

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
FRANK AND KRISTINE B. GIOTTO	:	DETERMINATION DTA NO. 826144
	:	
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Year 2011.	:	

Petitioners, Frank and Kristine B. Giotto, filed a petition for redetermination of a deficiency or for refund of personal income tax under article 22 of the Tax Law for the year 2011.

On March 4, 2015, petitioners, appearing by Barclay Damon LLP (David G. Burch, Jr., Esq., of counsel), and the Division of Taxation, appearing by Amanda Hiller, Esq. (Christopher O'Brien, Esq., of counsel), waived a hearing and submitted the matter for determination based on documents and briefs to be submitted by August 13, 2015, which date began the six-month period for issuance of this determination. After due consideration of the documents and arguments submitted, Donna M. Gardiner, Administrative Law Judge, renders the following determination.

ISSUE

Whether the Division of Taxation correctly calculated the Qualified Empire Zone Enterprise (QEZE) tax reduction credit pursuant to Tax Law § 16.

FINDINGS OF FACT

1. Petitioner Frank Giotto is the sole shareholder of Force Guided Relays International,

Inc., and TLC - The Light Connection, Inc., which qualify for benefits under the Empire Zones Program. Both entities are New York corporations that elected to be taxed under subchapter S of the Internal Revenue Code.

2. The Division of Taxation (Division) audited petitioners' income tax returns to determine the basis for QEZE tax reduction credits (TRC) claimed through the QEZE enterprises for the year 2011.

3. Petitioners reported \$4,746,508.00 as their New York adjusted gross income (AGI) on their 2011 form IT-604, Claim for QEZE TRC. The only loss claimed by petitioners on their 2011 form IT-201, New York State Resident Income Tax Return, was a \$3,000.00 capital loss.

4. During the audit review of petitioners' New York State income tax return, the auditor added back numerous itemized losses to their New York AGI. These itemized losses were: a schedule C loss in the amount of \$55,631.00, schedule D losses in the amount of \$191,884.00, a form 4797 loss in the amount of \$5,124.00 and schedule E losses in the amount of \$177,946.00.

5. Petitioners reported schedule C business income in the amount of \$24,369.00 on line 7 of their 2011 Form IT-201. The schedule C loss of Horsht, LLC, in the amount of \$55,631.00 (a non-QEZE business) was offset by an \$80,000.00 gain on two separate schedules C and the result was \$24,369.00 in taxable income reported on their form IT-201.

6. For the tax year 2011, petitioners had net short-term and net long-term capital losses in excess of \$100,000.00. Petitioners reported \$3,000.00 in capital losses on line 7 of their IT-201 with the balance of the losses carried forward. The auditor added back every itemized loss on schedule D capital gains and losses.

7. For 2011, petitioners had net ordinary gains of \$4,225.00 that they reported on line 8 of

their 2011 form IT-201. The auditor added back one itemized loss of \$5,124.00 from form 4797, which was offset against other gains of \$9,349.00 for a net gain of \$4,225.00.

8. Petitioners reported schedule E income of \$2,623,851.00, which represented the amount of income from all rental real estate, royalties, partnerships, S corporations and trusts. The auditor added back to the New York AGI the itemized passive and non-passive losses reported on Schedule E for purposes of calculating the TRC.

9. A Notice of Deficiency, L-040235317, dated December 9, 2013 was issued to petitioners for the additional amount of tax due for the year 2011 based upon the auditor's adjustments.¹

OPINION

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." The calculations of the first three factors are not in dispute.

C. The focus of this case devolves to the calculation of the tax factor in determining the

¹This notice included an adjustment to the business allocation percentage. However, that issue was resolved in favor of petitioners. The remaining tax portion of this assessment is \$8,232.00 plus interest.

TRC for a QEZE S corporation. 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.”

Therefore, the statute allows the Commissioner to determine the methods of computing the tax factor.

D. In the case of a shareholder of a QEZE S corporation, this method is detailed in the Division’s TSB-M-06(2)I and applies to taxpayers who have included losses in computing their New York State AGI, as follows:

“Shareholders of New York S corporations which are QEZEs: The numerator of the ratio is the shareholder’s income from the New York S corporation which is a QEZE allocable to New York State and included in New York adjusted gross income. Do not include any wages paid by the QEZE S corporation to the shareholder in the shareholder’s income from the QEZE S corporation allocable to New York State. If the shareholder’s income from the QEZE S corporation is zero or a loss, the tax factor is zero. The income from the QEZE S corporation allocable to New York State is the QEZE S corporation income from New York state sources The denominator of the ratio is New York adjusted gross income as shown on the shareholder’s return. Personal income tax taxpayers who have included losses in the computation of their New York State adjusted gross income compute the tax factor as described above without regard to the loss(es)” (TSB-M-06[2]I, February 2, 2006, p. 18).

E. The statute requires that in order to calculate the TRC, the shareholder’s tax factor is based on the ratio of the shareholder’s income from the QEZE divided by his New York AGI.

Section 16 of the Tax Law states that the shareholder's tax factor should be proportionate to the portion of the shareholder's tax attributable to the income of the QEZE. Tax Law § 16 does not require an add-back of losses.

The Division's reliance on the TSB as requiring an add-back of all the losses of the shareholder is misplaced. The TSB specifically states: "[p]ersonal income tax taxpayers who have included losses in the computation of their New York State adjusted gross income compute the tax factor as described above without regard to the loss(es)" (*id*). Petitioner correctly points out that this provision was intended to ensure that the apportionment reasonably reflected the portion of the shareholder's tax attributable to the income of the Empire Zone enterprise and clearly should include net capital gains or losses rather than including all capital gains and excluding all capital losses.

The Division argues that losses included in the taxpayer's New York AGI should be proportionately applied to the income of the QEZE and the non-QEZE. However, there is no reference made to non-QEZE income in the calculation of the TRC in either the Tax Law or the TSB.

The Division, in its calculations, excluded all capital losses and included all capital gains, which disproportionately increased petitioners' New York AGI and disproportionately reduced the percentage of petitioners' income derived from the Empire Zone enterprises. Petitioners added back net losses that actually reduced the amount of their New York AGI.

For example, the \$3,000.00 in losses that was used to reduce petitioners' New York AGI, were added back when determining the New York AGI for purposes of calculating the TRC. However, there is no basis for adding back the capital losses in the amount of \$188,884.00,

which offset capital gains within the same year. Petitioners had no tax on capital gains for 2011 because they had capital losses in excess of their capital gains for that year.

The Division suggests that even though petitioners had no capital gains for 2011, the amount of \$188,884.00 should be added back to their New York AGI for the sole purpose of calculating the TRC as if, without that credit, petitioners would have to pay tax on this amount, which was offset by capital losses. This methodology would distort the TRC. Petitioners are entitled to a TRC that is proportionate to their income from Mr. Giotto's two QEZE businesses as compared to their total New York AGI, for which they have a New York personal income tax liability. Therefore, the Division's calculations that added back the total amount of losses are in error and not supported by the statute or TSB.

F. The petition of Frank and Kristine B. Giotto is granted, the Notice of Deficiency, L-040235317, dated December 9, 2013 is canceled and petitioners' TRC is directed to be recalculated in accordance with this determination.

DATED: Albany, New York
February 11, 2016

/s/ Donna M. Gardiner
ADMINISTRATIVE LAW JUDGE