

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petitions

of

**FRANK AND KRISTINE GIOTTO**

for Redetermination of Deficiencies or for Refund of  
Personal Income Tax under Article 22 of the Tax Law  
for the Tax Years 2014 and 2015.

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DETERMINATION  
DTA NOS. 829214 AND  
829290

Petitioners, Frank and Kristine Giotto, filed petitions for redetermination of deficiencies or for refund of personal income tax under article 22 of the Tax Law for the tax years 2014 and 2015.

On January 8, 2021, petitioners, appearing by Barclay Damon LLP (David 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 these consolidated matters for determination based on documents and briefs to be submitted by June 23, 2021, which date commenced the six-month period for the issuance of this determination. After due consideration of the documents and arguments submitted, Jessica DiFiore, Administrative Law Judge, renders the following determination.

**ISSUE**

Whether the Division of Taxation correctly calculated the Qualified Empire Zone Enterprise tax reduction credit pursuant to Tax Law § 16 for the years 2014 and 2015.<sup>1</sup>

**FINDINGS OF FACT**

The parties entered into a stipulation of facts, which has been incorporated into the findings of fact below.

1. Petitioners, Frank and Kristine Giotto, filed joint New York State income tax returns for tax years 2014 and 2015.

2. Petitioner Frank Giotto is the Chief Executive Officer and sole shareholder in two corporations, each of which are in the general business of manufacturing and distributing fiber optic and related products.

3. The two corporations, Force Guided Relays (FGR) and TLC-The Light Connection, Inc. (TLC), are each located in Oriskany, New York, and are certified in the Oneida/Herkimer Empire Zones Program with an effective eligibility date of July 31, 2002.

4. Mr. Giotto also owns directly and through several trusts, 100% of the shares of stock in Fiber Instrument Sales, Inc. (FIS), a corporation also in the general business of the manufacture and distribution of fiber optic products.

5. FIS is located in Oriskany, New York, and is certified in the Oneida/Herkimer Empire Zones Program with an effective eligibility date of June 20, 2002.

6. FGR, TLC and FIS are qualified empire zone enterprises (QEZE).

7. FGR, TLC and FIS are each New York corporations that elected to be taxed under Subchapter S of the Internal Revenue Code.

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<sup>1</sup> Tax Law § 16 was amended effective January 1, 2015. However, the amendments do not affect the parts of the law relevant herein and therefore Tax Law § 16 will not be referenced separately for 2014 and 2015.

8. All of the New York employees and assets of FGR, TLC and FIS are situated at the Empire Zone location.

9. As a shareholder of FGR, TLC and FIS, 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 (TRC).

10. FGR, TLC and FIS each provided petitioners with federal schedule K-1s and New York schedule K-1 equivalents for the 2014 and 2015 tax years. The information provided on the federal and New York State schedule K-1s was used by petitioners to calculate the TRC claimed by petitioners on their New York State 2014 and 2015 personal income tax returns.

11. Pursuant to Tax Law § 16 (b), the TRC is the product of multiplying four factors: the benefit period factor, the employment increase factor, the zone allocation factor, and the tax factor.

12. The employment increase factor, the zone allocation factor, and the benefit period factor of the TRC for TLC and FGR in 2014 and for TLC, FGR, and FIS in 2015 are not in dispute.

13. The tax factor of the TRC is computed by shareholders on Claim for QEZE Tax Reduction Credit, form IT-604 (IT-604), which is filed with their personal income tax returns. The tax factor is the product of (i) the ratio of the shareholder's income from the 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.

14. The instructions to form IT-604 do not mention application of the business allocation percentage (BAP) in describing the procedure for calculating the tax factor as part of the TRC on returns prepared for shareholders of New York S corporations that are QEZEs. Line 21 of the IT-604 states “Enter the amount of your income from the QEZE allocated within NYS (see instructions).” The instructions for Line 21 specific to shareholders of New York S corporations that are QEZEs as set forth on the IT-604-I state as follows:

“This 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. Do not include any wages paid to you by the New York S corporation. The income allocable to New York State is the QEZE S corporation’s income from New York State sources.”

15. All of the income reported on line 21 of petitioners’ IT-604 forms was income from the S corporations and was included in New York adjusted gross income.

16. In accordance with their interpretation of Tax Law § 16, petitioners applied the tax factor formula from finding of fact 11 to their individual returns and determined the tax factor component and TRC as shown in the following table on their IT-604s:

	2014 NYS Income From QEZE allocated within NYS	2014 Tax Factor	2014 TRC	2015 NYS Income From QEZE allocated within NYS	2015 Tax Factor	2015 TRC
FGR	\$758,518.00	\$66,542.00	\$26,617.00	\$820,347.00	\$71,581.00	\$14,316.00
TLC	\$2,229,937.00	\$195,433.00	\$78,173.00	\$2,507,706.00	\$218,856.00	\$43,771.00
FIS	N/A	N/A	N/A	\$10,683,891.00	\$932,525.00 <sup>2</sup>	\$23,779.00

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<sup>2</sup> In paragraph 40 of the stipulation of facts submitted by the parties it states that the tax factor for the IT-604 for FIS was \$71,581. However, upon a review of the IT-604, the record shows that the tax factor for this IT-604 was \$932,525.00.

17. Petitioners calculated their TRC in schedule F on each individual IT-604 as the product of their tax factor from line 24, and (i) the benefit period factor, (ii) the employment increase factor, and (iii) the zone allocation factor as provided by the respective S corporation. The resulting TRC was set forth on each individual IT-604. Petitioners used the entire amount of income reported to them by the S corporations without applying the BAP.

18. The BAP for the 2014 and 2015 tax years as reported on the New York S Corporation Franchise Tax Return, form CT-3-S (CT-3-S), for each S corporation is predicated solely on the ratio of sales of New York State tangible personal property to all sales of tangible personal property. The location of property and employees does not factor into the calculation of the BAP, and the BAP does not impact the taxable income for a resident taxpayer.

19. The BAPs are not provided by S corporations to their shareholders on either the federal schedule K-1 or the New York schedule K-1 equivalent.

20. The BAP reported by FGR on its CT-3-S was 4.9025% for 2014 and 2.3772% for 2015.

21. The BAP reported by TLC on its CT-3-S was 25.6046% for 2014 and 26.0292% for 2015.

22. The BAP reported by FSI on its CT-3-S was 9.4106% for 2015.

23. The Division of Taxation (Division) performed an audit of petitioners' tax returns for 2014 and 2015 with respect to their claims for the TRC.

24. On February 24, 2017, the Division sent petitioners a letter advising them that it had completed its review of petitioners TRC, among other credits, for tax year 2014. The Division found that petitioners improperly allocated all of TLC's and FGR's business income to New York State in calculating the tax factor. The letter provided that attribution of the income from

an S corporation must include the ratio of the shareholder's income from the S corporation allocated within the state, entering into the New York adjusted gross income, to the shareholder's New York adjusted gross income. The letter advised that based on this requirement, adjustments were made reducing the TRC for TLC and FGR. The TRC was reduced by applying the BAP for the respective S corporation to the New York State income from that corporation and using that new amount as the income from the S corporation allocated within the state.

25. The Division sent petitioners a similar letter on February 28, 2017 regarding the TRC claimed for 2015 for FGR, TLC and FIS. The Division made the same adjustments to the TRC in 2015 using the BAP for each S corporation to determine the shareholder's income from the S corporation allocated within the state.

26. The Division reduced petitioners' TRC for each entity by applying the BAP for each S corporation to the income amount from the QEZE allocated within New York State as follows:

- a. The TRC for FGR for the 2014 tax year was reduced from \$26,617.00 to \$1,299.00.
- b. The TRC for TLC for the 2014 tax year was reduced from \$78,173.00 to \$20,036.00.
- c. The TRC for FGR for the 2015 tax year was reduced from \$14,316.00 to \$329.00.
- d. The TRC for TLC for the 2015 tax year was reduced from \$43,771.00 to \$11,387.00.
- e. The TRC for FIS for the 2015 tax year was reduced from \$23,779.00 to \$2,237.00.

27. In total, the Division reduced petitioners' TRC by \$83,467.00 in 2014 and by \$67,913.00 in 2015.

28. An account adjustment notice dated March 3, 2017 was issued to petitioners for 2014 recomputing the claimed overpayment of tax allowed to the next period to be \$560,339.00

instead of the \$647,562.00 requested based upon the adjustments attributable in part to the adjusted TRC.

29. An account adjustment notice dated March 8, 2017 was issued to petitioners for 2015 recomputing the claimed overpayment of tax allowed to the next period to be \$595,048.00 instead of the \$753,887.00 requested based upon the adjustments attributable in part to the adjusted TRC.

30. Petitioners did not claim any New York State resident credits on their 2014 and 2015 resident income tax returns.

### ***CONCLUSIONS OF LAW***

A. In 1986, the legislature enacted New York State's Economic Development Zones Act (the EDZ Program). The purpose of the program was to stimulate private investment, private business development, and job creation in targeted geographic areas characterized by persistent poverty, high unemployment, shrinking tax bases and dependence on public assistance (*see* General Municipal Law § 956). The EDZ Program offered a variety of state tax incentives designed to attract new businesses to the state and to enable existing businesses to expand and create more jobs (*see id.*). Over time, the EDZ Program gradually shifted its focus from poverty reduction to business development by relaxing eligibility requirements, and the program was changed to the Empire Zones Program Act in May of 2000 (L. 2000, ch. 63, part GG).

B. Businesses located in qualifying Empire Zone areas and that otherwise meet the statute's criteria could apply to the Department of Economic Development for a certificate of eligibility that they could then submit to the Department of Taxation and Finance in support of their claim for tax credits. These businesses are also referred to as QEZEs (*see* GML § 959 [a]). A QEZE is a business enterprise which is certified under article 18-B of the GML and meets the

employment test (Tax Law § 14 [a]). As stated above, FGR, TLC and FIS are all QEZEs. Among the credits available to QEZEs was the TRC.

C. The TRC is computed pursuant to Tax Law § 16. Tax Law § 16 (b) provides that the amount of the TRC “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.” 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 Mr. Giotto:

“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 in relevant part that:

“The tax factor shall be, in the case of article twenty-two of this chapter, the tax determined for the taxable year under such subsections (a) through (d) of section six hundred one of such article.”

E. Petitioner Frank Giotto was the sole shareholder of FGR and TLC and directly and through several trusts, the sole owner of FIS, all subchapter S corporations and certified QEZE corporations. All three companies were disregarded entities for federal and state tax purposes, and their tax attributes flowed through to petitioners, who filed joint 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; *Purcell v New York State Tax Appeals Trib.*, 167 AD3d 1101 [3d Dept 2018], *lv*



*dismissed* 33 NY3d 999, *lv denied* 33 NY3d 913 [2019]). As such, petitioners' New York State tax on income attributable to FGR, TLC and FIS was computed pursuant to article 22 of the Tax Law.

F. Petitioners argue that all of their income from FGR, TLC, and FIS is New York State income since Mr. Giotto, the sole shareholder, is a New York State resident. They assert that the entire net income of FGR, TLC and FIS, regardless of whether the product is shipped within New York or to points outside of New York, is included in the shareholder's income from the S corporations allocated within the state and should not be reduced by the BAP. They contend the application of the BAP is contrary to the Commissioner's obligation to prescribe an apportionment which reasonably reflects a portion of the shareholder's tax attributable to the income of the QEZE. All of petitioners' income from the S corporations is based on economic activity within the qualified Empire Zones, and therefore should be the basis for the calculation of the TRC without application of the BAP.

Petitioners' position is in direct contradiction to the Appellate Division, Third Department's holding in *Purcell*. The material facts in *Purcell* are similar to those in the instant matter. There, the relevant S corporation was certified as a QEZE and was a New York corporation that constructed commercial buildings mostly in New York and Virginia using prefabricated systems that it manufactured within an empire zone (*id.*). As an S corporation, its income and any applicable QEZE TRCs passed through to its sole shareholder, a New York resident, and such income was reported on his personal income tax returns that he jointly filed with his wife (*id.*). The taxpayers then calculated the TRC using all of the S corporation's income, including income derived from its operations in Virginia (*id.*). Upon review of petitioners' personal income tax returns for the relevant years, the Division determined

petitioners had miscalculated the TRCs because they did not exclude their out-of-state income when calculating the tax factor despite the fact that it was not “allocated within the state” pursuant to Tax Law § 16 (f) (2) (C) (*id.*). The Division then applied the BAP to determine the portion of the S corporation’s income that was allocated within the state for each of the relevant tax years (*id.*).

The Court determined that interpreting the meaning of the phrase “allocated within the state” was a question of statutory interpretation requiring consideration of the language and legislative history without deference to the Tax Appeals Tribunal’s (Tribunal’s) interpretation (*id.*; *Matter of Piccolo v New York State Tax Appeals Trib.*, 109 AD3d 107, 110 [3d Dept 2013]). The Court acknowledged that a tax credit is a form of exemption from taxation and must be strictly construed against the taxpayer, with any ambiguity to be held against the exemption (*id.*). It then noted that a taxpayer seeking an exemption from taxation bears the burden of proving a clear entitlement thereto showing that its suggested interpretation is the only reasonable construction (*id.*; *Piccolo*, 109 AD3d at 111-112). In rejecting the taxpayer’s position, the Court found that the Division’s method of applying the BAP to the S corporation’s income gave meaning to the phrase “allocated within the state,” and concluded that eligibility for the TRC for shareholders of New York S corporations is based only on income that is earned by such corporations within New York. The court concluded as follows:

“Allocation of a New York S corporation’s income within the state to a nonresident shareholder’s New York adjusted gross income is determined by application of the BAP reported by the corporation. When calculating QEZE credits, it is rational to interpret Tax Law § 16 (f) to require similar allocation of a New York S corporation’s income for resident shareholders based on the BAP reported by the corporation.”

The Court noted that this interpretation ensures similar treatment of resident and nonresident shareholders of S corporations and ensures that QEZE tax credits are based on economic activity that occurs only within qualified empire zones.

G. Petitioners argue that simply selling products that may be shipped to out-of-state purchasers does not circumvent the legislative intent of the QEZE and that this differentiates the instant case from *Purcell* because petitioners' S corporations did not perform work outside of New York State. They contend that use of the BAP to reduce the TRC should only be applied when a taxpayer is seeking both a TRC and a resident credit on the same income. However, the holding in *Purcell* was not limited to the facts in that case. There, the Court squarely addressed the issue of whether the phrase "allocated within the state" excluded out-of-state income when calculating a shareholder's QEZE tax reduction (167 AD3d at 1102-1103). The Court found that it does (*id.*). The Court did not qualify this holding as to what out-of-state income would trigger the use of the BAP (*see id.*). Moreover, to hold otherwise would render such language superfluous (*see id.*). Further, the resident credit involves a credit for residents against income tax otherwise due for any tax imposed by another state upon income derived therefrom that is also taxable in New York and is not related to the tax credits awarded by the Empire Zones Program, including the TRC (*see* Tax Law § 620 [a]).

H. Petitioner also argues that application of the BAP in computing the tax factor of the TRC is contrary to the legislative purpose of the empire zone program. However, as the Court noted in *Purcell*, use of the BAP ensures that "QEZE tax credits are based on economic activity that occurs only within qualified empire zones" (167 AD3d at 1105).

I. The Division's use of the BAP in determining the tax factor of the TRC reducing the claimed overpayment of tax for tax year 2014 and 2015 was proper.

J. The petitions of Frank and Kristine Giotto are denied, and the account adjustment notices dated March 3, 2017 and March 8, 2017 are sustained.

DATED: Albany, New York  
December 23, 2021

/s/ Jessica DiFiore  
ADMINISTRATIVE LAW JUDGE