SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 61

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CMSG RESTAURANT GROUP, LLC d/b/a LARRY FLYNT'S HUSTLER CLUB, JASON CASH MOHNEY, JOSEPH SULLO, ANTHONY GRANT and MICHAEL GRANT,

DECISION AND ORDER

Plaintiffs,

Index No. 153539/14

- against -

THE STATE OF NEW YORK, NEW YORK STATE DEPARTMENT OF TAXATION and FINANCE, THOMAS H. MATTOX in his Official Capacity as Commissioner of the New York State Department of Taxation and Finance, DONIELLE CHARLAND and TIMOTHY MURPHY, in their Official Capacities as Auditors and/or Supervisors of the New York State Department of Taxation and Finance,

Defendants.

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HON. ANIL C. SINGH, J.:

The entertainment industry is the lifeblood of Manhattan, attracting millions of tourists to New York City, employing thousands of talented people, and generating substantial profits for entertainment venues ranging from simple neighborhood cabarets to lavish Broadway shows. The State of New York taps this lucrative industry as a source of tax revenue, albeit selectively. While legislation exists taxing some forms of entertainment, the General Assembly has, for reasons of public policy, declined to tax other types.

Plaintiff CMSG Restaurant Group, LLC conducts business under the name of Larry Flynt's Hustler Club (the Club), which presents live adult entertainment, including topless dancing and lap dancing. Customers pay a cover charge to enter the club and, once in, buy scrips, the club's in-house currency. Scrips are used to tip employees, such as entertainers, floor

hosts, and bartenders, and to gain admission to private rooms to view entertainment. Defendants imposed sales taxes on the scrips and taxed the amounts paid by the floor hosts to work at the club. In this action, plaintiffs challenge the taxes assessed on the scrips as unconstitutional.

Motion sequence numbers 001 and 002 are consolidated for disposition. In motion sequence number 001, plaintiffs move by order to show cause for a preliminary injunction (1) barring defendants from enforcing the tax law on the ground of unconstitutionality; (2) staying any further adjudication by defendant New York State Department of Taxation and Finance (the Department) in regard to plaintiffs' liability under the tax laws; and (3) staying the Department's attempt to collect further taxes from plaintiffs pending the determination of this application. In motion sequence number 002, defendants move to dismiss the complaint.

The Department conducted a sales and use tax audit of the Club for the period from June 1, 2006, through November 30, 2008. On August 10, 2009, the Department issued a notice of determination to the Club and to each individual member asserting a tax deficiency of $4,874,873.71 plus penalties and interest for the audit period. Subsequent conciliation orders reduced the tax deficiency to $2,113,204.38 and abated all penalties. The tax deficiency is attributable to the sale of scrips and other kinds of income earned by the Club. Plaintiffs contest this audit and an assessment that will be issued for the period December 1, 2010, through May 31, 2013. At the time this lawsuit commenced, the second assessment had not been issued.

Plaintiffs filed petitions for redetermination of the 2006-2008 audit with the Department, which resulted in a hearing before an administrative law judge (ALJ). The ALJ's decision, dated January 30, 2014, upheld the Department's assessment. Plaintiffs filed an appeal of the ALJ's order with the New York Tax Appeals Tribunal (the Tribunal), and then commenced the instant

action on April 11, 2014. The Tribunal has not decided the appeal yet.

The Tax Law defines a place of amusement as "[a]ny place where any facilities for entertainment, amusement, or sports are provided." (Tax Law § 1101(d)(10) [McKinney]). Plaintiffs operate a "place of amusement." Thus, under the authority of Tax Law §1105(f)(1) the Club's admission charges are subject to tax. However, this section provides an exemption for "charges for admission to dramatic or musical arts performance." (*id.*). A "[d]ramatic or musical arts admission charge [is] [a]ny admission charge paid for admission to a theatre, opera house, concert hall or other hall or place of assembly for a live dramatic, choreographic or musical performance" (Tax Law § 1101 [d] [5]). The Tax Law does not provide a definition of "a live dramatic, choreographic or musical performance" (*id.*), or "dramatic or musical arts performances" (Tax Law § 1105 [f] [1]).

Plaintiffs contend that the exemption in Tax Law § 1105 (f) (1) should apply to the Club, as it offers "dramatic or musical arts performances." Moreover, Plaintiffs contend that defendants make an unconstitutional distinction between the type of performances offered at the Club and performances offered in other venues.

Additionally, the Tax Law defines a roof garden, cabaret or similar place as one "which furnishes a public performance for profit" or is "a room in a hotel, restaurant, hall or other place where music and dancing privileges or any entertainment, are afforded the patrons in connection with the serving or selling of food, refreshment or merchandise" (20 NYCRR 527.12 (b)). The entertainment provided at the Club would qualify it as a "roof garden, cabaret or similar place." Thus, under the authority of Tax Law §1105(f)(3) taxes are assessed on the Club for any "charge

made for admission, refreshment, service, or merchandise" within the state. (Tax Law § 1101(d)(4) [McKinney]); (Tax Law §1105(f)(3)).

The Tax Law draws a distinction where no tax is assessed on "a place where merely live dramatic or musical arts performances are offered in conjunction with the serving or selling of food, refreshment or merchandise so long as such serving or selling of food refreshment or merchandise is merely incidental to such performances." (Tax Law §1105(f)(3)). Plaintiffs contend that the distinction exempting taxes in Tax Law § 1105 (f) (3) should apply to the Club since the selling of refreshments at the Club is merely incidental to the performances.

Initially, the ALJ noted in her decision that, under Tax Law § 1132 (c), all taxpayer receipts are presumed to be taxable unless proven otherwise and that, under Tax Law § 689, a presumption of correctness are attached to statutory notices. The ALJ also noted that plaintiffs bear the burden of proving otherwise.

The ALJ defined the issues before her as being whether sales tax was due on the sale of scrips at the Club and on the amounts paid by the floor hosts to work at the Club. Scrips were used for admission to private rooms, lap dances, and to tip the entertainers, floor hosts, and bartenders. The ALJ discussed whether the admission charges to view performances in private rooms were subject to tax. The ALJ distilled the question to whether the performances were live dramatic choreographed musical performances within the meaning of the tax law and thus exempt from tax under Tax Law § 1105 (f) (1) and 1101 (d) (5). The ALJ found that while the Club qualified as a place of amusement, the entertainment offered at the Club did not qualify as exempt under the Tax Law. The ALJ found that the Club is a place of amusement where the

entertainers remove their clothing and create an aura of sexual fantasy. The entertainers perform a striptease that incorporates some dance and choreography, but that is not available for the exemption that is available to dance performances, because the dances at the Club were ancillary to the ultimate service sold, which was sexual fantasy. The Club did not provide dramatic choreographed musical performances, per Tax Law § 1101 (d) (5). Accordingly, the ALJ determined that the admission charges to the private rooms were taxable under section 1105 (f) (1) of the Tax Law.

The ALJ noted that the Club did not distinguish between the scrips attributed to admission charges to the private rooms and the scrips used to pay for other services. Therefore, all the scrip payments were taxable. As for the taxes assessed on the amounts paid by the floor hosts to work at the Club, the ALJ stated that plaintiffs did not demonstrate that such fees were not taxable. Plaintiffs failed to present evidence on the issue. The ALJ sustained the notices of determination issued August 10, 2009, as modified by the conciliation orders.

The ALJ did not rule on the Club's constitutional claims. The ALJ upheld the tax assessment on the basis of Tax Law § 1105 (f) (1), and did not consider the Department's additional theory that scrips were taxable as charges of a roof garden, cabaret, or similar place under Tax Law § 1105 (f) (3). Plaintiffs addressed section (f) (3) in their application to the Tribunal.

In this action, plaintiffs' first cause of action seeks a declaration that Tax Law § 1105 (f) (1) and (3) are unconstitutional on their face and as applied to plaintiffs under Article 1, sections 6, 8, 9 and 11 of New York's constitution, and the First and Fourteenth Amendments of the United States Constitution. The second cause of action seeks a permanent injunction precluding

defendants from enforcing the tax provisions against them and ordering a refund of all payments previously collected under those provisions.

It is argued that the tax laws pose an impermissible prior restraint on speech and expression; impose a direct tax on protected expression; are legislatively and administratively gerrymandered to apply to only a narrow group of taxpayers; and impose a differential tax on protected expression whereby some forms of protected expression are subject to taxation under the challenged tax laws and others are not. Plaintiffs seek an injunction on the grounds that the tax law violates freedom of speech and expression, equal protection, and due process. Alternatively, plaintiffs seek an injunction on the ground that the Club is exempt from taxation under Tax Law § 1105 (f) (1) and (3) because topless dance constitutes a dramatic or musical arts performance.

Defendants argue that plaintiffs have not exhausted their administrative remedies therefore the court lacks subject matter jurisdiction over plaintiffs' claim that the law is unconstitutional as applied to plaintiffs,

One who objects to the actions of an administrative agency must exhaust available administrative remedies before seeking relief in a court of law (*Watergate II Apts. v Buffalo Sewer Auth.,* 46 NY2d 52, 56-57 [1978]). When a constitutional claim hinges upon factual issues reviewable at the administrative level, it should be examined by the responsible administrative agency in order that the necessary factual record be established (*Siao-Pao v Travis*, 23 AD3d 242, 242-243 [1st Dept 2005]; *Matter of Wilkins v Babbar,* 294 AD2d 186, 187 [1st Dept 2002]; *Matter of Roberts v Coughlin*, 165 AD2d 964, 965–966 [3d Dept 1990]). A claim that requires the resolution of mixed factual and legal questions must also be reviewed at

the administrative agency (*Matter of Contest Promotions-NY LLC,* 93 AD3d 436, 437 [1st Dept 2012]).

Here, defendants correctly argue that the exhaustion of administrative remedies doctrine requires that plaintiffs await the decision of the Tribunal and, if the decision is not satisfactory, file an Article 78 petition.

However, an exception to this rule arises when the objecting party claims that the statute is facially unconstitutional or wholly inapplicable to that party, or that resort to an administrative remedy would be futile, or that pursuing such remedy would cause irreparable injury (*id.*; *Coleman v Daines,* 79 AD3d 554, 560 [1st Dept 2010], *affd* 19 NY3d 1087 [2012]). Exhaustion of administrative remedies is also not required where the claim presents a purely legal question that can be resolved without regard to the facts (*Matter of Contest*, 93 AD3d at 437). In such cases, the aggrieved party may apply to a court of law without exhausting its administrative remedies.

In this case, plaintiffs fail to show that the Tax Law is wholly inapplicable to the Club or that waiting for the Tribunal's decision would be futile or that it would cause irreparable injury. Moreover, the court cannot consider the Club's "as-applied" challenge. An "as-applied" challenge requires a court "to consider whether a statute can be constitutionally applied to the defendant under the facts of the case" (*People v Stuart,* 100 NY2d 412, 421 [2003]). The ALJ made a factual finding that the entertainment at the Club was not the kind of performance exempt from tax. This determination hinges upon facts which are reviewable by the Tribunal. Before this court can assess the Club's "as-applied" constitutional challenge to the Tax Law, the nature of what is being taxed – that is, the entertainment at the Club – must be decided. The Tribunal

must make a factual determination whether the Club's entertainment is a dramatic or musical arts performance, and whether the sale of refreshments is incidental to the performances. Accordingly, the issue of whether the law is unconstitutional as applied to plaintiffs is premature.

In contrast to an "as-applied" constitutional challenge, a facial constitutional challenge to a governmental restriction requires a court "to examine the words of the statute on a cold page and without reference to the defendant's conduct" (*id.*). That sections (f) (1) and (3) of Tax Law § 1105 are not facially unconstitutional has already been determined (*Matter of 677 New Loudon Corp. v State of N.Y. Tax Appeals Trib.*, 85 AD3d 1341, 1347 [3d Dept 2011], *affd* 19 NY3d 1058 [2012]).

Both sides cite extensively to *New Loudon,* so it is worth discussing in detail. The petitioner in *New Loudon* operated an "adult juice bar . . . where patrons may view exotic dances performed by women in various stages of undress" (*id.* at 1341). The ALJ found that the fees charged for dances on the stage and dances in private rooms were tax exempt under Tax Law § 1105 (f) (1), and rejected the Division's claim that liability could be imposed under Tax Law § 1105 (f) (3). The Tribunal reversed the ALJ's decision, concluding that sales tax liability could be imposed under each of the cited subdivisions. Petitioner commenced an Article 78 proceeding to challenge the Tribunal's determination. The Third Department upheld the Tribunal's decision.

The Third Department stated that "petitioner failed to meet its burden of establishing that the private dances offered at its club were choreographed performances" (*id.* at 1344). The petitioner's expert, by her own admission, did not view any of the private dances performed at petitioner's club and based her opinion on private dances at other adult entertainment venues

(*id.*). "Given the dearth of evidence on this point, the Tribunal's conclusion that petitioner was not entitled to the requested exemption insofar as it related to the club's couch/private dance sales was entirely rational and, as such, will not be disturbed" (*id.* at 1344-45). In addition to finding that the petitioner did not produce enough evidence, the Third Department found that what evidence was presented did not support the petitioner's viewpoint. The petitioner was not entitled to the application of Tax Law 1105 § (f) (1), because the record showed that the dancers were not required to have any formal dance training, and that and other evidence did not show that the dances were choreographed performances (*id.* at 1345-46).

In regard to Tax Law § 1105 (f) (3), the Third Department upheld the Tribunal's decision that it did not provide a tax exemption for the petitioner (*id.* at 1346). The record upheld the Tribunal's express finding that the petitioner's club constituted a cabaret or similar place where a public performance is staged for profit. The petitioner argued that, because it provides "live dramatic or musical arts performances" and its beverage sales are "merely incidental to such performances," it is outside the taxable reach of Tax Law § 1105 (f) (3). However, the Tribunal had found that the dances offered at the petitioner's club did not constitute "live dramatic or musical arts performances" within the meaning of the statute. The Third Department stated: "Having already found that the Tribunal's resolution of that factual issue was rational, we need not proceed to consider whether petitioner's beverage sales would qualify as incidental" (*id.*). Concerning the constitutional claim, the Third Department held:

> Simply put, each of the statutory provisions at issue is facially neutral and in no way seeks to levy a tax upon exotic dance as a form of expression. Further, and contrary to petitioner's conclusory assertions, there is nothing in the record to suggest that the subject taxing scheme is being applied in a discriminatory manner. Notably, neither the Tribunal's decision nor the underlying statutes

> preclude an adult juice bar from qualifying for the claimed exemptions under a different set of circumstances . . .

(*id.* at 1347).

The Court of Appeals affirmed the Third Department with three judges dissenting, holding that "[p]etitioner's remaining constitutional argument is unavailing" (19 N.Y.3d at 1061).

By affirming the Third Department, the New York Court of Appeals has necessarily ruled that Tax Law §1105(f)(1) and (f)(3) are constitutional on its face. Under the doctrine of stare decisis, we must follow the posture of the highest court in the state. Therefore, plaintiffs' facial challenge of the tax law fails.

On the other hand, Plaintiffs have urged us to take credence to the dissent in *New Loundon*. Judge Smith in the dissent, viewed the case as the State's attempt to tax admission charges paid for dance performances as unconstitutional. Focusing his analysis on the meaning of the word "choreography," Judge Smith suggested that the Tax Appeals Tribunal, which the majority upheld, violated constitutional rights by discriminating on the basis of content.

Even if this court were to adopt the dissent in *New Loudon*, the analysis used in Judge Smith's dissent is inapplicable to the case at bar. A semantic analysis of the word "choreography" or to consider the nuanced distinction between highbrow and lowbrow dancing is a red herring because the Club in the instant action and the juice bar in *New Loudon* charged patrons for services in distinctly different ways. *New Loudon* involved admission charges for dance performance fees collected from patrons. Here, the Club used scrips as a form of in-house currency for a variety of purposes, including admissions to private rooms, and to pay for a variety

of services, including lap dancers and tips to entertainers, hosts and bartenders. Thus the tax is not singling out the dancing at the Club, but rather, equally applying the tax to sale of the scrips by applying the statutory provisions in a facially neutral manner.

Accordingly, defendant's motion to dismiss is granted and plaintiff's motion for a preliminary injunction is denied as moot.

In conclusion, it is

ORDERED that motion sequence number 001 by plaintiffs is denied; and it is further

ORDERED that motion sequence number 002 by defendants to dismiss this action is granted, and the complaint is dismissed without prejudice.

Date: January 28, 2015
New York, New York

Anil C. Singh