STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
CARMEN M. QUINONES	:	DETERMINATION DTA NOS. 826795,
for Redetermination of Deficiencies or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 2010, 2011 and 2012.	:	826804 AND 827510

Petitioner, Carmen M. Quinones, filed petitions for redetermination of deficiencies or for refund of New York State and New York City personal income tax under Article 22 of the Tax Law for the years 2010, 2011 and 2012.

A hearing was held before Catherine M. Bennett, Administrative Law Judge, on August 16, 2016 at 10:30 A.M., in Rochester, New York, with all briefs to be submitted by November 22, 2016, which date began the six-month period for the issuance of this determination. In accordance with Tax Law § 2010(3), for good cause shown, the due date was extended an additional three months upon notice to the parties. Petitioner appeared pro se. The Division of Taxation appeared by Amanda Hiller, Esq. (Marvis A. Warren, Esq. and Jennifer Hink-Brennan, Esq., of counsel).

ISSUES

Whether the Division of Taxation properly determined that interest income received by petitioner from the District of Columbia Tobacco Settlement Revenue Bonds must be added to federal adjusted gross income pursuant to the modification set forth in Tax Law § 612(b)(1). In determining this issue, the following issues must be resolved:

a) Whether petitioner has proven by clear and convincing evidence that the interest income

she received from the District of Columbia Tobacco bonds should be excluded from income on the basis of strict statutory construction of Tax Law § 612(b)(1).

b) Whether petitioner has proven by clear and convincing evidence that the interest income she received from the District of Columbia Tobacco bonds should be excluded from income on the basis that the District of Columbia is not a "state."

c) Whether petitioner has proven by clear and convincing evidence that the interest income she received from the District of Columbia Tobacco bonds should be excluded from income under Internal Revenue Code § 104(a)(2) as proceeds received on account of personal physical injuries or physical sickness; and

d) Whether petitioner has proven by clear and convincing evidence that the interest income she received from the District of Columbia Tobacco bonds should be excluded from New York adjusted gross income as interest created by compact or agreement to which New York is a party, under Tax Law § 612(b)(1).

FINDINGS OF FACT

1. Carmen M. Quinones, petitioner, was a New York resident and filed New York resident personal income tax returns for the years in question.

2. During the years in issue, petitioner owned District of Columbia Tobacco Settlement Revenue Bonds (DC bonds) and received interest from such bonds.

3. The origin of the DC bonds, and their historical background, is pertinent to the discussion herein. An article submitted into evidence by petitioner and published by The National Association of State Budget Officers, dated December 20, 2013, entitled "Update on the Tobacco Master Settlement Agreetment [sic] and Its Impact on States" provides the following, in pertinent part:

"States began to file numerous lawsuits against the tobacco industry in the 1990's. The premise behind the lawsuits was that states were facing increased Medicaid and other healthcare costs due to the harmful effects of tobacco products; additionally, it was alleged that the tobacco industry had engaged in a series of deceptive practices. Instead of defending each state lawsuit individually, major tobacco companies in the late 1990's began discussions regarding a joint settlement with the states. The discussions would eventually lead to an agreement in 1998 known as the Tobacco Master Settlement Agreement (MSA). The MSA was agreed to by the four largest tobacco companies in the United States (Philip Morris, R.J. Reynolds, Lorillard, and Brown and Williamson) and the Attorneys General of 46 states as well as the District of Columbia, Puerto Rico and the Virgin Islands; four states (Florida, Minnesota, Mississippi and Texas) reached their own settlements with the tobacco industry prior to the MSA.

* * *

The agreement, . . . required the participating tobacco companies to pay approximately $200 billion to states over the next 25 years to help cover healthcare costs associated with smoking.

* * *

The payments are increased for inflation, but can be reduced if the participating tobacco companies market shares fall and/or if U.S. cigarette sales decrease.

* * *

A number of states decided to securitize their tobacco settlement funds, meaning that the states received an upfront, lump sum payment by selling bonds backed by the stream of settlement payments that would be received from tobacco companies.

* * *

. . . the central purpose of the MSA was to reduce smoking, and in particular youth smoking. The agreement contained numerous restrictions on the advertising, marketing, and promotion of cigarettes.

* * *

The MSA did not place any restrictions on how states spent the funds. In addition to spending the funds on programs designed to reduce the use of cigarettes and other tobacco products, state have spent the payments for other purposes including various healthcare programs and to help solve budget shortfalls."

The DC bonds sold to investors like petitioner were backed by the stream of settlement

payments under the MSA, and as part of their investor incentive, paid interest. It is this interest that petitioner seeks to exclude as nontaxable pursuant to IRC § 104(a)(2), among other theories.

4. The Division of Taxation (Division) performed a limited scope audit of petitioner's income tax returns and determined that petitioner failed to add the interest income received from the DC bonds to her federal adjusted gross income (AGI), as a New York modification for each tax year. Accordingly, the Division adjusted petitioner's New York AGI by adding the interest income from the DC bonds for each year.

5. The Division issued statements of proposed audit changes (statements) dated December 27, 2013, December 1, 2014, and November 30, 2015, for tax years 2010, 2011 and 2012, respectively. After the information that identified the statements as pertaining to the respective tax years, the explanation for the adjustment on each statement was virtually identical, in pertinent part, as follows:

> "Interest income on obligations from any state other than New York State or any political subdivision of another state, though exempt from federal income tax, is taxable to New York (Sections 612[b][1] and 1303 of the New York State Tax Law). Such income should have been reported on line 20 of the 2010 Form IT-201 or on line 12 of the 2010 Form IT-150.[1]
>
> All or part of the income that was credited to your account or which you received from the mutual funds(s) shown below was derived from non-New York State and local obligations. Because you did not make the proper line modification on your New York State return, we have adjusted your New York taxable income for the portion of the non-New York interest income included in your distribution(s) from the mutual fund(s)."

6. The Division issued a notice of deficiency to petitioner, dated March 5, 2014, asserting additional personal income tax due for tax year 2010 in the amount of $999.00, plus interest; a notice of deficiency to petitioner, dated February 25, 2015, asserting additional personal income

[1] The language in the statements of proposed audit changes pertaining to tax years 2011 and 2012 only makes reference to reporting on line 20 of Form IT-201 for those tax years.

tax due for tax year 2011 in the amount of $846.00, plus interest; and a notice of deficiency to petitioner, dated April 4, 2016, asserting additional personal income tax due for tax year 2012 in the amount of $1,097.00, plus interest.

7. The Division made reference numerous times throughout the hearing, and later in its brief, to the Division's Technical Service Bureau's Memorandum, TSB-M-95(4)I, issued on January 29, 1996. The memorandum sets forth information regarding the tax treatment of interest income on federal, state and municipal bonds and obligations. It states in pertinent part:

> "The taxation of interest income for New York State and New York City personal income tax purposes generally conforms to the federal income tax treatment. However, there are exceptions in the case of certain bonds and obligations issued by the United States government, its possessions and agencies, and by states other than New York and their political subdivisions and agencies. The interest income on these bonds and obligations may be taxable for federal purposes but not for New York purposes or vice-versa.–Interest income that is exempt from federal income tax but subject to New York income tax must be added to federal adjusted gross income in computing New York adjusted gross income. (Sections 612[b][1] and [c][2] of the Tax Law).
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> * * *
>
> The following updated list, which is not all inclusive, indicates whether the interest income on certain bonds and obligations is subject to New York tax.
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> * * *

Agency and Obligations	**Subject to New York State Income Tax**
Washington, D.C.:	
a) Metropolitan Area Transit Authority	Yes
b) Housing and Urban Development	Yes

SUMMARY OF THE PARTIES' POSITIONS

8. Petitioner makes the following arguments:

a) The clear language of the statute is the clearest indicator of legislative intent and

the Division erred in its finding that the interest income from the DC bonds is taxable.

b) The District of Columbia (DC) is not a "state" within Tax Law § 612(b)(1), and therefore the interest from the DC bonds are not taxable by that statute.

c) The MSA and subsequent revenue bond securitization are reassignments of settlement proceeds for damages due to physical injuries or sickness, and excluded from taxation by IRC § 104(a)(2).

d) The tobacco bond obligations are not taxable by New York, since they represent obligations created by a compact or agreement (the MSA) to which New York is a party, being expressly excluded from recapture as an adjustment to federal AGI under Tax Law § 612(b)(1).

9. The Division asserts the following:

a) Although the plain language of Tax Law § 612(b)(1) does not state that interest from DC obligations must be added to a resident's federal adjusted gross income, the statute's terms, crafted broadly, clearly show that its intention is to exclude income only from New York obligations or obligations of political subdivisions created by New York and another state.

b) DC is a "state" for this purpose. The Division maintains that a conformity provision of the Tax Law requires the use of federal definitions for terms used by New York tax statutes in a similar context, and accordingly, the term "state" expressly includes DC.

c) Petitioner has not proven that her interest income should be excluded as proceeds received on account of personal physical injuries or physical sickness, since she did not receive any payments on account of physical injuries or physical sickness.

d) Petitioner has not proven that her interest income should be excluded as interest created by a compact or agreement to which New York is a party.

The Division concluded that petitioner failed to prove by clear and convincing evidence that the Division improperly required her to add the interest income she received from DC bonds to federal AGI in determining her New York AGI.

CONCLUSIONS OF LAW

A. As a New York resident, petitioner's New York taxable income is her New York AGI less New York deductions and New York exemptions (Tax Law § 611[a]). Petitioner's New York AGI equals her federal AGI with specific modifications both increasing and decreasing federal AGI (Tax Law § 612[a]). The modification in issue in this matter is the addition of certain interest income, as follows:

> "Interest income on obligations of any state other than this state, or of a political subdivision of any such other state unless created by compact or agreement to which this state is a party, to the extent not properly includible in federal adjusted gross income. . . ." (Tax Law § 612[b][1]).

B. Petitioner asserts that her interest income from the DC bonds should not be added to her federal AGI in determining her New York AGI because Tax Law § 612(b)(1) does not expressly state that the interest from DC bonds must be added, and DC is not a state. The Division counters with the argument that, although the plain language of Tax Law § 612(b)(1) does not state that interest from DC obligations, if exempt from federal income tax, must be added to a resident's federal AGI, the statute's broad terms clearly show its intention to exclude income only from New York obligations or obligations of political subdivisions created by New York and another state. Furthermore, the Division maintains that for this purpose, DC is a state.

C. The courts may, in a proper case, indulge in a departure from literal construction and

will sustain the legislative intention although it is contrary to the literal letter of the statute (McKinney's Cons Laws of NY, Book 1, Statutes § 111). The editor's notes referencing statutory construction under this section provided further guidance:

> "In considering the necessity of literal construction of a statute or the propriety of a departure therefrom, it must be kept in mind that the intent of the Legislature is the primary object sought in the interpretation of statutes: (citation omitted) and that whenever such intention is apparent it must be followed in construing the statute (citation omitted). While such intention is first to be sought from a literal reading of the act itself, and the words and language used (citation omitted), giving such language its natural and obvious meaning (citation omitted), it is generally the rule that the literal meaning of the words used must yield when necessary to give effect to the intention of the Legislature (citation omitted). In the interpretation of statutes, the spirit and purpose of the act and the objects to be accomplished must be considered and given effect (citation omitted), and the literal meanings of words are not to be adhered to or suffered to defeat the general purpose and manifest policy intended to be promoted (citation omitted). The letter of a statute is not to be slavishly followed when it leads away from the true intent and purpose of the Legislature or leads to conclusions inconsistent with the general purpose of the statute or to consequences irreconcilable with its spirit and reason; (citation omitted) and statutes are not to be read with literalness that destroys meaning, intention, purpose or beneficial end for which the statute has been designed (citation omitted) (Editors Notes, McKinney's Cons Laws of NY, Book 1, Statutes § 111)."

Consistent with the suggested legislative intent and the Division's long-standing policy of its treatment of interest income on bonds and other obligations, is TSB-M-95(4)I, described in pertinent part in Finding of Fact 6. The memorandum clearly indicates that the interest income from obligations of other states[2] and DC are included in New York AGI. By its own terms, the list of obligations is not all inclusive, but establishes that the income from bonds and obligations of states other than New York and from certain federal governmental departments or agencies in DC are subject to tax.

In ***Matter of Xerox Corporation v. New York State Tax Appeals Tribunal*** (110 AD3d

[2] A listing of bonds of other states, inapplicable herein, is omitted for this discussion.

1262 [2013]), the Court addressed the principles of statutory construction in the following manner:

> "Under well-established law, 'an agency's interpretation of the statutes it administers must be upheld absent demonstrated irrationality or unreasonableness," (***Lorillard Tobacco Co. v. Roth***, 99 N.Y.2d 316, 322, 756 N.Y.S.2d 108, 786 N.E.2d 7 [2003] [internal quotation marks and citation omitted]; ***see Matter of Chesterfield Assoc. v. New York State Dept. of Labor***, 4 N.Y.3d 597, 604, 797 N.Y.S.2d 389, 830 N.E.2d 287 [2005]**; *Matter of Island Waste Servs., Ltd. v. Tax Appeals Trib. of the State of N.Y.***, 77 A.D.3d 1080, 1082, 909 N.Y.S.2d 790 [2010]**, *lv. denied*** 16 N.Y.3d 712, 2011 WL 1675376 [2011]). "While as a general rule courts will not defer to administrative agencies in matters of pure statutory interpretation, deference is appropriate where the question is one of specific application of . . . broad statutory term[s]' by the agency charged with administering the statute, here, the Department (***Matter of O'Brien v. Spitzer***, 7 N.Y.3d 239, 242, 818 N.Y.S.2d 844, 851 N.E.2d 1195 [2006] [internal quotation marks and citations omitted]; ***see Lorillard Tobacco Co. v. Roth***, 99 N.Y.2d at 322–323, 756 N.Y.S.2d 108, 786 N.E.2d 7**; *Kurcsics v. Merchants Mut. Ins. Co.***, 49 N.Y.2d 451, 459, 426 N.Y.S.2d 454, 403 N.E.2d 159 [1980]**; *Matter of Mobil Intl. Fin. Corp. v. New York State Tax Commn.***, 117 A.D.2d 103, 106–107, 501 N.Y.S.2d 947 [1986]; compare ***Matter of Elmer W. Davis, Inc. v. Commissioner of Taxation & Fin.***, 104 A.D.3d 50, 53, 957 N.Y.S.2d 427 [2012]; ***Matter of Michael A. Goldstein No. 1 Trust v. Tax Appeals Trib. of the State of N.Y.***, 101 A.D.3d 1496, 1497, 957 N.Y.S.2d 433 [2012]**, *lv. denied*** 21 N.Y.3d 860, 971 N.Y.S.2d 80, 993 N.E.2d 758 [2013])."

Based upon the foregoing, the Division's interpretation of Tax Law § 612(b)(1) is neither irrational nor unreasonable, reflective of apparent legislative intent to identify specific interest as a modification add back, and consistent with the Division's long established treatment of interest of this type. Accordingly, petitioner's argument that the Division's taxation of interest income fails to follow the letter of the law, and is thus not taxable, is dismissed as without merit.

D. Petitioner next argues that DC is not a "state" within the Tax Law and, thus, the DC bond interest cannot be taxed by the statute in issue. The Division maintains that Tax Law § 607(a) counters petitioner's argument. It states, in pertinent part:

> "Any term used in this article shall have the same meaning as when used in a comparable context in the laws of the United States relating to federal income

> taxes, unless a different meaning is clearly required but such meaning shall be subject to the exceptions or modifications prescribed in this article or by statute."

The Division maintains that Tax Law § 607(a) promotes conformity by importing federal definitions of terms into New York statutes when used in a similar context (***see Matter of Wilmorite, Inc., Tax Appeals Tribunal***, November 14, 2013, citing ***Dreyfus Special Income Fund v. NYS Tax Comm'n***., 126 AD2d 368 [3d Dept 1987], ***affd***, 72 NY2d 874 [1988]). Internal Revenue Code (IRC) § 103, dealing specifically with bond interest, provides as part of its definitions, the following definition of "state": "The term "State" includes the District of Columbia and any possession of the United States" (IRC § 103[c][2]). Terms used in the state tax law are to be accorded the same meaning as those used in the Internal Revenue Code, unless a different meaning is clearly required (***see Dreyfus Special Income Fund***). Inasmuch as both Tax Law § 612(b)(1) and IRC § 103(c)(2) relate to bond interest in a similar context, the conformity provision dictates that the meaning of the word "state" will include DC. Thus, petitioner's argument that Tax Law § 612(b)(1) cannot impose tax on her bond interest because DC is not a state, fails.

E. Petitioner next argues that because the MSA was for damages paid in settlement for physical injuries and sicknesses caused to United States citizens by tobacco companies from tobacco smoking, the proceeds are not taxable under IRC § 104(a)(2). IRC § 104(a)(2), addressing the taxation of compensation for injuries or sickness, provides in pertinent part, as follows:

> (a) In general.--Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include–
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> * * *
>
> (2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness; . . . ."

IRC § 61, defining gross income, refers to the components of gross income of an

individual (***see Harriss v. Comm'r of Internal Revenue***, T.C. Memo. 2017-5 [2017]). Likewise, also appearing in Title 26 of the IRC, Subtitle A (Income Taxes), Chapter 1, Subchapter B, is IRC § 104(a)(2), addressing items specifically excluded from gross income of an individual. Damages for personal injuries are excludable from the gross income of an individual because they make the injured party whole from a previous loss of personal rights, i.e., they restore a loss to capital and "roughly correspond to return of capital" (***Commissioner v. Glenshaw Glass Co.***, 348 US 426 [1955]; ***Starrels v. C.I.R.***, 304 F2d 574 [9th Cir. 1962]). Petitioner in this case did not receive damages for personal injuries or any type of injury or sickness. She did not have a loss of personal rights or any loss in capital. Instead, petitioner received interest from the DC bond that she purchased as an investment. Bonds were sold to investors by many states and DC, backed by the stream of settlement payments that would be received from tobacco companies. There is a remote correlation at best between the bond interest petitioner received and damages for personal injuries or personal illness. But clearly, any damages for personal injury or sickness paid by the tobacco companies were not paid to petitioner, and the bond interest cannot be converted in order to be characterized as such. Accordingly, the bond interest is not excluded from gross income under IRC § 104(a)(2).

F. The final argument presented by petitioner is that the tobacco bond obligations are not taxable by New York State, because they represent obligations created by a compact or agreement, i.e., the MSA, to which New York State is a party, and not subject to the adjustment to federal AGI under Tax Law § 612(b)(1). Petitioner has misread the statute. The Division relies upon a provision of statutory construction to counter petitioner's misinterpretation. The Division references a well-established rule of construction, that:

> ". . . the common marks of punctuation have been in use for centuries, and it is well known that their chief function is to make the writer's meaning clear. Hence if such meaning is not clear the marks may be considered, and they frequently

> form a valuable aid in determining the legislative intent. *The use of a comma before the disjunctive "or," in construing a sentence in a statute, ordinarily indicates an intention to discriminate the first half of sentence from the second half*" (Editors notes, McKinney's Cons Laws of NY, Book 1, Statutes § 253) (emphasis added).

The foregoing construction results in a different reading of Tax Law § 612(b)(1) than is suggested by petitioner, i.e., that the political subdivision must be created by a compact or agreement to which New York is a party, not the obligation. The bonds are not of a political subdivision which was created by compact or agreement with New York and another party. This argument is also rejected as having no merit.

G. Petitioner has simply not carried her burden of proof that the bond interest from the DC bonds should not be subject to the add-back modification required by Tax Law § 612(b)(1) (Tax Law § 689[e]).

H. The petition of Carmen M. Quinones is denied and the notices of deficiency dated March 5, 2014, February 25, 2015, and April 4, 2016 are hereby sustained.

DATED: Albany, New York
August 17, 2017

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE