STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
JAMES R. SHORTER, JR.	:	DETERMINATION DTA NO. 813571
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law and the New York City Administrative Code for the Year 1991.	:	

Petitioner, James R. Shorter, Jr., c/o Thacher Proffitt & Wood, 2 World Trade Center, 39th Floor, New York, New York 10048, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law and the New York City Administrative Code for the Year 1991.

On June 26, 1995 and July 12, 1995, respectively, James R. Shorter, Jr., Esq., and the Division of Taxation by Steven U. Teitelbaum, Esq. (Susan Hutchison, Esq., of counsel) waived a hearing and agreed to submit this matter for determination based upon the submission of documents and briefs. The Division of Taxation submitted its documentary evidence on August 3, 1995. Petitioner, in turn, submitted his documentary evidence and a brief on September 15, 1995. The Division of Taxation submitted its brief on November 6, 1995, and petitioner submitted his reply brief on February 28, 1996, which began the six-month period for issuance of this determination. After a review of the evidence and arguments submitted, Thomas C. Sacca, Administrative Law Judge, renders the following determination.

ISSUE

Whether petitioner properly computed the amount of his federal deduction for state and local income taxes where petitioner was subject to the federal overall limitation on itemized deductions.

FINDINGS OF FACT

1. Petitioner, James R. Shorter, Jr., filed a New York State and City of New York Resident Income Tax Return, Form IT-201, for the Year 1991. Petitioner computed his state, local and foreign income taxes for purposes of line 40 of Form IT-201 as follows:

INCOME TAXES & OTHER SUBTRACTION ADJUSTMENTS (LINE 40 - IT - 201)

FEDERAL AGI		165,849
FEDERAL WORKSHEET		
1. FED ITEM DED (PRE SEC. 68 LIMIT)		62,980
2. INVESTMENT INTEREST, MEDICAL & CASUALTY AND THEFT LOSSES		(2,440)
3. FED ITEM DED SUBJECT TO LIMIT		60,540
4. FED ITEM DED SUBJ TO LIMIT X 80%		48,432
5. FEDERAL AGI		165,849
6. $100,000 LIMIT		100,000
7. LINE 5 LESS LINE 6 (NOT < 0)		65,849
8. 3% X LINE 7		1,975
9. REDUCTION OF ITEM DED (MIN 4 OR 8)		1,975
10. FED ITEM DED (POST SEC. 68 LIMIT)		61,005
REDUCTION %		3.26%

LINE 40 ADJUSTMENTS NY WORKSHEET (PAGE 14 OF INSTRUCTIONS)		
1. FED ITEM DED SUBJECT TO LIMIT		60,540
2. INC TAXES & SUBTRACTION ADJUSTMENTS		19,885
3. LINE 1 LESS LINE 2		40,655
4. FED ITEM DED WKSHT LINE 9		1,975
5. LINE 3 X 80%		32,524
IS LINE 5 > LINE 4?	YES	
6. LINE 4 LESS LINE 5		0
7. LINE 2 LESS LINE 6		19,885
TAXES PLUS SUBTRACTION ADJUSTMENTS		19,885
APPLY FEDERAL REDUCTION TO TAXES		19,236

In making his computation of total itemized deductions (line 39 of Form IT-201) and the state, local and foreign taxes (line 40 of Form IT-201), petitioner determined that the federal overall limitation on certain itemized deductions under Internal Revenue Code ("IRC") § 68 is applied pro rata to all federal itemized deductions, including the deduction for income taxes paid to a state, local or foreign jurisdiction, that are reduced under Section 68. For purposes of

the New York subtraction modification, the amount of the federal deduction for such taxes is determined after the application of the percentage reduction computed for federal income tax purposes.

2. After audit, the Division of Taxation ("Division") claimed that petitioner made the following errors in his computation of New York itemized deductions:

a. petitioner incorrectly carried over the amount on line 26 of his Internal Revenue Service Form 1040, Schedule A, to line 39 of his Form IT-201[1]; and

b. petitioner incorrectly reported state, local and foreign income taxes from line 5 Form 1040, Schedule A to line 40 of Form IT-201.

According to the Division, since petitioner's federal adjusted gross income exceeded $100,000.00, he was subject to an overall limitation on certain of his claimed itemized deductions, pursuant to IRC § 68 (i.e., 3% of the taxpayer's adjusted gross income in excess of $100,000.00, however, limited in that total otherwise allowable itemized deductions may not be reduced by more than 80%). Section 68 of the IRC reduces certain itemized deductions in excess of the above-described limit from the total otherwise allowable itemized deductions. Section 68 does not specifically reduce the certain itemized deductions by a pro rata amount. In effect, on petitioner's resident income tax return, Form IT-201, federal itemized deductions are reported after the federal limitation is applied.

3. On September 26, 1994, the Division issued to petitioner a Statement of Proposed Audit Changes which decreased petitioner's itemized deductions as shown on his 1991 New York State resident income tax return. The Division arrived at the adjustment of $1,968.00 to petitioner's New York taxable income by decreasing the amount of total itemized deductions that appeared on line 39 of petitioner's income tax return, Form IT-201, and increasing the amount of state, local and foreign income taxes that appeared on line 40 of petitioner's income tax return, Form IT-201. The resulting increase to taxable income caused a tax increase of

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[1]Petitioner conceded in his brief that he incorrectly carried over the amount in line 26 of IRS Form 1040, Schedule A to line 39 of Form IT-201.

$242.39. The Statement of Proposed Audit Changes indicated that interest and penalties were imposed pursuant to sections 684(a) and 685(b)(1) and (2) of the Tax Law.

4. On November 7, 1994, the Division issued to petitioner a Notice of Deficiency for the Year 1991 indicating total amount of tax, penalty and interest due of $317.19. However, petitioner made payment of $211.15 leaving tax, penalty and interest due of $106.04.

CONCLUSIONS OF LAW

A. In determining an individual's New York taxable income, federal itemized deductions are reduced by certain amounts as set forth in Tax Law § 615(c). The New York itemized deduction of a resident individual, (assuming such taxpayer has elected and is permitted the itemized deduction), is defined in Tax Law § 615(a) as:

> "[T]he total amount of his deductions from federal adjusted gross income, other than federal deductions for personal exemptions, as provided in the laws of the United States for the taxable year, <u>with the modifications specified in this section</u>, except as provided for under subsection (f) of this section."

Tax Law § 615(c) provides:

> "(c) Modifications reducing federal itemized deductions. The total amount of deductions from federal adjusted gross income shall be reduced by the amount of such federal deductions for:
>
> (1) income taxes imposed by this state or any other taxing jurisdiction . . ."

The statute further provides that the amount of the federal deduction for state, local and foreign income taxes constitutes the New York subtraction adjustment. The Division's position is that petitioner's federal deduction for state and local income taxes is the amount as shown on Form 1040, Schedule A, line 5 ($19,885.00). This is based upon New York personal income tax regulation § 115.2(g).[2] Petitioner's position is that his federal deduction for state and local income taxes is 3.26% less than the amount shown on Form 1040, Schedule A, line 5, or $19,236.00.

B. Pursuant to Internal Revenue Code § 68, for tax years beginning after 1990, an individual whose adjusted gross income exceeds a specified threshold amount is required to

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[2]For 1991, the regulation was then current § 117.11(g); renumbered § 115.2(g).

reduce the amount allowable for itemized deductions by the lesser of (i) 3% of the amount by which adjusted gross income exceeds such threshold amount or (ii) 80% of the total amount of otherwise allowable itemized deductions (IRC § 68[a]). The original threshold amount was $100,000.00, and beginning in 1992, the threshold was adjusted for cost of living increases. Certain itemized deductions (medical expenses, investment interest and casualty and gambling losses) are excluded from the reduction under IRC § 68(c). Additionally, the overall reduction of the itemized deductions to which § 68(a) does apply may not exceed 80% of the total itemized deductions (IRC § 68[a][2]). In 1991, as applied to petitioner, the 80% limitation did not apply, and petitioner's itemized deductions for taxes, interest and charitable deductions were reduced by $1,975.00 (i.e., 3.26% of total itemized deductions shown in Schedule A of Federal Form 1040). IRC § 68 does not provide for allocation of the reduction to specific itemized deductions. In fact, it only specifies the specific classes of itemized deductions to which the reduction does not apply and presumably, therefore, to which the reduction would not be allocated. Nor does the 80% "cap" as to the maximum reduction of itemized deductions provide for its allocation to specific deductions. Subject to that cap, the amount of the reduction of itemized deductions is based solely upon 3% of the amount by which adjusted gross income exceeds the threshold amount. However, as this gross reduction amount does not relate to any particular deduction, and IRC § 68 does not provide any basis for an allocation, a pro rata allocation among the itemized deductions that are subject to this overall limitation is appropriate.

C. The Division argues that there is no basis for petitioner's position that IRC § 68 requires a pro rata allocation. Petitioner responds that the amount of the federal deduction for income taxes should be determined by assuming that IRC § 68 requires a pro rata allocation among the itemized deductions subject to the federal overall limitation on itemized deductions. IRC § 68 does not specifically provide an allocation method because the Federal scheme does not require allocation for purposes of determining a taxpayer's current year's tax. IRC § 68 reduces certain itemized deductions in excess of the above-described limit from the otherwise

allowable itemized deductions. Tax Law § 615(c)(1) provides that the amount of taxes deducted for Federal income tax purposes constitutes the New York subtraction adjustment. It does not specify the method for determining the Federal deduction. As previously discussed, IRC § 68 does not prescribe any specific allocation of the Federal overall limitation to specific deductions. It would therefore be reasonable to assume that both provisions apply the pro rata principle for apportioning expenses on other amounts that are attributable to more than one item, by allocating such amount pro rata in accordance with the relative amounts of the individual items included in the base to which the allocation is applied. Such method of allocation was applied for purposes of Tax Law § 615(c)(3) by the Division and sustained by the Appellate Division in Golden v. State Tax Commission (90 A.D. 2d 941, 457 N.Y.S. 2d 905). In Golden, the taxpayer incurred investment expenses largely attributable to the operation of an office in which investment decisions were made. A portion of the taxpayer's investment income was from U.S. Treasury Bills. The court held that the investment expenses should be allocated to the otherwise exempt income from U.S. Treasury Bills in the same proportion as the income from such Treasury Bills is to total income. Accordingly, a pro rata portion of such expenses was treated as allocable to tax exempt income for purposes of Tax Law § 615(c)(3), which resulted in a deficiency. This is the situation at issue herein, also involving Tax Law § 615(c), regarding an allocation of a reduction against the specific deductions to which such reduction is applied under IRC § 68.

D. In establishing the amount of petitioner's New York itemized deduction, the Division relies on 20 NYCRR 115.2(g)(1), which provides as follows:

> "(g) (1) Cap on modifications where a resident individual is subject to the Federal overall limitation on itemized deductions.
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> (i) In the case of a resident individual subject to the Federal overall limitation on itemized deductions pursuant to section 68 of the Internal Revenue Code, the total of the modifications referred to in subdivisions (a) through (f) of this section shall not exceed the Federal tax benefit of the itemized deductions subject to such modifications. The Federal tax benefit is the amount of itemized deductions subject to such modifications which, after application of the Federal overall limitation, results in an increase in total Federal itemized deductions allowed for Federal purposes, assuming that the Federal overall limitation applies first to those Federal itemized deductions which are not subject to such modifications. The

amount of the Federal tax benefit is determined by calculating the difference between the total Federal itemized deductions (after application of all Federal limitations other than the Federal overall limitation), computed with and without the itemized deductions subject to modification under such subdivisions (a) through (f), which are allowed after application of the Federal overall limitation. In other words, the amount of the Federal tax benefit is the excess of

(a) the Federal itemized deduction actually allowed over

(b) a hypothetical Federal itemized deduction allowed, computed as if the itemized deductions not subject to modification were the taxpayer's only Federal itemized deductions. In the case of an individual subject to the Federal overall limitation based upon 3 percent of Federal adjusted gross income, the cap on modifications will only apply when the amount of the Federal overall limitation exceeds the hypothetical Federal itemized deduction. In the case of an individual subject to an overall limitation based upon 80 percent of Federal itemized deductions, the cap on modifications will always apply.

(ii) This rule follows the Federal method applying the tax benefit rule and provides an ordering of the itemized deductions subject to the Federal overall limitation such that the limitation is first applied to those itemized deductions for which a New York subtraction modification is not required. Under this ordering convention, a taxpayer will, in most cases, recognize a full Federal tax benefit of the itemized deductions for which New York subtraction modifications are required and such taxpayer accordingly will be required to subtract the full amount of the subtraction modifications.

The New York personal income tax regulation provides an "ordering convention" with respect to itemized deductions subject to the "Federal overall limitation" under IRC § 68, such that the limitation is first applied to those itemized deductions for which a New York subtraction modification is not required (see, 20 NYCRR § 115.2[g][1][ii]). As stated in the regulation, this ordering convention will in most cases reduce a taxpayer's New York itemized deductions by the full amount of the itemized deduction for income taxes and other items to which the New York subtraction modification applies. This is accomplished under the regulation by limiting the New York subtraction modification to the so-called "Federal tax benefit" as referred to in the regulation of the Federal itemized deduction subject to the Federal overall limitation. The Federal tax benefit for purposes of this regulation is the amount by which (a) the Federal itemized deduction actually allowed (i.e., after application of the Federal overall limitation) exceeds (b) a hypothetical itemized deduction that would have been allowed, if the itemized deductions that are not subject to the New York subtraction modification were

the taxpayer's only Federal itemized deductions. To determine such hypothetical Federal itemized deduction, the regulation appies an ordering convention that assumes the Federal overall limitation first reduces deductions not subject to the New York subtraction modification. This ordering convention fails to apply the more generally accepted pro rata method of allocation. As a result of the use of the ordering convention in computing the excess of (a) over (b), the only circumstances in which the New York subtraction modification under Tax Law § 615(c)(1) would be less than the entire amount of New York Income Taxes paid by a taxpayer (and other deductions subject to the New York subtraction modification) are: (i) if all of the taxpayers' Federal itemized deductions were subject to the New York subtraction modification (in which case there would be no other deductions against which to apply the Federal overall limitation) or (ii) if the 80% Federal cap on the reduction applies (in which event the cap would apply to the deductions subject to the New York subtraction modification). To illustrate this, the regulation states that:

> "In the case of a individual subject to the Federal overall limitation based upon 3% of Federal adjusted gross income, the cap on modifications will only apply when the amount of the Federal overall limitation exceeds the hypothetical Federal itemized deduction. In the case of an individual subject to an overall limitation based upon 80 percent of Federal itemized deductions, the cap on modifications will always apply."

The regulation adopts an approach whereby the New York itemized deductions for income taxes are reduced, first by the pro rata portion of the Federal overall limitation under IRC § 68 and, then, the full amount of such taxes are subtracted from itemized deductions by application of the ordering convention.

E. The Division asserts that the regulation implements the policy underlying Tax Law § 615(c) of not allowing any deduction of income taxes. The Division's theory is that, after applying the methodology comparing the actual to the hypothetical Federal itemized deduction, the allowable New York itemized deduction is identical to the result which would be obtained had the itemized deduction subject to modifications not been allowed as Federal itemized deductions. In effect, the use of the ordering convention is justified on the basis that, except in the limited circumstances noted above, it results in the inclusion of the full amount of the taxes

in the New York subtraction adjustment (notwithstanding the Federal overall limitation, which if applied on a pro rata basis would reduce the amount of such subtraction modification). Stated another way, income taxes are not deductible pursuant to Tax Law § 615(c)(1), therefore, any methodology that results in the maximum exclusion of such income taxes furthers the statutory purpose. However, such reasoning does not assist in determining what portion of such income taxes actually were deducted for Federal income tax purposes. Furthermore, failure to allocate the IRC § 68 Federal overall limitation to all itemized deductions, including income taxes, before determining the New York subtraction adjustment, goes beyond disallowance of deductibility of income taxes. In effect, the itemized deduction for income taxes that already was reduced, based on a pro rata allocation of the IRC § 68 reduction (the starting point for determining the New York itemized deductions) is again reduced by the same amount under the New York subtraction adjustment using the Division's ordering convention. Consequently, the portion of the income tax deduction is disallowed twice. Surely, this goes beyond the policy that such taxes are not deductible for New York income tax purposes. To prevent such double disallowance, the IRC § 68 reduction should be applied to taxes using the pro rata rule discussed above.

F. The Division asserts that the regulation conforms to Federal policy regarding the tax treatment of state tax refunds and other similar payments with respect to IRC § 68. The description in the House-Senate Conference Committee Report relating to the enactment of IRC § 68 does in fact state:

> "For purposes of determining the tax treatment of State income tax refunds and other similar payments, the present-law tax benefit rule applies." (H.R. Rep. 101-964, 101st Cong. 2d Sess. 1032[1990]).

Application of the tax benefit rule to state income tax refunds was discussed in the legislative history of the 1984 amendments to IRC § 111. The Senate Finance Committee Report stated:

> "The treatment accorded under section 111 to State income tax refunds and other itemized deductions subject to the zero bracket amount or similar statutory floor fails to reflect economic reality in certain cases. The statute assumes that a taxpayer first recovers the portion (if any) of the amount deducted in the prior year

> that did not reduce taxable income.[3] The assumption that the first dollars recovered are not those which produced a tax benefit may, in certain cases, be erroneous and produce a windfall to the taxpayer.
>
> Thus, in the above example, the couple claimed excess itemized deductions of $300 in 1983 and reduced their total taxable income by that amount. If they had deducted only those taxes which they actually owed to the State, they would have claimed only $100 in excess itemized deductions ($3,200 other itemized deductions, plus $300 State taxes, less the $3,400 zero bracket amount). By allowing them to recover $200 without tax consequences, the regulations fail to achieve the tax benefit rule's objective of putting taxpayers in roughly the same position as if the "erroneous" deduction had never been taken.
>
> The committee has concluded that the law should be amended to more accurately reflect the tax benefit concept." (S. prt. 98-169, V1.I[April 2, 1984] at 472-73).

Thus the treatment of tax refunds under the tax benefit rule was modified in 1984 to differ from the treatment applied to other items under the tax benefit rule. The Federal policy with regard to tax refunds in this instance was not an attempt to determine whether the taxpayer's deduction produced a tax benefit, but rather to avoid permitting a taxpayer who in effect deducted more taxes than were properly payable from obtaining a windfall when such overpayment was refunded. To do otherwise creates an incentive for taxpayers to overpay (and deduct) state income taxes in year one so that they can obtain a tax-free refund thereof in year two. The Federal computational rule achieves that result. However, Tax Law § 615(c) does not apply to tax refunds. It applies to all tax payments that are deducted for Federal purposes, and for this purpose it should be assumed that all such taxes were properly payable. All payment of taxes, not merely payments of the correct amount, are subject to Tax Law § 615(c)(1). Consequently, the abuse that Congress sought to prevent in amending IRC § 111 is not present here.

The Division's interpretation of the tax benefit rule also overlooks its fundamental purpose. The tax benefit rule is a judicially developed doctrine designed to ameliorate some of the inflexibilities of annual accounting periods and approximate the results produced by a tax system based on transactional, rather than annual, accounting (Frederick v. Commissioner, 101

[3] The portion that did not reduce taxable income will be the difference between the taxpayer's other itemized deductions and the zero bracket amount.

T.C. 35,40). IRC § 111 is a partial codification of the tax benefit rule which generally requires the inclusion in income of amounts that were deducted in a prior tax year to the extent that those amounts generated a tax benefit through a reduction in the amount of tax liability in the prior tax year. The tax benefit rule only is applied when a subsequent event (such as a refund of a tax overpayment) occurs which is fundamentally inconsistent with the premise on which an earlier deduction is based. The purpose of the rule is to achieve rough transactional parity within the frame work of a tax system requiring annual calculations (Rev. Rul. 92-91, 1992-2 C.B. 49, 50). Thus, the tax-benefit rule requires inclusion of an amount in gross income in the current year to the extent that the amount was deducted in a prior year, the deduction resulted in a tax benefit, and an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based and a non-recognition provision of the IRC does not prevent inclusion in gross income (Frederick v. Commissioner, supra).

In the context of IRC § 68, the Internal Revenue Service promulgated a Revenue Ruling that used a computational method similar to that stated in the New York tax regulations relating to Tax Law § 615. This Revenue Ruling is premised on application of the tax benefit rule, but with specific emphasis on the concept that this computational method merely puts the taxpayer in the same position as if the proper amount of taxes had been deducted in the prior year. Again the desired policy result is to prevent taxpayers from obtaining a windfall with respect to recoveries of tax payments for prior years that were refunded because they were not properly payable in the earlier year (see, Rev. Rul. 93-75, 1993-2 C.B. 63, 64). Tax Law § 615(c)(1) is not concerned with the same policy. It is not aimed at preventing overpayments of New York State income tax, but rather to add back amounts allocable to taxes that actually were applied on a Federal return as itemized deductions that reduce taxable income, and the amount of which are included in the New York itemized deduction in Line 39 of Form IT-201 before application of the New York subtraction adjustment.

G. Petitioner's argument that the regulation is unconstitutional because it was not promulgated with respect to any change in the New York Tax Law must be rejected. The Court

of Appeals, in National Elevator Industry, Inc. v. New York State Tax Commission, (49 NY2d 538, 427 NYS2d 586), recognized that an administrative agency was free to make changes, on a prospective basis, of its interpretations of the tax law. The Court said:

> "We know of no rule of law (surely there is no constitutional proscription) against altered or inconsistent prospective rulings in the administration of tax laws. Indeed the administration of tax laws would be unacceptably hobbled were there any such inhibiting rule of law. The taxing authorities are not to be foreclosed from the rational application for the future shifts in understandings of the economic realities of underlying transactions, of movement in the judicial reading of legislative enactments or of other forms of new wisdom born of experience. Indeed with the enactment of the State Administrative Procedure Act in 1975 the Legislature expressly recognized the authority of administrative agencies of State government to change rulings prospectively: '[N]othing in this section shall prevent an agency from prospectively changing any declaratory ruling.' (§ 204.)".

Thus, contrary to petitioner's argument, the regulation is a valid attempt to interpret Tax Law § 615(c)(1). Alternatively, even if there was some requirement (which there clearly is not) that an administrative agency could promulgate regulations only in response to a statutory change, this regulation was issued in an attempt to cap what could otherwise be an excessive subtraction modification from itemized deductions. This potentially excessive modification arose from the changes to the IRC, enacted as part of the Revenue Reconciliation Act of 1990, which flowed through to the New York State personal income tax as a result of federal conformity. Based upon the foregoing, it is evident that the regulation was constitutionally enacted.

H. Petitioner argues that the negligence penalty should be abated with respect to his mistake in carrying over the amount on Line 26 of Form 1040, Schedule A to Line 39 of Form IT-201 (which suggests that the Lines above it are totaled) and the absence of explicit instructions for Line 39, which contributed to this error. In addition, petitioner claims that the negligence penalty should be abated with respect to the amount of the deduction he claimed for state, local and foreign income taxes because he made a good faith challenge of the applicability and correctness of the relevant personal income tax regulation.

Negligence is the lack of due care in failing to do what a reasonable and ordinarily prudent person would do under the circumstances (Marcello v. Commissioner, 380 F2d 499; Kelly v.

Commissioner, 29 TCM 1090). Petitioner's filing of an incorrect return as a result of a honest mistake in carrying over the amount on Line 26 of his Form 1040, Schedule A, are insufficient grounds for the imposition of the negligence penalty (Bennett v. Commissioner, 139 F2d 961; United States v. Fuller, 42 F2d 471; Wirt v. Commissioner, 55 TCM 1369; Chippi v. Commissioner, 30 TCM 1014; Marcelle v. Commissioner, 15 TCM 1174).

Petitioner may be guilty of negligence even though he has made a good faith challenge to the amount of his deduction for state, local and foreign taxes (Evans v. Commissioner, 235 F2d 586; Kelly v. Commissioner, supra). Here, however, imposing the negligence penalty upon petitioner is not appropriate because there existed a bona fide dispute between petitioner and the Division as to the proper amount of the deduction (McKinley v. Commissioner, 37 TCM 1769; Imhoff v. Commissioner, 29 TCM 966).

I. The petition of James R. Shorter, Jr. is granted; and the Notice of Deficiency dated November 7, 1994 is cancelled.

DATED: Troy, New York
August 22, 1996

/s/ Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE