STATE OF NEW YORK

DIVISION OF TAX APPEALS

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| In the Matter of the Petitions<br>of<br>**LISA M. & GREGORY E. HENSON, CYNTHIA M. & THOMAS J. HAMEL, JILLIAN C. HENSON AND MADISON M. HENSON**<br>for Redetermination of Deficiencies or for Refunds of Personal Income Tax under Article 22 of the Tax Law for the Years 2008 and 2009. | : | DETERMINATION<br>DTA NOS. 825068, 825254, 825255, 825256, AND 825257 |

Petitioners, Lisa M. and Gregory Henson, Thomas J. and Cynthia M. Hamel, Jillian C. Henson and Madison M. Henson, filed petitions for redetermination of deficiencies or for refund of personal income tax under Article 22 of the Tax Law for the years 2008 and 2009.

A hearing was held before Thomas C. Sacca, Administrative Law Judge, in Albany, New York, on July 3, 2013, at 10:00 A.M., with all briefs to be submitted by January 3, 2014, which date commenced the six-month period for 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 and 2009.

## *FINDINGS OF FACT*

1. Petitioners, Lisa M. and Gregory E. Henson, Thomas J. and Cynthia M. Hamel, Jillian C. Henson and Madison M. Henson, are indirect owners of Resort Funding LLC. Resort Funding elected to be taxed as a partnership pursuant to the Internal Revenue Code and Tax Law § 601(f). Two of the members of Resort Funding are Hamel Capital, Inc., and Henson Capital, Inc., and petitioners are the shareholders of these two corporations. Hamel Capital and Henson Capital are Delaware corporations that began doing business in New York State on October 13, 2004 and October 12, 2004, respectively. Both corporations elected to be taxed as subchapter S corporations pursuant to the Internal Revenue Code and Tax Law § 660. As a result, Hamel Capital and Henson Capital were disregarded for federal and state tax purposes, and their tax attributes flowed through to petitioners.

2. Resort Funding became certified under Article 18-B of the General Municipal Law as a Qualified Empire Zone Enterprise (QEZE) within the boundaries of the Syracuse Empire Zone as of December 16, 2001.

3. Resort Funding's only office is located in Syracuse, New York. All of its operations are run from that office. Furthermore, all of Resort Funding's operations are contained within the Syracuse Empire Zone.

4. Resort Funding provides development financing for the creators of timeshares, consumer credit facilitation to the developer to finance the end loans to consumers and the servicing of all related notes. During the years at issue, Resort Funding had approximately 45 employees and a payroll of approximately $4,600,000.00.

5. Petitioners each filed New York State resident personal income tax returns for the years 2008 and 2009. As shareholders of Hamel Capital and Henson Capital, petitioners reported

and paid tax to New York on all income that flowed through to them from Resort Funding, Hamel Capital and Henson Capital. Petitioners do not pay tax to any other state and did not take a resident credit for tax paid in any other state.

6. Petitioners, as the flow-through taxpayers owning Resort Funding, claimed the Empire Zone tax reduction credit found in Tax Law § 16 on their returns for each of the years at issue. The tax reduction credit is calculated on the Division of Taxation's (Division's) Form IT-604.

7. Michael O'Shea, CPA and tax principal with the accounting firm, Firley, Moran, Freer & Eassa, served and continues to serve as accountant for Resort Funding and several of the petitioners. He prepared the returns of Resort Funding, the two subchapter S corporation members and all of the petitioners except Mr. Hamel during the years at issue. Mr. O'Shea reviewed Mr. Hamel's personal return and conferred with Mr. Hamel's accountant and determined that Mr. Hamel's personal return was prepared consistently with the returns of the other petitioners. According to Mr. O'Shea's testimony, petitioners calculated the Empire Zone tax reduction credit on their returns by applying the four-factor formula 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 and, thus, they are not at issue in this matter.

9. Petitioners' calculation of the fourth factor, the tax factor, however, is at issue. The tax factor, in the case of a shareholder of a New York subchapter S corporation, is the product of the ratio of the shareholder's income from the certified QEZE allocated within New York State divided by the shareholder's New York State adjusted gross income, multiplied by the

shareholder's New York State income tax. It is, in essence, the portion of the shareholder's New York State income tax resulting from income from the QEZE allocated to New York.

10. Petitioners applied the tax factor formula to their individual returns and claimed the resulting tax reduction credits. For 2008 and 2009, petitioners Lisa M. and Gregory E. Henson claimed tax reduction credits of $53,027.00 and $44,869.00, respectively; petitioner Madison M. Henson claimed tax reduction credits of $32,405.00 and $29,714.00, respectively; petitioner Jillian C. Henson claimed tax reduction credits of $32,405.00 and $29,714.00, respectively; and petitioners Cynthia M. and Thomas J. Hamel claimed tax reduction credits of $117,603.00 and $107,317.00, respectively.

11. Resort Funding filed New York State partnership returns, form IT-204, for the years 2008 and 2009. Henson Capital and Hamel Capital each filed New York State S corporation franchise tax returns, form CT-3-S, for the years 2008 and 2009. Each franchise tax return indicated the retention of the corporations' elections of S corporation treatment.

12. The Division performed a field audit of petitioners' personal income tax returns for 2008 and 2009. The audit of petitioners included a review of all aspects of their claimed Empire Zone credits. After examination, the Division recalculated the tax reduction credit that was claimed by petitioners for each of the years at issue, stating that they improperly allocated all of Resort Funding's business income to New York State in calculating the tax factor. Instead, the Division maintained, petitioners should have used only Resort Funding's income allocated within New York State, which the Division defined as the company's income reported on petitioners' forms K-1, multiplied by Resort Funding's business allocation percentage as reported on the partnership tax returns and by the subchapter S (Hamel Capital and Henson Capital) corporations' business allocation percentages as reported on the franchise tax returns.

13. In reaching its determination, the Division recalculated each petitioner's tax factor by applying Resort Funding's business allocation percentage, as reported on the partnership tax returns, and the subchapter S corporations' business allocation percentages as reported on the franchise tax returns. Resort Funding reported a business allocation percentage of 67.3344% on its 2008 return and 71.7250% on its 2009 return. Hamel Capital and Henson Capital reported business allocation percentages of 100.0000% on their 2008 returns and 98.5805% on their 2009 returns. As a result of the application of Resort Funding's, Hamel Capital's and Henson Capital's business allocation percentages, each petitioner's tax reduction credit claimed for the years at issue was reduced by approximately 30 percent.

14. On July 5, 2012, the Division issued to Lisa M. and Gregory E. Henson, Notice of Deficiency number L-037208541-6, which asserted $17,321.81 in additional personal income taxes due, plus interest, for the year 2008. On March 16, 2012, the Division issued to Lisa M. and Gregory E. Henson, Notice of Deficiency number L-037208543-4, which asserted $12,977.00 in additional personal income taxes due, plus interest, for the year 2009.

15. On June 29, 2012, the Division issued to Madison M. Henson, Notice of Deficiency number L-037208538-8, which asserted $10,585.02 in additional personal income taxes due, plus interest, for the year 2008. On July 5, 2012, the Division issued to Madison M. Henson, Notice of Deficiency number L-037208540-7, which asserted $8,704.35 in additional personal income taxes due, plus interest, for the year 2009.

16. On July 5, 2012, the Division issued to Jillian C. Henson, Notice of Deficiency number L-037208542-5, which asserted $10,585.16 in additional personal income taxes due, plus interest, for the year 2008. On July 5, 2012, the Division issued to Jillian C. Henson, Notice of

Deficiency number L-037208536-1, which asserted $8,704.35 in additional personal income taxes due, plus interest, for the year 2009.

17. On July 2, 2012, the Division issued to Cynthia M. and Thomas J. Hamel, Notice of Deficiency number L-037208537-9, which asserted $38,416.32 in additional personal income taxes due, plus interest, for the year 2008. On July 5, 2012, the Division issued to Cynthia M. and Thomas J. Hamel, Notice of Deficiency number L-037208544-3, which asserted $30,344.00 in additional personal income taxes due, plus interest, for the year 2009.

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.

20. Petitioners submitted 15 proposed findings of fact and 20 proposed conclusions of law. In accordance with State Administrative Procedure Act (SAPA) § 307(1), petitioners'

proposed findings of fact have been generally accepted and made a part of the Findings of Fact herein, with the following exceptions:

(i) proposed findings of fact 11, 12, 14 and 15 are argument or conclusions of law;

(ii) the last two sentences of proposed finding of fact 5 are unnecessary in rendering this determination; and

SAPA does not require rulings to be made upon proposed conclusions of law and none are made herein.

***SUMMARY OF THE PARTIES' POSITIONS***

21. Petitioners argue that they calculated the tax reduction credit on their 2008 and 2009 returns in a manner consistent with the clear language and spirit of Tax Law § 16 and the instructions to form IT- 604. Petitioners maintain that as shareholders of subchapter S corporations that were members of a QEZE, Resort Funding's income and credits flowed through to them and were to be reported on their New York State personal income tax returns. They emphasize that as residents, under the law, all of their income from Resort Funding was allocated to New York State and, therefore, was to be used in calculating the tax factor. Additionally, petitioners point out that the Division's use of the business allocation percentages was without statutory or regulatory authority and incorrect as the taxpayers involved did not file returns under Article 9-A. 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. Finally, petitioners believe the legislative intent of the Empire Zones Program was to offer various incentives to businesses that agree to create employment and make investments in areas that are economically depressed. One such reward for such businesses, or shareholders, members, or partners of pass-through businesses is a tax reduction credit. Petitioners insist that there was

never an intent by the Legislature to reduce the tax reduction credit because the QEZE's products, while manufactured at the certified location, were shipped out of New York State.

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 requires application of Resort Funding's and the subchapter S corporation's 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.

## *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. Tax Law § 16, which was part of the Act, allows for a credit, known as the Empire Zone tax reduction credit, against corporate and personal income taxes of a QEZE, or as is applicable here, a shareholder of a New York S corporation that is a QEZE.

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 at issue.

C. At issue in this case is the method of calculation of 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.

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.

Simply put, the tax factor is the product of 1) the shareholder's New York State income tax, multiplied by 2) a fraction, the numerator of which is the shareholder's income from the QEZE allocated to New York State, and the denominator of which is the shareholder's New York State adjusted gross income. Determination of the shareholder's tax, according to Tax Law § 16(f)(1), is to be made pursuant to Articles 9-A or 22, depending on the filing nature of the taxpayer claiming the credit.

E. Petitioners were shareholders of Henson Capital, Inc., and Hamel Capital, Inc., subchapter S corporations that were members of Resort Funding, the QEZE. It is uncontroverted that Resort Funding, Henson Capital, Inc., and Hamel Capital, Inc., were disregarded entities for federal and state tax purposes, and that their tax attributes flowed through to petitioners, all 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

was computed based on all of their nonexcluded income from Resort Funding pursuant to Article 22, and 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 Resort Funding 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 Resort Funding, which, for the years at issue, was as they reported.

F. The Division went a step further than the statute provides by applying the business allocation percentages of Resort Funding and the S corporation intervening entities to Resort Funding's income, thereby reducing petitioners' income allocated to New York State and, correlatively, their tax factor. Petitioners correctly point out that there is no mention in Tax Law § 16 of application of the business allocation percentage when the tax reduction credit is claimed by resident shareholders of subchapter S corporations under Article 22. Similarly, it is not discussed in a regulation on point. However, it is the Division's position that it is appropriate to apply Article 9-A principles discussed in the first sentence of Tax Law § 16(f)(1) to Article 22 taxpayers.

G. 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 [1975], ***lv denied*** 37 NY2d 708 [1975]; ***Matter of Blue Spruce Farms v. New York State Tax Commn.***, 99 AD2d 867 [1984], ***affd*** 64 NY2d 682 [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 [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 [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 [1983]).

H. 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 to the extent that its interpretation relies on its special competence. (***Matter of Jennings v. Commissioner of Social Services***, 71 AD3d 98 [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, 974 [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, 1012 [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].)

I. 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. It is petitioners', and not Resort Funding's tax factor that must be determined in this case and, therefore, the Division's insistence on calculating the tax factor under Article 9-A was incorrect. Because it did so, the Division incorrectly allocated only a portion of Resort Funding's income to New York, and not the entire income to which petitioners' tax liability was attributable, as Tax Law §16 requires.

The authority that the Division points to in support of its adjustments is misplaced. It argues that the allocation language of Tax Law § 16(f)(2) supports its case because petitioners are shareholders of a QEZE that is a corporation taxable under Article 9-A, and therefore Tax Law § 210(3) would apply to determine the allocation of the income of the S corporation. The Division argues that it must apply the business allocation percentage because of the phrase "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" (Tax Law § 16[f][2][c]). On the contrary, that language has clear meaning that supports petitioners' case. As here, where the shareholder is a resident taxpayer, 100 percent of the shareholder's nonexcluded income from the S corporation is allocated to New York. The entire net income of the company, regardless of its source, is included in the shareholder's S corporation income allocated within the state and, therefore, should not be reduced in the calculation of the tax factor in particular or the tax reduction credit. In addition, Tax Law § 16 clearly looks at the shareholder's, and not the

corporation's, portion of income that is allocated to New York. In contrast, the business allocation percentage focuses only on the corporation's receipts from the sale of tangible personal property in New York State or receipts earned in New York State. Petitioners' tax liabilty and therefore, their respective tax reduction credits are based on all income from the QEZE taxed in New York, and not simply New York receipts.

The Division also relies on the language in the instructions to form IT-604, which reads that "[t]he income allocable to New York State is the QEZE S corporation's income from New York State sources." To the extent that this language in form IT-604 could be interpreted to support the Division's position and adds the requirement of application of a business allocation percentage, it differs from or expands the statute. Such an addition or expansion must be created by the legislative or regulatory processes, and not merely through memoranda or instructions (***see Matter of Stuckless***, Tax Appeals Tribunal, August 17, 2006). In conclusion, there is simply no statutory or directory authority for the use of the business allocation percentage in the instant case.

J. It is noted that 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 does not appear in the instructions for calculating the tax factor for personal income tax taxpayers, including shareholders of S corporations.

K. 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'" (***Matter of 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 Matter of Lunding***; ***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 does not support this type of result.

L. In the instant matter, the Division applied the incorrect statutory method for calculating the tax factor, thereby reducing petitioners' claim for a credit that they were entitled to under the clear and unambiguous language of the statute. As discussed above, petitioners' tax factor was the portion of their tax attributable to the income of the S corporation. As the ultimate issue in this case is one of pure, legal interpretation, deference to the Division is not required, and

this forum is charged with the responsibility of construing the clear and unambiguous statutory language as 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 [2009].) Hence, 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 and 2009 returns.

M. 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.

N. The petitions of Lisa M. and Gregory E. Henson, Thomas J. and Cynthia M. Hamel, Jillian C. Henson and Madison M. Henson are granted, and the notices of deficiency issued to petitioners are canceled.

DATED: Albany, New York
April 10, 2014

/s/ Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE