STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
FRANK AND KRISTINE GIOTTO	:	DETERMINATION DTA NOS. 824841 AND 825174
for Redetermination of Deficiencies or Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 2008, 2009, and 2010.	:	

Petitioners, Frank and Kristine Giotto, filed petitions for redetermination of deficiencies or for refund of New York State personal income taxes under Article 22 of the Tax Law for the years 2008, 2009, and 2010.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, in Albany, New York, on May 17, 2013, with all briefs to be submitted by December 30, 2013, which date commenced the six-month period for the issuance of this determination. Petitioners appeared by Hiscock & Barclay LLP (David G. Burch, Jr., Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Christopher O'Brien, Esq., of counsel).

ISSUE

Whether petitioners properly calculated the empire zone tax reduction credit pursuant to Tax Law § 16 on their personal income tax returns for the years 2008, 2009, and 2010.

FINDINGS OF FACT

Petitioners submitted 18 proposed findings of fact, which have been incorporated substantially into the facts below, except proposed finding 6, which has been modified to better reflect the record. Petitioners also submitted 20 proposed conclusions of law, which are rejected

because the State Administrative Procedure Act does not require rulings to be made upon proposed conclusions of law.

1. Petitioner Frank Giotto is the chief executive officer and sole shareholder in several corporations, which are each in the general business of manufacturing and distributing fiberoptic and related products. Included in those corporations are two entities certified in the Empire Zones Program, namely, TLC-The Light Connection, Inc. (TLC) and Force Guided Relays International, Inc. (Force Guided Relays).

2. TLC purchases and packages fiber that it buys in raw form and packages into simplex, duplex, or multifiber cables that are used in connecting computers within buildings. Force Guided Relays deals in electromechanical relays, which are fail-safe relays on transit cars. It imports the major part from Germany into New York and either sells the part alone or installs it on a board to make it functional to the end user. Both companies export approximately 75 percent of their products outside New York. However, all of the companies' operations are contained solely within an empire zone.

3. Both companies employ contractors outside of New York and spend a significant amount to advertise their products outside of New York. Sales agents visited out-of-state accounts about once every three months.

4. When New York State certified TLC and Force Guided Relays as empire zone enterprises, Mr. Giotto was not informed that exporting products out of New York would decrease empire zone benefits, even though both companies exported a similar percentage of products when they were certified.

5. As a New York resident and the sole shareholder of the two companies, Mr. Giotto paid tax on all of the income that flowed through to him individually from the two New York S

corporations. During the years in issue, 2008, 2009 and 2010 (audit period), petitioners did not pay tax to any other state and did not take a resident tax credit for tax paid to another state.

6. As a shareholder of TLC and Force Guided Relays, Mr. Giotto was eligible to claim, and did claim, certain empire zone benefits for the audit period. Included in these benefits was the tax reduction credit, which is meant to eliminate New York State income tax on income that is earned in New York State by a certified entity within an empire zone. The tax reduction credit is calculated on form IT-604.

7. Petitioners' returns for the years in issue were prepared by Tammy L. Trippany, CPA, RFC, of Firley, Moran, Freer and Eassa. Ms. Trippany calculated the tax reduction credit on their returns by applying a four-factor formula found in Tax Law § 16.

8. Pursuant to Tax Law § 16(b), the tax reduction credit is the product of multiplying four factors: the benefit period factor, the employment increase factor, the zone allocation factor, and the tax factor. The parties do not dispute petitioners' calculations of the first three factors.

9. The fourth factor, the tax factor, is the product of (i) the ratio of the shareholder's income from the certified qualified empire zone enterprise (QEZE) from New York State sources to the shareholder's New York State adjusted gross income; and (ii) the shareholder's New York State income tax. The tax factor produces the portion of the shareholder's New York State income tax resulting from income from the QEZE that was allocated to New York.

10. In accordance with their interpretation of Tax Law § 16, petitioners applied the tax factor formula from Finding of Fact 8 to their individual returns and claimed the resulting tax reduction credits as shown in the following table:

Tax Reduction Credits

	2008	2009	2010
TLC	$35,669.63	$66,450.80	$162,059.72
FGR*	$22,516.79	$46,131.95	$64,162.73

* Force Guided Relays

11. Between May 2011 and May 2012, the Division performed an audit of petitioners' personal income tax returns, reviewing all aspects of the empire zones credits, including the tax reduction credit, for the years 2008, 2009 and 2010. The Division recalculated the tax reduction credit for both QEZE corporations for all three years to comport with its reading of Tax Law § 16. More specifically, the Division recalculated the tax reduction credits that were claimed by petitioners for each of the years at issue, stating that they improperly allocated all of TLC's and Force Guided Relays' business income to New York State in calculating the tax factor. Instead, the Division maintained, petitioners should have used only income allocated within New York State by each of the corporations in accordance with the business allocation percentage of each corporation.

12. The Division believed that petitioners had erred in using 100% of their income from each of the certified QEZE corporations in the tax reduction credit formula as the income allocated to New York State. The Division interpreted the statutory language to mean that taxpayers were to use the certified QEZE's income allocated to New York State in the formula and divide that by the taxpayer's New York adjusted gross income and multiply the result by the taxpayer's New York tax. Fred Houser, the Divison's auditor, emphasized that when the term allocate is used, both the concept and method are done at the corporate level. Further, the Division felt the business allocation was used to ensure that the credit amounts would be consistent with other taxpayers in similar situations.

13. Mr. Houser could not identify any statute, regulation, guidance document or instruction that required or supported the application of the business allocation percentage to the tax reduction calculation or the reduction of the tax reduction credit.

14. Although the Division submitted the recomputation of the QEZE tax reduction credit for the years 2008 and 2010, it failed to do so for 2009. However, it is undisputed that the Division revised the calculation of the credit to reflect TLC's and Force Guided Relays' business allocation percentages when determining petitioners' income from the QEZE allocated in New York State on the form IT-604 for all three years in issue. This was reflected in the proposed findings of fact submitted by petitioner as well.

15. The Division issued to petitioners a Notice of Deficiency, dated October 25, 2011, for the year 2008, which asserted additional income tax due of $47,635.77 plus interest. The explanation given in the notice stated:

> We have recalculated your claim of the QEZE Tax Reduction Credit to exclude losses from the adjusted gross income figure used to compute your credit. We have also recalculated the credit using a figure for your income-from-QEZE which reflects the QEZE's New York State business allocation percentage. Under separate cover you will be receiving, or have already received, schedules which detail the computation of these adjustments.

The Division issued a Notice of Deficiency to petitioners, dated October 25, 2011, for the year 2009, which asserted additional income tax in the sum of $11,299.12 plus interest. The explanation given in the notice was, in substance, the same as that given in the notice issued to petitioners for the year 2008.

16. The Division issued to petitioners a Notice of Deficiency, dated May 11, 2012, which asserted additional income tax due for the year 2010 in the sum of $30,428.10 plus interest. The explanation in the notice referred to a May 3, 2012 letter to petitioners, which it said described

the computation of all adjustments. The May 3, 2012 letter was notable to the extent that the Division made the discretionary adjustment to the New York State business allocation percentages for TLC and Force Guided Relays that reflected an average of a single-weighted property, wage and receipts factor, notwithstanding that there was no statutory authority for a three-factor test vis-a-vis the business allocation percentage after 2007. Only the receipts factor had been used to calculate the business allocation percentage of the two companies for the years 2008 and 2009.

17. At hearing, Mr. Houser explained that the Division had used the three-factor test to more accurately reflect the business operations of TLC and Force Guided Relays. The application of the three-factor test to the tax years 2008 and 2009 resulted in a greater tax reduction credit for taxpayers and the Division conceded to the adjustment on the record at hearing. For 2008, the tax reduction credit was increased to $45,488.00 ($15,114.00 for Force Guided Relays and $30,374.00 for TLC) and the deficiency was decreased to $13,961.00. For 2009, the tax reduction credit was increased to $80,661.00 ($32,487.00 for Force Guided Relays and $48,174.00 for TLC) and the deficiency was decreased to $2,664.00. As noted, there was no adjustment for 2010 because the three-factor test had previously been applied.

18. The instructions to form IT-604 do not mention application of the business allocation percentage in describing the procedure for calculating the tax factor as part of the tax reduction credit on returns prepared for shareholders of New York S corporations that are QEZEs. The instructions do, however, state that the tax factor "is the income from the New York S corporation that is a QEZE, allocable to New York State and included in New York adjusted gross income. . . . The income allocable to New York State is the QEZE S corporation's income from New York State sources."

19. In 2006, the Division issued a Technical Services Bureau Memorandum addressing QEZE tax credits (***see*** Technical Services Bureau Memorandum, TSB-M-06[1]C and TSB-M-06[2]I, February 2, 2006). The section of the TSB-M discussing calculation of the tax factor by shareholders of New York S corporations that are QEZEs states that "[t]he income from the QEZE S corporation allocable to New York State is the QEZE S corporation income from New York State sources." Again, there is no mention of application of the business allocation percentage under the applicable section in the document.

SUMMARY OF THE PARTIES' POSITIONS

20. Petitioners argue that they calculated the tax reduction credit on their 2008 through 2010 returns consistent with the clear language of Tax Law § 16 and the instructions to form IT-604, and that the Division had no authority to require application of the corporations' business allocation percentages in calculating the tax factor. Petitioners argue that the Division's assertion of unfairness to nonresidents if the business allocation percentage is not used is flawed, as is its position that failure to utilize the business allocation percentage will permit double dipping by taxpayers claiming the resident credit. Petitioners also assert that the Division's interpretation of Tax Law § 16 violates the equal protection clauses of the United States and New York State constitutions.

21. The Division asserts that in order to properly determine the income allocated to New York State for purposes of the tax factor, Tax Law § 16 and the Privileges and Immunities Clause of the United States Constitution required application of the corporations' business allocation percentages to their income. In addition, the Division maintains that, as the agency charged with enforcement of Tax Law § 16, its interpretation should be given significant weight and judicial deference, as long as its interpretation is not irrational, unreasonable or inconsistent

with the governing statute. The Division believes that petitioners are ignoring the allocation required in Tax Law § 16 in order to gain an advantage based solely on their New York residency.

CONCLUSIONS OF LAW

A. Chapter 63 of the Laws of 2000 amended the Tax Law to provide benefits under the Empire Zones Program Act, amending articles 9-A, 22, 32 and 33 of the Tax Law to provide new tax credits, which applied to taxable years beginning on or after January 1, 2001. The Act included Tax Law § 16, which provides for the QEZE tax reduction credit against corporate and personal income taxes of a QEZE and shareholders of New York S corporations that are QEZEs.

B. Tax Law § 16(b) provides that the amount of the tax reduction credit "shall be the product of (i) the benefit period factor, (ii) the employment increase factor, (iii) the zone allocation factor and (iv) the tax factor." Neither party disputes petitioners' calculations of the first three factors for the years in issue.

C. At issue in this case is the method used to calculate the tax factor. Tax Law § 16(f)(2)(C) provides the following with respect to the determination of the tax factor for shareholders of an S corporation, such as petitioners:

> Where the taxpayer is a shareholder of a New York S corporation which is a qualified empire zone enterprise, the shareholder's tax factor shall be that portion of the amount determined in paragraph one of this subdivision which is attributable to the income of the S corporation. Such attribution shall be made in accordance with the ratio of *the shareholder's income from the S corporation allocated within the state*, entering into New York adjusted gross income, to the shareholder's New York adjusted gross income, or in accordance with such other methods as the commissioner may prescribe as providing an apportionment which reasonably reflects the portion of the shareholder's tax attributable to the income of the qualified empire zone enterprise. In no event may the ratio so determined exceed 1.0. (Emphasis added.)

D. Tax Law § 16(f)(1) states that:

> [T]he tax factor shall be, in the case of article nine-A of this chapter, the larger of the amounts of tax determined for the taxable year under paragraphs (a) and (c) of subdivision one of section two hundred ten of such article. The tax factor shall be, in the case of article twenty-two of this chapter, the tax determined for the taxable year under subsections (a) through (d) of section six hundred one of such article.

E. Petitioner Frank Giotto was the sole shareholder of TLC and Force Guided Relays, both subchapter S corporations and certified QEZE corporations. Both companies were disregarded entities for federal and state tax purposes, and their tax attributes flowed through to petitioners, both of whom filed personal income tax returns as New York State residents under Article 22 of the Tax Law during the years at issue (***see*** Tax Law § 660). As such, petitioners' New York State tax on income attributable to TLC and Force Guided Relays was computed pursuant to Article 22, not Article 9-A.

Tax Law § 16 clearly requires use of the shareholder's portion of income from the QEZE that is allocated to New York State in calculating the tax factor. As New York State residents, all of petitioners' income from TLC and Force Guided Relays was allocated to New York, and their tax determined under Tax Law § 601. Consequently, consistent with the statute, petitioners' tax factor was the amount of their tax that was attributable to the income from TLC and Force Guided Relays, which was as they reported for the years in issue.

F. Without any authority for doing so, the Division applied a business allocation percentage to TLC's and Force Guided Relays' income, thereby reducing petitioners' income allocated to New York State and, in turn, their tax factor. Neither statute nor regulation provides for the application of the business allocation percentage when the tax reduction credit is claimed by resident shareholders of subchapter S corporations under Article 22.

Tax Law § 16(f)(2) plainly states that when the taxpayer seeking the tax reduction credit is a shareholder of an S corporation, the *shareholder's* tax factor is the portion of his tax as determined under Tax Law § 16(f)(1), which in this case was pursuant to Article 22. The Division's invocation of Tax Law § 210(3) was based on a misreading of the plain language of Tax Law § 16(f)(1) and (2). It is irrelevant that the S corporations are taxed under Article 9-A, because Tax Law § 16(f)(2) clearly shifts the focus to the shareholder and his liability.

It is also of no moment that the instructions to form IT-604 define income allocable to New York State as the QEZE S corporation's income from New York sources. To the extent that this language could be interpreted to support the Division's position and arguably adds the requirement of applying a business allocation percentage, it differs from and expands the plain language of the statute. The Tribunal has strongly cautioned that such additions must be created by the legislative or regulatory processes, and not simply through memoranda or instructions (***see Matter of Stuckless***, Tax Appeals Tribunal, August 17, 2006).

G. The use of a business allocation percentage is discussed in the Technical Services Bureau Memorandum on point (***see*** TSB-M-06[1]C and TSB-M-06[2]I). It is raised, however, in the context of instructions for calculating the tax factor for corporate partners. That situation is not present here. Such language is conspicuously missing from the instructions for calculating the tax factor for personal income tax taxpayers, including shareholders of S corporations.

H. The Division further argues that its adjustment was warranted by the Privileges and Immunities Clause of the United States Constitution as a matter of fairness to nonresident taxpayers. The Privileges and Immunities Clause, found in Article IV of the Constitution, requires that "[t]he Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States." "The object of the Privileges and Immunities Clause is to

'strongly . . . constitute the citizens of the United States one people,' by 'plac[ing] the citizens of each State upon the same footing with the citizens of other States, so far as the advantages resulting from citizenship in those States are concerned'" (***Lunding v. New York Tax Appeals Tribunal***, 522 US 287, 296 [1998][citations omitted]).

As petitioners correctly state, the case law in this area does not bar their calculations pursuant to Tax Law § 16, which fairly and constitutionally limits the benefit of the tax reduction credit to New York tax liability attributable to a QEZE's activities within an Empire Zone (***see Lunding v. New York Tax Appeals Tribunal***; ***Shaffer v. Carter***, 252 US 37 [1920]; ***Travis v. Yale & Towne Mfg. Co.***, 252 US 60 [1920]). Both residents and nonresidents benefit from the credit in a proportionate manner. Indeed, under petitioners' interpretation of Tax Law § 16, both resident and nonresident taxpayers calculate the tax factor and, thus, receive the tax reduction credit proportionately based on their income from the QEZE allocated to New York. They both receive the same percentage of tax abatement. Conversely, as petitioners rightly argue, the Division's position actually treats nonresident taxpayers more favorably than resident taxpayers, as nonresident taxpayers could receive a credit for 100 percent of their tax paid on the income from the QEZE while residents in the same situation could receive credit for a smaller percentage of their tax liability. Clearly, the Privileges and Immunities Clause should not and does not support such a result.

The Division's argument that the availability of the resident credit could reduce petitioners' tax liability in such a way that they would be "double dipping," or getting multiple credits on the same income not intended by the Tax Law is without merit here. First, petitioners did not apply for or receive a resident credit during the years in issue. Second, the Tax Law

provides a safeguard for such behavior, effectively prohibiting a taxpayer from availing himself of both credits and paying less tax than actually owed. (***See*** Tax Law § 620[b][2].)

I. A tax credit is a particularized species of exemption from tax (***Matter of New York Fuel Terminal Corp.***, Tax Appeals Tribunal, August 27, 1998). Statutes creating exemptions from tax are to be strictly construed (***see Matter of Grace v. New York State Tax Commn.***, 37 NY2d 193, 371 NYS2d 715 [1975], ***lv denied*** 37 NY2d 708, 375 NYS2d 1027 [1975]; ***Matter of Blue Spruce Farms v. New York State Tax Commn.***, 99 AD2d 867, 427 NYS2d 744 [1984], ***affd*** 64 NY2d 682, 485 NYS2d 526 [1984]). Statutory rules of construction provide that "[t]he legislative intent is to be ascertained from the words and language used, and the statutory language is generally construed according to its natural and most obvious sense, without resorting to an artificial or forced construction" (McKinney's Cons Laws of NY, Book 1, Statutes § 94). Where the statute is clear, the courts must follow the plain meaning of its words, and "there is no occasion for examination into extrinsic evidence to discover legislative intent . . ." (McKinney's Cons Laws of NY, Book 1, Statutes § 120; ***see Matter of Raritan Dev. Corp. v. Silva***, 91 NY2d 98, 667 NYS2d 327 [1997]; ***Matter of Schein***, Tax Appeals Tribunal, November 6, 2003). Where, as here, words of a statute have a definite and precise meaning, it is not necessary to look elsewhere in search of conjecture so as to restrict or extend that meaning (***Matter of Erie County Agricultural Society v. Cluchey***, 40 NY2d 194, 386 NYS2d 366 [1976]). As the language of the statute is clear, it is appropriate to interpret its phrases in their ordinary, everyday sense (***Matter of Automatique v. Bouchard***, 97 AD2d 183, 470 NYS2d 791 [1983]).

J. The Division correctly asserts that it is generally recognized that the interpretation of a statute by an agency charged with its enforcement is entitled to great weight and deference to the

extent that its interpretation relies on its special competence. (***Matter of Jennings v. Commissioner of Social Services***, 71 AD3d 98, 893 NYS2d 103 [2010].) Moreover, the construction given statutes and regulations by the agency responsible for their administration, if not irrational or unreasonable, should be upheld. (***Matter of Garofolo v. Rosa***, 26 Misc3d 969, 891 NYS2d 899 [Sup Ct, Kings County 2009].) However, a pure legal interpretation of clear and unambiguous statutory terms requires no deference to interpretation of an agency charged with the statute's enforcement, inasmuch as there is little or no need to rely on any special expertise on the agency's part. (***Matter of Lewis Family Farm, Inc. v. New York State Adirondack Park Agency***, 64 AD3d 1009, 882 NYS2d 762 [2009].) In fact, "[a]n administrative practice contrary to or inconsistent with the statute is without legal effect and will be disregarded by the courts." (***In re Billings' Estate***, 70 NYS2d 191, 194 [1947].)

Therefore, it is proper for this forum to construe the clear and unambiguous statutory language to give effect to the plain meaning of the words used (***Matter of Brown v. New York State Racing and Wagering Board***, 60 AD3d 107, 115, 871 NYS2d 623, 629 [2009]) and it is determined that the clear language contained in Tax Law § 16 supports petitioners' calculation of the tax reduction credit as reported on their 2008, 2009 and 2010 returns.

K. As petitioners' application of Tax Law § 16 is deemed correct, their alternative argument that the Division's application of the statute violates the equal protection clauses of the United States and New York State constitutions is moot.

L. The petitions of Frank Giotto and Kristine B. Giotto are granted, and the two notices of deficiency with respect to 2008 and 2009, dated October 25, 2011, and the notice of deficiency with respect to 2010, dated May 11, 2012, are canceled.

DATED: Albany, New York
June 12, 2014

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE