STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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| In the Matter of the Petitions<br>of<br>**FIVE STAR EQUIPMENT, INC.**<br>for Redetermination of Deficiencies or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 2007, 2008 and 2010. | DECISION<br>DTA NOS. 824861 AND 825006 |

Petitioner, Five Star Equipment, Inc., filed an exception to the determination of the Administrative Law Judge, issued on March 13, 2014. Petitioner appeared by Hancock Estabrook, LLP (Richard E. Scrimale, Esq., and James P. Youngs, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Robert J. Tompkins, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a letter brief in opposition. Petitioner filed a reply brief. Oral argument was heard in Albany, New York on October 15, 2014, which date began the six-month period for the issuance of this decision.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

## *ISSUES*

I. Whether, pursuant to Tax Law § 208 (9) (f) (3), petitioner's New York State net operating loss deduction for a given year may not exceed the net operating loss deduction taken on its federal tax return for that year and must arise from the same source year as that federal net operating loss deduction.

II. Whether the Division of Taxation's disallowance of certain New York net operating

losses carried forward and claimed as deductions by petitioner on its 2007, 2008 and 2010 corporation franchise tax returns, based on the foregoing net operating loss deduction limitation rules of Tax Law § 208 (9) (f) (3), violated the Supremacy Clause, Commerce Clause or Privileges and Immunities Clause of the United States Constitution or the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution.

## *FINDINGS OF FACT*

We find the facts as determined by the Administrative Law Judge except for finding of fact "5," which has been modified to more accurately reflect the record. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

1. Petitioner, Five Star Equipment, Inc., is a Pennsylvania corporation authorized to do business in New York State. Included among petitioner's business activities is the purchase of different types of heavy construction machinery and equipment, some of which is resold and some of which is rented.

2. Petitioner timely filed a U. S. income tax return for an S corporation (Form 1120S) and a New York State general business corporation franchise tax return (Form CT-3) for each of the years 2004 through 2010, including the three years (2007, 2008 and 2010) at issue in this proceeding. The federal and New York State amounts of income and loss for these years are as follows:

| YEAR | FED. INCOME | NYS INCOME | FED. NOL | NYS NOL |
|---|---|---|---|---|
| 2004 | ($4,253,678.00) | $91,2234.00 | ($4,253,678.00) | $0.00 |
| 2005 | $2,736,990.00 | ($3,332,175.00) | $0.00 | ($3,332,175.00) |
| 2006 | $715,147.00 | ($732,394.00) | $0.00 | ($732,394.00) |

| | | | | |
|---|---|---|---|---|
| 2007 | $952,181.00 | $585,457.00 | $0.00 | $0.00 |
| 2008 | ($1,119,668.00) | $431,706.00 | ($1,119,668.00 | $0.00 |
| 2009 | ($88,043.00) | ($572,860.00) | ($88,043.00) | ($572,860.00) |
| 2010 | $489,321.00 | $4,135,647.00 | $0.00 | $0.00 |

3. For the years 2004 through 2010, petitioner utilized its net operating losses as follows:

| YEAR | FED. NOL UTILIZED | SOURCE YEAR | NYS NOL UTILIZED | SOURCE YEAR |
|---|---|---|---|---|
| 2004 | $0.00 | n/a | $0.00 | n/a |
| 2005 | $0.00 | n/a | $0.00 | n/a |
| 2006 | $362,178.00 | 2004 | $0.00 | n/a |
| 2007 | $952,181.00 | 2004 | $585,457.00 | 2005 |
| 2008 | $0.00 | n/a | $431,706.00 | 2005 |
| 2009 | $0.00 | n/a | $0.00 | n/a |
| 2010 | $489,321.00 | 2004 | $2,315,012.00 | 2005 |
| 2010 | n/a | n/a | $732,394.00 | 2006 |
| 2010 | n/a | n/a | $572,860.00 | 2009 |

4. As set forth above, for each of the three years in issue (2007, 2008 and 2010), petitioner reported New York State income and offset the same by claimed net operating losses, as follows:

> a) 2007: Petitioner reported New York State income in the amount of $585,457.00, and claimed an offsetting New York net operating loss deduction (NOLD) in the amount of $585,457.00, representing a portion of the $3,332,175.00 New York net operating loss (NOL) incurred in and carried forward from the year 2005.
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> b) 2008: Petitioner reported New York State income in the amount of $431,706.00, and claimed an offsetting New York NOLD in the amount of $431,706.00, representing a portion of the remaining $2,746,718.00 balance of the New York NOL incurred in and carried forward from the year 2005.

c) 2010: Petitioner reported New York State income in the amount of $4,135,647.00, and claimed a partially offsetting New York NOLD in the amount of $3,620,266.00, based upon the remaining $2,315,012.00 balance of the New York NOL incurred in and carried forward from the year 2005, plus a $732,394.00 New York NOL incurred in and carried forward from the year 2006, and a $572,860.00 New York NOL incurred in and carried forward from the year 2009.

5. The Division of Taxation (Division) reviewed petitioner's franchise tax returns for each of the years in issue. On October 25, 2010, the Division issued to petitioner a notice of deficiency asserting additional corporation franchise tax due for the years 2007 and 2008 in the respective amounts of $26,660.00 and $16,667.00, plus interest. On February 10, 2012, the Division issued to petitioner a notice of deficiency asserting additional corporation franchise tax due for the year 2010 in the amount of $160,950.00, plus interest.

6. The foregoing deficiencies result from the Division's disallowance of the New York NOLDs claimed by petitioner for each of the years at issue because the same did not correspond to the source years and amounts of petitioner's Federal NOLDs for such years, as follows:

a) 2007: Petitioner offset its federal taxable income of $952,181.00 by a federal NOLD in the same amount arising and carried forward from a federal NOL for the year (source year) 2004. In contrast, petitioner's 2007 New York State income of $585,457.00 was offset by a New York NOLD in the same amount arising, carried forward from and consisting of a portion of petitioner's New York NOL ($3,332,175.00) for the year 2005 (source year). Since the source year (2005) of the New York NOLD claimed for 2007 differed from the source year (2004) of the NOL upon which the federal NOLD claimed for 2007 was based, the Division disallowed the claimed 2007 New York NOLD.

b) 2008: Petitioner did not have federal taxable income but rather had a current year (2008) Federal NOL, $1,119,668.00. In contrast, petitioner's 2008 New York State income of $431,706.00 was offset by a New York NOLD in the same amount arising, carried forward from and consisting of a portion of the remaining $2,746,718.00 balance of petitioner's New York NOL carried forward from the year 2005 (source year). Since petitioner had no federal NOLD for 2008, the Division disallowed the claimed 2008 New York NOLD.

c) 2010: Petitioner offset its federal taxable income of $489,321.00 by a federal NOLD in the same amount arising and carried forward from a federal NOL for the year (source year) 2004. In contrast, petitioner's 2010 New York State income of $4,135,647.00 was (partially) offset by a New York NOLD in the amount of $3,620,266.00 arising, carried forward from and consisting of:

i) the remaining $2,315,012.00 balance of petitioner's New York NOL ($3,332.175.00) for the year 2005 (source year);

ii) $732,394.00 representing petitioner's New York NOL for the year 2006 (source year); and

iii) $572,680.00 representing petitioner's New York NOL for the year 2009 (source year).

Since the source years (2005, 2006 and 2009) of the New York NOLD claimed for 2010 differed from the source year (2004) of the NOL upon which the federal NOLD claimed for 2010 was based, the Division disallowed the claimed 2010 New York NOLD.

7. As described above, the deficiencies asserted by the Division are based on the facts that: a) the New York NOLD claimed by petitioner for 2007 was from a different source year than the federal NOLD claimed for 2007; b) there was no federal NOLD for 2008 and thus the amount of the New York NOLD claimed for 2008 exceeded the amount of the federal NOLD claimed for 2008; and, c) the New York NOLD claimed for 2010 was from different source years and exceeded the amount of the federal NOLD claimed for 2010.

8. Petitioner attributes the variation in its annual federal versus New York State income or loss amounts, in large part, to the differences between the amounts of depreciation allowable as a business deduction at the federal level versus the amounts allowable under Tax Law Article 9-A. More specifically, the Internal Revenue Code (IRC) provides for various accelerated rates

of depreciation with respect to qualified business property.[1] In contrast, as of 2003, Article 9-A limited the amount of depreciation to that computed using the straight-line method of calculation. This limitation of New York depreciation versus federal depreciation, imposed by enactment of the New York State Legislature in 2003, is commonly referred to as federal/state decoupling.[2] The differences in the amounts and timing of allowable depreciation deductions resulting from decoupling contribute (here significantly) to the year-to-year net income or net loss results for federal versus New York State purposes. In turn, and in conjunction with the NOL amount and source year deduction limitation rules of Article 9-A, these year-to-year differences can, and in this case did, result in the disallowance and loss of net operating loss deductions that would be available where federal and state income and loss years are more closely aligned.

***THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE***

Addressing the first issue, the Administrative Law Judge noted that this Tribunal and the Court of Appeals have upheld both the amount and source year limitations on the NOLD (***see e.g. Matter of Refco Properties, Inc.***, Tax Appeals Tribunal, July 11, 1996; ***Matter of Royal Indem. Co. v Tax Appeals Trib.***, 75 NY2d 75 [1989]). The Administrative Law Judge dismissed petitioner's contention that these rules were based upon an erroneous interpretation of Tax Law § 208 (9) (f) (3) because the same argument has been repeatedly rejected (***Matter of Lehigh***

[1] It is undisputed that during the period 2004 through 2010 (and beyond) Congress enacted various provisions allowing, extending or expanding the amount of depreciation that could be deducted as a business expense. Hereinafter, for simplicity, federal depreciation may be generically referred to as accelerated or bonus depreciation.

[2] At the New York State level, this depreciation limitation is one of several addition/subtraction modifications required to be made in determining entire net income. In this instance, there is an addition (add-back) modification for federal depreciation and an accompanying subtraction modification for allowable New York depreciation (***see generally*** Tax Law § 208 [9]). The resulting federal/state difference essentially reflects the federally available opportunity to front-load depreciation deductions resulting, in some instances, in federal net operating losses in earlier years as opposed to the operating results obtained from the relatively smaller depreciation deductions allowable but spread over a longer period of time at the New York State level under Article 9-A.

***Valley Indus.***, Tax Appeals Tribunal, May 5, 1988; ***Matter of Eveready Ins. Co. v New York State Tax Commn.***, 129 AD2d 958 [1987], ***lv denied*** 70 NY2d 604 [1987]; ***Matter of Aetna Cas. & Sur. Co. v Tax Appeals Trib. of State of N.Y.***, 214 AD2d 238 [1995], ***lv denied*** 87 NY2d [1996]). Comparing the foregoing cases to this matter, the Administrative Law Judge determined that the creation of misalignments between a taxpayer's federal and New York NOL neither impacts nor invalidates the New York limitations on its state NOLD.

Observing that the decoupling of New York and federal rules produced the instant result, the Administrative Law Judge found that this situation does not differ from others where deductions are available at the federal level but not at the state level (***see e.g. Matter of Karlsberg v Tax Appeals Trib. of State of N.Y.***, 85 AD3d 1347 [2011], ***lv dismissed*** 17 NY3d 900 [2011]). The Administrative Law Judge also noted that, as the Legislature affirmatively acted to decouple New York and federal depreciation rules in 2003, it apparently knew of the effect. As such, the Administrative Law Judge noted that the remedy, if any, would rest with the Legislature. Based upon the foregoing, the Administrative Law Judge held that the Division properly disallowed the deductions at issue using the amount and source year limits.

Addressing the second issue, the Administrative Law Judge observed that facial challenges to a statute's constitutionality remain outside of this agency's jurisdiction (***Matter of Eisenstein***, Tax Appeals Tribunal, March 27, 2003), but a taxpayer may challenge whether the application of a statute is constitutional (***Matter of David Hazan, Inc.***, Tax Appeals Tribunal, April 21, 1998, ***confirmed sub nom Matter of David Hazan, Inc. v Tax Appeals Trib. of State of N.Y.*** 152 AD2d 765 [1989], ***affd*** 75 NY2d 989 [1990]). In such cases, the Administrative Law Judge noted, petitioner bears the burden of proving unconstitutionality (***Matter of Brussel***, Tax Appeals Tribunal, June 25, 1992).

The Administrative Law Judge first addressed petitioner's implied preemption argument under the Supremacy Clause (US Con, Art VI, Cl 2), namely that the decoupling, caused by New York's amount and source year rules, conflicted with the congressional objectives behind adopting accelerated and bonus depreciation provisions (***see Fidelity Fed. Sav. & Loan Assoc. v De La Cuesta***, 458 US 141 [1982]; ***Balbuena v IDR Realty LLC***, 6 NY3d 338 [2006]; ***Crosby v Natl Foreign Trade Council***, 530 US 363 [2000]). The Administrative Law Judge observed that, while the goals of the accelerated, or bonus, depreciation were clear, taxpayers, including petitioner, were free to utilize that method or a depreciation method that would not create a misalignment between federal and New York NOL. However, as noted by the Administrative Law Judge, petitioner failed to provide any indication that Congress either implicitly or expressly intended to bind the States to the federal bonus depreciation rules (***see Mobil Oil Corp. v Commissioner of Taxes of Vermont***, 445 US 425 [1980]). As such, the Administrative Law Judge held that petitioner failed to carry its burden on this point.

The Administrative Law Judge then considered the contention that the application of the amount and source year limitations violated the Commerce Clause (US Con, Art I, § 8, Cl 3). The Administrative Law Judge rejected the premise of this argument because, regardless of whether an entity operated exclusively within New York, exclusively outside of New York, or both within and outside of New York, it could elect to avail itself of the bonus depreciation (***compare R. J. Reynolds Tobacco Co. v City of N.Y. Dept. of Fin.***, 237 AD2d 6 [1997], ***lv dismissed*** 91 NY2d 956 [1998], ***motion for reconsideration denied*** 92 NY2d 874 [1998]). The Administrative Law Judge explained that entities operating exclusively within New York, as well as those operating both within and outside of New York, face the same choice between using either bonus depreciation or straight line depreciation, and the same consequences. Based upon

the foregoing, the Administrative Law Judge found no merit in the claim that the application of the amount and source year limits results in a Commerce Clause violation.

Similarly, the Administrative Law Judge rejected the claim that the application of the amount and source year limitations violated the Equal Protection Clause, as well as the Privileges and Immunities Clause (US Con, Art IV, § 2). The Administrative Law Judge noted that the courts rejected this argument in ***Matter of Aetna***, and that states may forego strict conformity with federal tax rules, resulting in such effects as the unavailability or disallowance of certain deductions, without violating constitutional limitations (***Matter of Greco Bros. Amusement Co. v Chu***, 113 AD2d 622 [1986]). The Administrative Law Judge also observed that the broad legislative goal of assuring stability in state finances provides the requisite rational basis for enactments such as the instant decoupling (***see e.g. Brady v State of New York***, 80 NY2d 596 [1992], ***cert denied*** 509 US 905 [1993]). The Administrative Law Judge also opined that the result complained of in this matter is equally likely to occur with any taxpayer, resident or nonresident, doing business in New York and electing federal bonus depreciation. Therefore, the Administrative Law Judge concluded that this argument must fail because petitioner failed to make a prima facie showing of unequal treatment (***see Trump v Chu***, 65 NY2d 20 [1985], ***lv dismissed*** 474 US 915 [1985]).

Accordingly, the Administrative Law Judge determined that petitioner failed to carry its burden on either issue, and sustained the notices of deficiency.

## *ARGUMENTS ON EXCEPTION*

On exception, petitioner raises arguments that mirror those raised before the Administrative Law Judge. It contends that neither Tax Law § 208 (9) (f) (3) nor the Division's regulations specifically provide for the amount and source year limitations. Petitioner also notes

that prior cases addressed these rules before the Legislature's decoupling in 2003. While it acknowledges the value of stare decisis, petitioner maintains that the interplay between decoupling and those rules now make it appropriate for administrative or judicial correction by striking the amount and source year limits on the New York NOLD.

Petitioner also argues that the application of these rules violates various provisions of the Constitution. It disagrees with the Administrative Law Judge's characterization of the misalignment between federal and New York NOLD as a deduction that is available at one level but not another. Instead, petitioner contends that the decoupling rules result in a direct impairment to the congressional goal of spurring investment in the economy, and, as such, the amount and source year limitations should be preempted by implication.

Additionally, petitioner argues that the rules violate the Commerce Clause by denying NOLD to entities engaged in interstate commerce. Petitioner notes that, by taking advantage of the accelerated federal deduction, petitioner would forego future New York deductions, and thus place itself at a disadvantage with its New York competitors. Conversely, if it seeks to play on a level field with its New York competitors utilizing straight line depreciation, petitioner must forego the accelerated federal deduction, placing itself at a disadvantage against competitors that operate in states with coupled NOLD rules. Petitioner contends that the determination erred in failing to recognize this extraterritorial effect, which affects interstate commerce. On these grounds, petitioner submits that the application of the amount and source year limits on the New York NOLD violates the dormant Commerce Clause.

Petitioner also contends that these rules violate both the Privileges and Immunities Clause and the Equal Protection Clause because they disadvantage non-resident taxpayers that elect to take federal bonus depreciation. It contends that the Administrative Law Judge missed the point

by stating that all taxpayers doing business in New York face the same choice (i.e., use accelerated depreciation or straight line depreciation), because the impacts differ greatly among non-resident taxpayers. As stated above, non-resident taxpayers, like petitioner, must choose between losing New York State deductions or foregoing deductions at the federal level and in other states. As these rules have the practical effect of discriminating against non-resident taxpayers, petitioner submits that the amount and source year limits violate the Privileges and Immunities Clause and the Equal Protection Clause.

As petitioner's arguments on exception mirror those raised below, the Division contends that the analysis in the determination properly addressed and rejected those points. It notes that the Administrative Law Judge properly cited ***Mobil Oil Corp.*** in rejecting the preemption argument because, therein, the Supreme Court stated that an explicit directive from Congress was required for federal rules to preempt state tax rules.

The Division also disagrees with petitioner's position that the amount and source year rules violate any constitutional restrictions. It notes that businesses operating solely in New York and those operating both in and outside of the State may both incur New York NOL without a corresponding federal NOL. The Division argues that there is no discriminatory effect burdening interstate commerce because, in both situations, neither entity would be able to claim its respective New York NOLD.

The Division also disagrees with petitioner's argument that the application of the amount and source year rules violates the constitution by placing petitioner at a disadvantage compared to competitors that operate exclusively outside of New York. It summarizes this argument as stating that competitors may have a lower overall state tax burden because they do not operate in New York and, therefore, the potential higher tax burden for a corporation operating in and out

this State causes a burden on interstate commerce. It notes that the record contains no evidence of petitioner's competitors in other states or how those states tax them. The Division also contends that the denial of a state tax deduction, which causes a higher tax in that state than would occur in other states, does not unfairly burden interstate commerce. Thus, it contends that the notices of deficiency were properly sustained.

***OPINION***

The instant matter involves the Division's denial of net operating loss deductions claimed by petitioner resulting in the subject notices of deficiency. It is well-established that "the burden of proof to overcome tax assessment rests upon the taxpayer" (***Matter of Grace v State Tax Commn.***, 37 NY2d 193, 195 [1975], ***lv denied*** 37 NY2d 708 [1975]). Deductions are a form of exemption from taxation and, as such,

> "'the party claiming it must be able to point to some provision of law plainly giving the exemption'. . . . Indeed, if a statute or regulation authorizing an exemption is found, it will be 'construed against the taxpayer,' although the interpretation should not be so narrow and literal as to defeat its settled purpose . . ." (***id.*** at 196, ***quoting People ex rel. Savings Bank of New London v Coleman***, 135 NY 231, 234 [1892] [citations omitted]).

With regard to the first issue, we find that the Administrative Law Judge properly analyzed and the applied the relevant case law herein. Specifically, both the amount and source year limitations on the New York NOLD have been upheld (***Matter of Refco Prop.***; ***Matter of Royal Indemnity***; ***Matter of Lehigh Valley***; ***Matter of Eveready***; ***Matter of Aetna***). As noted in the determination, the Legislature must have been aware of these rules when it decoupled New York and federal NOL because the amount and source year limits existed at the time of the 2003 legislative changes. Therefore, the effects from the interplay between decoupling and the NOLD rules do not serve as a rationale for invalidating the amount and source year limits. As such, we

agree with the Administrative Law Judge's analysis on this issue.

Upon review, the Administrative Law Judge properly determined that federal law does not preempt the amount and source year limits on the New York NOLD. As stated by the Supreme Court in ***Mobil Oil Corp.***, "[a]bsent some explicit directive from Congress," the federal and States' tax systems may treat items differently (***Mobil Oil Corp.***, 445 US at 448). This is especially true of deductions, which are not provided as a matter of right, but exist solely due to legislative grace (***Matter of Grace***). As such, we concur with the preemption analysis in the determination.

The Administrative Law Judge also properly determined that the application of the amount and source year rules do not burden interstate commerce. As noted in the determination, businesses in New York, and those operating both in and out of the State, face the same choice (accelerated or straight-line depreciation), and the same consequences (foregoing either bonus federal depreciation or potential future New York NOLD). Complaints that these rules create an extraterritorial effect that burdens interstate commerce (i.e., that utilizing straight-line depreciation to preserve potential future New York NOLD places businesses at a disadvantage to those who do not do business in New York) must also be rejected. Initially, we note that the record lacks the factual support required to find the alleged discriminatory impact. Moreover, petitioner has not offered, nor could we find, any legal support for concluding that a state tax system improperly burdened interstate commerce by disallowing an exemption from taxation allowed by other states. Therefore, the arguments raised on exception fail to persuade us that the application of the limit and source year limits on the NOLD burden interstate commerce.

On the Equal Protection and Privilege and Immunities claim, we find that the Administrative Law Judge properly analyzed the facts and applied the relevant law. Petitioner

failed to make a prima facie showing of unequal treatment. Additionally, as stated in the determination, this argument was previously rejected in ***Matter of Aetna***. Moreover, assuring the stability of state finances serves as an adequate basis for Legislative act of decoupling federal and New York NOLD rules (***see Matter of Greco Bros. Amusement Co. v Chu***, 113 AD2d 622 [1986]; ***Brady v State of New York***). We also find that analysis to be equally applicable to the claimed violation of the privileges and immunities clause.

Given the foregoing, we conclude that petitioner failed to meet its burden of proving clear entitlement to the sought-after NOLD, and sustain the subject notices of deficiency.

Accordingly, it is hereby ORDERED, ADJUDGED and DECREED that:

1. The exception of Five Star Equipment, Inc. is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petitions of Five Star Equipment, Inc. are denied;

4. The notices of deficiency, dated October 25, 2010 and February 10, 2012, are sustained.

DATED: Albany, New York
April 15, 2015

/s/ Roberta Moseley Nero
Roberta Moseley Nero
President

/s/ Charles H. Nesbitt
Charles H. Nesbitt
Commissioner

/s/ James H. Tully, Jr.
James H. Tully, Jr.
Commissioner