether a nonresident with high-value property historically based in New York can avoid source income on a sale by moving the property out of state before the sale.

Conclusion

Given the substantial sales tax tag accompanying purchases of high-end artwork and other luxury items, the push for creative transactions and structuring in this realm is no surprise. As Edgar Degas said, "Art is not about what you see, but what you make others see." But given New York's renewed focus on art and luxury items, practitioners and taxpayers should be aware that the state sees tax avoidance and has been active in finding ways to curb it. ■

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