

# **New York State Tax Litigation**

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## I. REPRESENTATION

Lincoln's adage that "he who is his own lawyer has a fool for a client" appears particularly apt for those taxpayers who represent themselves in tax disputes, since not only are they often unfamiliar with the procedural aspects of the litigation process, but they are also often unfamiliar with the tax law. Although administrative law judges make every effort to accommodate pro se taxpayers, proceedings at the Division of Tax Appeals are governed by the Tax Law and the CPLR. Pro se taxpayers with little knowledge in these statutory areas generally fare poorly, frequently making arguments that have been rejected countless times in the past by other taxpayers. In addition, they

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often create a hearing record so decidedly adverse that a later appeal to the Tax Appeals Tribunal becomes extraordinarily difficult.

The Department of Taxation, on the other hand, is represented by skillful and experienced lawyers who are conversant with the cases and with the system. The Department's counsel are also adept at defusing the actions of auditors who have deviated from established audit procedures during the audit. Taxpayers not representing themselves at the Division of Tax Appeals or the Tax Appeals Tribunal may be represented by an accountant or by an attorney. Taxpayers appealing an adverse decision of the Tax Appeals Tribunal via an Article 78 proceeding to the Appellate Division may only be represented by an attorney.

## **II. CONCILIATION CONFERENCE**

A taxpayer who disagrees with audit finding will be given the opportunity to participate in a mediation conference with the auditor. This conference is held under the under the auspices of the Bureau of Mediation and Conciliation Services (BCMS), which is a separate operating bureau within the Department of Taxation reporting directly to the Commissioner of Taxation and Finance. The goal of the Conciliation Conferee is to resolve tax disputes without the necessity of a formal hearing before the Division of Tax Appeals. A request for a Conciliation Conference must generally be made within 90 days after the issuance of a Notice of Determination. The taxpayer who deems the Conciliation Order issued by the Conferee following the Conference unacceptable, may request a formal hearing before the Division of Tax Appeals within 90 days after the Conciliation Order is issued.

A taxpayer who wishes to bypass the Conciliation Conference may do so by filing a request for a formal hearing before the Division of Tax Appeals within 90 days after the issuance of a Notice of Determination. These time periods are jurisdictional; a taxpayer who fails to timely file a request for a hearing before the Division of Tax Appeals will lose all appeal rights in the administrative tax tribunals. (Relief may still be sought in some cases by bring a declaratory judgment action in state supreme court challenging the constitutionality or the applicability of the statute or assessment.

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However, this path is perilous at best.)

### **III. THE DIVISION OF TAX APPEALS**

The Division of Tax Appeals, in contrast to BCMS, is an autonomous unit of the Department of Taxation and is independent of the Commissioner of Taxation and Finance. The Administrative Law Judges who preside over hearings at the Division of Tax Appeals are experienced and impartial. Still, the Department of Taxation has an advantage in the Division of Tax Appeals, since tax laws are construed narrowly and in favor of the government. Hearings are held at the offices of the Division of Tax Appeals, located at 500 Federal Street, in Troy. The majority disputes with the Department of Taxation heard today involve sales tax. Decisions of the Tax Appeals Tribunal, the Appellate Division, Court of Appeals, or United States district or appeals courts sitting in New York may be cited as authority for the taxpayer's case. However, the doctrine of *staré decisis* has no application to cases decided by Administrative Law Judges. Accordingly, those determinations have no precedential value and may not be cited as authority in any brief. In the 2009-2010 fiscal year, Administrative Law Judges sustained 80.2 percent of the deficiencies or other action asserted by the Department of Taxation; they cancelled 9.4 percent of the deficiencies or other action; and they modified 10.4 percent of the deficiencies or other action. *New York State Division of Tax Appeals, Annual Report Fiscal Year 2009-2010*.

### **IV. ANALYZING A SALES TAX CASE**

In fiscal year 2009-10, sales tax cases represented 59 percent of the cases heard in the Division of Tax Appeals. This is not surprising. With the lure of interest, penalties, and large revenues upon which the sales tax is based, the Department of Taxation aggressively pursues sales tax revenue through audit. To emerge victorious in a sales tax dispute, the taxpayer should be conversant with some important principles involving sales tax litigation. First, auditors often attack the adequacy of the taxpayer's books and records. Should the Division find these records inadequate, it may resort

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to “external indices,” one of which is a “test period” audit, in which an extrapolation could be made over a lengthy term. Since penalties will also be extrapolated, this is a dangerous position for the taxpayer to be in.

The first question is whether the Division was justified in resorting to external indices. The Division must make an explicit request for books and records for the entire audit period. If only a “weak and casual” request is made for records (*Matter of Christ Cella*, 477 NYS2d 858), the taxpayer may be excused from having failed to provide records. If the auditor failed to conduct a sufficient examination of the records, the use of a test period audit has been held improper. Does the audit report actually document a finding of inadequacy of records? *Matter of King Crab*, 522 N.Y.S.2d 978. If not, the Division may be unable to establish inadequacy of records. Resort to a test period audit is not justified unless it is “virtually impossible” to determine tax based upon available records. *Matter of Chartair*, 411 NYS2d 41. Did the auditors fail to review books and records because they were “too voluminous”? *Matter of Names in the News*, 429 NYS2d 755. The Division may not employ an “economic feasibility” test in resorting to a test period audit. The taxpayer has a right to a detailed audit under Tax Law §1138. *Matter of Chartair, supra*.

Did the taxpayer or his representative actually consent to a test period audit? Merely complying with a request to provide records for a test period does not, without more, evidence a waiver of the taxpayer’s right to a complete audit. *Matter of James G. Kennedy*, 509 NYS2d 199. Did the Division “deliberately overlook” records which were helpful to the taxpayer? *Matter of Merrick Discount Center*, DTA No. 800362. Was there a change in auditors? Did the original auditor appear at the hearing or at least provide an affidavit? If not, the evidence may not be sufficient to justify resort to external indices. *Matter of Kenneth Schuck Trucking*, DTA No. 816129. If the audit period was extended, were those records requested? Was an independent review of records relating to the extended audit period made? If adequate records exist for the extended audit period, the Division “cannot ignore them.” *Matter of Adamides*, 521 NYS2d 826.

Even if the taxpayer failed to comply with the Division’s record keeping regulations, it may not “prescribe the type of proof that a taxpayer must provide at hearing” in order to prevail. *Matter of John G. Avildsen*, DTA No. 809722. If the amount of tax paid was “easily ascertainable” from

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records provided, a denial of credit by the Division was held to constitute the “mindless elevation of form over substance” and could not be considered “anything other than an arbitrary and capricious exercise of power.” *Matter of Riluc*, 565 NYS2d 265. Did the Division request records not typically kept by persons involved in the taxpayer’s line of business? If so, the taxpayer has the right to substantiate the proper collection of tax due through supporting documents. *Matter of Raemart Drugs*, 555 NYS2d 458.

Assuming resort to estimate procedures was warranted, did those procedures lack a “rational basis,” or did an extrapolation yield a grossly inaccurate estimate the tax liability? *Matter of Yonkers Plumbing*, 403 NYS2d 792. Was the Division’s method “reasonably calculated” to reflect the taxes due? *Matter of W.T. Grant Company*, 2 NY2d 196, *cert denied* 355 US 869. Was the audit methodology founded upon the auditor’s “experience” without any indication that the experience relates to the present audit? *Matter of Grecian Square*, 119 AD2d 948. Was the method chosen by the Division to estimate sales arbitrary and capricious? *Matter of King Crab*, *supra*.

Was the imposition of penalties proper? Did the taxpayer make a “reasonable effort” to ascertain tax liability? *Matter of Northern States Contracting, Inc.*, DTA 806161. Was any understatement of tax unintentional? *Matter of G & R Machinery*, DTA 804590. As these cases demonstrate, knowledge of the taxpayer’s substantive rights constitutes the best insurance against an unfavorable result. Having a meritorious case may unfortunately be insufficient to prevail at hearing unless the proper legal arguments are advanced.

**V. MOTIONS FOR SUMMARY DETERMINATION**

NYCRR § 3000.9(b)(1) provides that ““summary determination” may be granted “if, upon all of the papers and proofs submitted, the administrative law judge finds . . . no material and triable issue of fact is presented and that the . . . judge can, therefore, as a matter of law, issue a determination in favor of any party.” A motion for summary determination forces the Department to “lay bare” its proof at an earlier stage. In that sense, the motion serves as a proxy for discovery. It can also provide an effective means of presenting the case to the ALJ prior to the hearing in a light

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most favorable to the taxpayer. Most evidence, which often consists of auditor's testimony, his logs and other documentary evidence, is typically presented for the first time at the hearing before the ALJ in Troy.

A motion for summary judgment may eliminate the undesirable element of surprise. Surprise at hearing may derail even the strongest of cases. Once served with a motion for summary determination, the Department must respond by proving the existence of a genuine issue of triable fact. Facts not controverted in opposing papers are deemed admitted. *Fair v. Stanley Fuchs*, 631 N.Y.S.2d 153 (1st Dept. 1995) held that a party opposing a motion for summary judgment "must produce evidentiary proof in admissible form sufficient to require a trial of material questions of fact . . . mere conclusions, expressions of hope or unsubstantiated allegations or assertions are insufficient." Accordingly, affirmations of counsel would be insufficient to defeat the motion. Affidavits by the auditor as well as other evidence in admissible form would seemingly be required to oppose to such a motion.

## **VI. TAX APPEALS TRIBUNAL**

Following a hearing at the Division of Tax Appeals, any party may appeal all or part of the Determination to the Tax Appeals Tribunal, provided a Notice of Exception is filed within 30 days after service of the Determination on the parties. The Tax Appeals tribunal sits as the final administrative tax tribunal in the state. In the 2009-2010 fiscal year, the Tax Appeals Tribunal sustained the deficiency or other action asserted by the Department of Taxation in 71.7 percent of cases; it cancelled the deficiency or other action asserted in 13.0 percent of the cases; it modified the deficiency or other action asserted in 8.7 percent of the cases, and it remanded the case to the Administrative Law Judge in 6.5 percent of the cases.

A brief may be filed within 30 days after the filing of the Notice of Exception. 30-day extensions for filing a Notice of Exception may be granted "for cause." In practice, such extensions are granted as a matter of course, provided a letter requesting the extension is received by the Division of Tax Appeals within the 30-day period for filing the Notice of Exception. The Tax

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Appeals Tribunal, also located in Troy, has three Commissioners who serve nine-year terms and who may be removed only for cause. Tax procedure in the administrative tax tribunals is governed by rules promulgated by the Tax Appeals Tribunal. In many respects, these rules resemble procedural rules found in the CPLR. Oral argument may be requested before the Tax Appeals Tribunal, and is routinely but not automatically granted.

## **VII. ARTICLE 78 REVIEW OF TAX APPEALS TRIBUNAL DECISIONS**

Taxpayers wishing to contest adverse determinations of the Tax Appeals Tribunal generally have only one choice: an Article 78 proceeding to review the determination of a “state body” (i.e., the Tax Appeals Tribunal), pursuant to CPLR §7804. Article 78 review must be commenced within 4 months following an adverse decision by the Tax Appeals Tribunal. A CPLR Article 78 proceeding is the “dotted line” in the flowchart that brings the tax dispute out of administrative tribunal system and into the New York judicial court system. From a tax petitioner’s standpoint, Article 78 is far from perfect: it possesses treacherous statutes of limitations, it is inherently capable of providing only narrowly circumscribed relief, and it imposes onerous bonding requirements. Still, like the Spirit of St. Louis, Article 78 will at least take the taxpayer into the courtroom of the Appellate Division, where counsel may be able to convince the Court of reversible error below.

An Article 78 petition is returnable to the Appellate Division, 3rd Department, in Albany. If corporate sales tax is in issue, the taxpayer must deposit the tax or post an undertaking. No undertaking is required to seek review of personal income and corporate tax determinations, including responsible person determinations; however, assessment and collection of these taxes may proceed during the pendency of an Article 78 proceeding.

The actual Article 78 proceeding is commenced by service of a Notice of Petition and Petition upon the parties described above made returnable to the Appellate Division, 3rd Department, on at least 20 days’ notice. At least five days before the return date of the Petition, the Commissioner must appear by serving an answer, or otherwise moving to dismiss. (A motion to dismiss could be based upon a lack of jurisdiction for failing to properly serve all parties or for failing to obtain the required

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bond, or dismissal could result from failing to state a cause of action.)Judicial review is limited to the record before the agency — no new evidence may be submitted. The stipulated record and a brief must be filed within 9 months after the date of commencement of the proceeding.

CPLR § 217 provides that “a proceeding against a body . . . must be commenced within four months after the determination to be reviewed becomes final and binding.” Tax Law §2016 provides that the four-month period commences after notice of the Tax Appeals Tribunal is served. The statute then provides that “service by certified mail shall be complete upon deposit of such notice . . . in a post office.” Therefore, the taxpayer actually has less than four months from receipt of the notice in which to commence an Article 78 proceeding. The Department of Taxation keeps meticulous records, including affidavits by clerks, concerning the manner in which certified copies of decisions are mailed.

Arguments made by the taxpayer concerning either the taxpayer’s own timely mailing, or the Department’s failure in this regard, will in all likelihood fail. One might presume that only the Department of Taxation need be served with an Article 78 petition. This presumption would be erroneous: Tax Law § 2016 provides that “[t]he petitioner shall designate the tax appeals tribunal and the commissioner of taxation and finance as respondents in the proceeding for judicial review.” (The Tax Appeals Tribunal does not, however, participate in the proceeding.) Section 2016 continues, providing that “[i]n all other respects the provisions and standards of article seventy-eight of the [CPLR] shall apply.” CPLR §7804(c) provides that “notice of petition must be served upon the attorney general by delivery of such order or notice to an assistant attorney general.”

Therefore, the Department of Taxation, the Tax Appeals Tribunal and the Attorney General must all be served in an Article 78 proceeding. One might also assume that since the taxpayer may be served with notice of the Tax Appeals Tribunal decision by certified mail, the taxpayer could, similarly, commence an Article 78 proceeding by serving the three required recipients by certified mail. This is not the case: Although CPLR §307(2) does provide that personal service may be effected upon a state agency (*i.e.*, Department of Taxation and Tax Appeals Tribunal) by certified mail, § 307(1) appears to require personal delivery by a process server upon the Attorney General.

Additionally, one more trap awaits the unwary regarding service of process by certified mail: CPLR §307(2) provides that such service is not effective unless “the front of the envelope bears the legend “URGENT LEGAL MAIL.” Given the tangle of statutory provisions governing service, it

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would appear far preferable to serve all parties personally by process server, rather than to serve by certified mail and hope that all statutory requirements have been met. Although the taxpayer may have contested the deficiency to the Tax Appeals Tribunal without paying any disputed tax, this courtesy of the New York Legislature ends at the filing of the Article 78 petition, at least with respect to some types of tax.

Thus, a jurisdictional prerequisite to instituting an Article 78 proceeding involving, *inter alia*, sales tax or real property transfer gains tax, is the filing of a bond to cover contested amounts and court costs. Although a bond is not required in order to initiate an Article 78 proceeding based upon deficiency relating to income tax, the Department may nevertheless assess and collect a deficiency during the pendency of such an Article 78 proceeding. If the Department decides to assess tax during the proceeding, the taxpayer must either pay the deficiency or file a bond (a letter of credit may also be acceptable to the Department) pending ultimate disposition of the case.

Although it may seem unjust for the Appellate Division to dismiss meritorious cases on procedural grounds such as the failure to serve the Article 78 petition in the proper manner — and perhaps it is unjust — a body of case law has evolved which makes it virtually impossible for a court to entertain a petition which suffers from jurisdictional defects. The petition must be verified (CPLR §7804) and must comply with all provisions of the CPLR which govern pleadings.

Thus, it must make factual allegations in separately numbered paragraphs and must state a legally cognizable cause of action, or the action will be susceptible to a motion to dismiss. The Court of Appeals held in *Spodek v. New York State Com'r. of Taxation and Finance*, 628 N.Y.S.2d 256 (1995), that the commencement-by-filing provisions in CPLR §304 apply to proceedings originating in the Appellate Division. Thus, before service of the Article 78 petition on the required recipients, the Petition must be filed (and an index number purchased) from the Clerk of the Appellate Division.

After purchasing the index number, personal service (preferably by a process server) must be made on the recipients. After such service is complete, proof of such service must be filed with the Appellate Division “not later than 15 days after the date on which the [four-month] statute of limitations expires.” CPLR § 306(b) Pursuant to Tax Law § 2016, the taxpayer must include as part of the petition (1) the determination of the Administrative Law Judge (ALJ), (2) the decision of the Tax Appeals Tribunal, (3) the transcript of the hearing (if any) before the ALJ, and (4) any exhibit or document submitted into evidence at any stage in the proceeding. Judicial review of the agency

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determination will be limited to a review of the record.

After issue has been joined (*i.e.*, the Department has served an answer or moved to dismiss), and within nine months of the date of the Notice of Petition, the taxpayer must file with the Appellate Division an original and nine copies of a reproduced full record, as well as ten copies of the taxpayer's brief. In reviewing the determination of the Tax Appeal Tribunal, CPLR §7803 provides that the determination will be upheld if it is supported by "substantial evidence." In addition, the burden of proof is generally on the taxpayer to show that the agency determination was arbitrary or capricious, or not supported by the evidence. This includes responsible person determinations made under the income and sales tax laws for corporate officers and employees.

After submission of the record and brief, oral argument is scheduled. Taxpayer's counsel is generally allowed 15 minutes for oral argument. Approximately six weeks later, the Court will render a full opinion or memorandum decision. The prevailing party will then draft a proposed order for execution by the Appellate Division Clerk. After service of this order with Notice of Entry, the nonprevailing party will then have 30 days in which to seek leave (permission) to appeal to the Court of Appeals. The Court of Appeals seldom grants leave to appeal in tax cases.

### **VIII. APPEALS TO COURT OF APPEALS**

Appeals to the Court of Appeals may be taken either by permission or as of right. In either case, no oral argument on the motion is permitted. Appeals as of right may be taken where (i) two justices dissented on a question of law in favor of the taxpayer; or (ii) the issues in dispute directly involve a constitutional question. With respect to (i), it is not enough that there have been two dissenting judges; each must have advocated judgment in favor of the taxpayer based on questions of law. With respect to (ii), even where a constitutional question is presented, the appeal will be dismissed if the decision could have been decided on other grounds. Thus, a constitutional question cannot be raised solely to obtain jurisdiction.

A motion seeking permission to appeal may be based upon three grounds: (i) the decision conflicts with a prior Court of Appeals decision; (ii) a novel question is presented; or (iii) a question of substantial public importance is presented. Permission is typically sought under (ii) or (iii). The motion must include (a) a concise statement of facts; (b) a statement of the procedural history and

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a showing that the motion is timely; (c) a showing that the Court has jurisdiction; (d) an argument as to why the case merits review; and (e) an identification of portions of the record where the questions sought to be reviewed were preserved for appellate review. Within 10 days taking an appeal by right or by permission, the petitioner must “perfect” the appeal by filing a jurisdictional statement. The petitioner must then file and serve his brief, with the record and original exhibits. Leave to appeal to the Court of Appeals, rarely granted, may be sought if the taxpayer in the Appellate Division. In recent years, the U.S. Supreme Court has granted certiorari to relatively few petitioners involving substantive state tax issues.

The Appellate Division will affirm if it finds the decision was (i) supported by “substantial evidence” and was not (ii) erroneous, arbitrary or capricious. Following submission of the record and briefs, oral argument before five judges will be scheduled in the Appellate Division. Within 4 to 6 weeks, a decision will be handed down. An appeal to the Court of Appeals from an adverse decision of the Appellate Division must be taken within 30 days after being served with a notice of entry. Failure to timely take an appeal is a fatal jurisdictional defect that will foreclose all further relief. The Court of Appeals generally reviews only questions of law. However, it may also review the Appellate Division’s reversal of the administrative tribunal’s finding of fact or exercise of discretion.

## **IX. DECLARATORY RELIEF AGAINST DEPARTMENT OF TAXATION**

Although the administrative dispute mechanism is fairly administered by competent judges, tax disputes often result in manifest unfairness to the taxpayer, since protest and filing deadlines are strictly enforced, notices are unclear, and unintended forfeiture of rights frequently occurs. Taxing statutes are narrowly construed and administrative tribunals have little or no equitable jurisdiction. Moreover, Article 78 proceedings are procedurally and substantively weighted against the taxpayer, the standard of review being the difficult to surmount “arbitrary and capricious” formulation. In the federal arena, suits against the IRS may proceed in federal courts only if the taxpayer has paid the tax and then sues for a refund; otherwise the taxpayer must litigate in Tax Court. The doctrine of sovereign immunity will, with few exceptions, pose an impenetrable bar resulting in dismissal of most actions brought by the taxpayer in federal court, except when expressly authorized by statute.

Yet, the doctrine of sovereign immunity exerts less pull in New York state courts. In fact, the

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Court of Appeals has expressly recognized that administrative remedies are not the sole method of contesting the validity of a taxation statute: “A tax assessment may be reviewed in a manner other than that provided by statute where the constitutionality of the statute is challenged or a claim is made that the statute by its own terms does not apply...” *Slater v. Gallman*, 377 N.Y.S.2d 448. Thus, even a taxpayer who has contested — and lost — in the administrative tribunals, may seek another “day in court” in state supreme court, a naturally more hospitable venue. Moreover, once in supreme court, the Department’s own counsel will mostly likely transfer the file to the Attorney General’s office to litigate the matter. Since the Attorney General may not have the same institutional loyalty to the Department, a satisfactory accord may be reached even where none was possible the Department’s counsel at the administrative tribunals stage.

Challenging the constitutionality of a taxing statute is difficult, as is succeeding in an argument that a taxing statute is unconstitutional or by its terms inapplicable. Nonetheless, the legislature is by no means incapable of enacting vague or unconstitutional statutes, and a serious challenge in supreme court may in the end vindicate the taxpayer’s interests. Thus, in *Tennessee Gas Pipeline Company v. Urbach*, 96 NY2d 124 (2001), a declaratory judgment action, the Court of Appeals reversed the Appellate Division and declared the gas import tax unconstitutional as violative of the Commerce Clause.

In practice, a declaratory judgment action in state supreme court is commenced by filing a summons and complaint as in any other civil action. The usual rules of procedure as provided in the CPLR apply. Often, a complaint is brought on by an order to show cause (OSC) seeking injunctive relief and a stay of collection until a hearing has been held. The Department does not like to litigate outside of its administrative tribunal forum. Nevertheless, a taxpayer who seeks a declaratory judgment and alleges that a statute is unconstitutional or inapplicable is entitled to a judgment declaring the parties’ rights. The appellate division has held that it is improper to ““dismiss’ a complaint seeking a declaratory judgment, since the proper action is to declare that the statute is — or is not — constitutional. If there is a real question as to whether the statute is unconstitutional or inapplicable, the Attorney General, on its client’s — the Department’s — instruction, may seek to resolve the dispute without forcing the court to render a decision on the merits, which could further impede the Department’s efforts to collect tax against other similarly situated taxpayers if the Department were to lose and the statute were held to be inapplicable or unconstitutional.

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Even if the taxpayer seeking a declaratory judgment appears unlikely to succeed on the merits, the mere presence of the taxpayer and his attorney in state supreme court with a Summons and an OSC against the Department and the Commissioner will more likely elicit the attention of an attorney or official with the power and inclination to settle the dispute than would the taxpayer on the receiving end of a telephone call from a collection agent. The declaratory judgment action can be an extremely useful device, especially where other viable options appear few.