

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
HOWARD SOLOMON : DECISION
 : DTA NO. 822845
for Redetermination of a Deficiency or for Refund :
of New York State and New York City Personal :
Income Tax under Article 22 of the Tax Law and :
the Administrative Code of the City of New York :
for the Year 2004. :

Petitioner, Howard Solomon, filed an exception to the determination of the Administrative Law Judge issued on June 3, 2010. Petitioner appeared by Hodgson Russ, LLP (Christopher L. Doyle, Esq., of counsel). The Division of Taxation appeared by Mark Volk, Esq. (Kevin R. Law, Esq., of counsel).

Petitioner filed a brief in support of his exception. The Division of Taxation filed a brief in opposition. Petitioner filed a letter brief in lieu of a formal reply brief. Oral argument, at petitioner's request, was heard on December 8, 2010, in Troy, New York.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether, for purposes of the add-back to federal adjusted gross income under Tax Law § 612(b)(1), interest income paid on bonds issued by states other than New York, which are federally tax-exempt but taxable in New York, equals either the gross interest income paid on the bonds, or such gross interest paid less amortized bond premiums allocable to the tax year.

FINDINGS OF FACT

We find the facts are determined by the Administrative Law Judge. These facts are set forth below.

In 2004, petitioner, Howard Solomon, was a resident of New York State and New York City.

For periods prior to and including 2004, petitioner engaged in various investing activities. As part of his overall investing strategy, petitioner bought and held federally tax-exempt obligations issued by state and local governments other than New York (the municipal bonds).

In 2004, petitioner received gross interest payments on the municipal bonds of \$4,886,453.43.

Often these federally tax-exempt municipal bonds were purchased at a premium. For example, if a bond carried a stated interest rate that was in excess of current market rates, petitioner paid a premium to acquire the bond.

The 2004 amortized portion of the total premium paid to acquire the municipal bonds was \$2,329,347.72.

Petitioner also acquired municipal bonds that had accrued but unpaid interest that was appropriately owed to the seller of the bonds. Accordingly, the price paid by petitioner to acquire those bonds was increased to reflect the accrued but unpaid interest that was due to the seller. In 2004, petitioner recovered \$859,220.60 of accrued interest that petitioner had paid in connection with his purchases of municipal bonds (the pre-paid interest). This recovered amount was included in the \$4,886,453.43 of gross interest petitioner received in 2004.

Since the municipal bonds produced interest that was federally tax-exempt, petitioner did

not include any of the interest revenue he received in 2004 from the municipal bonds in his adjusted gross income on his 2004 Form 1040.

Petitioner timely filed his 2004 New York resident income tax return (Form IT-201).

In preparing his 2004 IT-201, petitioner reported interest income from the municipal bonds at line 19. The total amount reported was \$1,697,886.00, which was computed by reducing the municipal bond gross interest payments received by petitioner in 2004 (*i.e.*, \$4,886,453.43) by the pre-paid interest recovered by petitioner in 2004 (*i.e.*, \$859,220.60) and the 2004 amortized portion of the bond premium petitioner paid to acquire the bonds as calculated by his brokerage firm (*i.e.*, \$2,329,347.72).

The Division of Taxation (Division) audited petitioner's 2004 IT-201 and determined that it was appropriate to increase the state and local bond interest income reported at line 19 by the 2004 portion of the bond premium (*i.e.*, \$2,329,347.00). The Division did not disturb petitioner's treatment of the pre-paid interest.

On February 19, 2008, based on its audit determination, the Division issued to petitioner a Notice of Deficiency, which asserted a total of \$141,507.77 in additional income tax due, plus interest, for the year 2004.

Following a conciliation conference, which sustained the auditor's adjustments, petitioner filed a timely petition with the Division of Tax Appeals.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge reviewed the relevant Federal and New York statutes. The Administrative Law Judge rejected petitioner's interpretation because "interest income" as used in Tax Law § 612(b)(1) clearly differs from the Internal Revenue Code (IRC or the Code),

as New York provides different treatment of amortized bond premium. The Administrative Law Judge noted that petitioner's calculation of amortized bond premium would result in a double benefit situation. Accordingly, the Administrative Law Judge sustained the Notice of Deficiency.

ARGUMENTS ON EXCEPTION

Petitioner argues that the determination of the Administrative Law Judge should be reversed. Petitioner states that annual interest income is defined as gross interest payments received less the amount of bond premium allocated to that year. Petitioner argues that the Federal conformity principle must apply because this does not present a clear situation requiring a different meaning. Petitioner also argues that the Administrative Law Judge incorrectly noted the potential double benefit to himself for several reasons, including limitation in Tax Law § 615(f) and changes to the Tax Law. Petitioner also noted that the Legislature embraces double benefit in certain situations.

The Division argues that the Administrative Law Judge properly sustained the Notice of Deficiency. The Division argues that the Federal conformity principle does not apply here because the Code specifically excludes municipal bond interest from taxation. The Division additionally argues that petitioner's source differentiates interest income as a separate offset of the amortized bond premium and not inclusion within the definition of interest income.

OPINION

As a New York resident, petitioner's New York taxable income is his New York adjusted gross income (AGI) less New York deductions and New York exemptions (*see* Tax Law § 611[a]). Petitioner's New York AGI equals his Federal AGI with specific modifications, both increasing and decreasing his Federal AGI (*see* Tax Law § 612[a]).

Included among the modifications increasing Federal AGI for purposes of computing New York AGI is interest income on bonds issued by states other than New York, including political subdivisions of such states, to the extent not properly included in Federal AGI (Tax Law § 612[b][1]).¹ In the present matter, there is no dispute that interest income on petitioner’s federally exempt municipal bonds was properly subject to New York income tax under this statutory add-back modification.

The issue is whether “interest income” under Tax Law § 612(b)(1) constitutes either the gross annual interest payments, or the gross annual interest payments less amortized bond premiums allocable to the year at issue. The Tax Law does not define interest income. Tax Law § 607(a) provides for conformity with the Code, stating, in part that:

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.

The New York courts have generally followed the Federal construction of similar provisions found in the Tax Law (*see Matter of Marx v. Bragalini*, 6 NY2d 322 [1959]; *Matter of Friedsam v. State Tax Commn.*, 64 NY2d 76 [1984]; *Matter of Hunt v. State Tax Commn.*, 65 NY2d 13 [1985]).

Petitioner asserts that Tax Law § 607(a) requires that interest income under Tax Law § 612(b)(1) be calculated as payments less bond premium. In support of its position, petitioner references IRC § 171 and the regulations promulgated thereunder. These regulations provide that, with respect to a taxable bond, the bondholder must offset the periodic interest payments

¹ Tax Law § 612(b)(1) provides the following to be added back into a taxpayer’s federal adjusted gross income: “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”

with the bond premium allocable to that period (*see* IRC § 171[e]; Treas Reg § 1.171-2). Put alternatively, a taxpayer reports annual interest payment as the net of qualified stated interest less the relevant amortized bond premium. Petitioner also cites the historical treatment of amortized bond premiums, specifically the Technical and Miscellaneous Revenue Act of 1988 (Pub L 100-647), as the reason for the dissonance between the IRC and Tax Law schemes. Petitioner argues that this is similar to *Matter of Friedsam* and that State legislative response was required to counter the federal change and retain the gross interest income definition.

We note that the federal conformity principle does not affect this matter because the Code does address the subject matter (Tax Law § 607[a]). This is not a case where the Tax Law specifically references terms from the Code (*see e.g. Matter of Brookfield Power Corp.*, Tax Appeals Tribunal, November 10, 2010). Rather, Tax Law § 612(b)(1) calls for the treatment of interest income that is not included within the Federal adjusted gross income and must be added back at the state level. We find that the New York scheme for addressing this income, generated from bonds issued by states other than New York, differs from the Code because the latter exempts such income from taxation while the former imposes tax, clearly requiring a different result (*c.f. Matter of Webster v. Tully*, 56 NY2d 532 [1982]). Accordingly, we hold that it is inappropriate to look to Federal law for guidance on federally tax-exempt municipal bonds because the Code is silent on such income.

We are not persuaded by petitioner's attempts to define interest income as the net of gross interest income less allocable bond premium. The Division's understanding of interest income in Tax Law § 612(b)(1) as gross interest income is not only reasonable, but the same definition used in the Code. Form 1099-INT reports taxable and exempt interest income as gross interest income

paid without an adjustment for the bond premium. IRS Publication 550 defines the offset as a separate adjustment to interest income. Treas Reg §§ 1.1016-5(b), 1.171-2(a) and Treasury Decision 8746 each identify the term interest income as separate and apart from the offset of the amortized bond premium provided by the Code. We find that this is not a situation where state legislative action was required to preserve the existing definition of interest income because there was no change (*c.f. Matter of Friedsam, supra*).

Contrary to petitioner's assertions, the 1988 modifications to the Code did not result in any change to the meaning of interest income, but in how bond premiums were reported. Treas Reg § 1.171-2(a), *Offsetting qualified stated interest with premium*, does not provide a definition of interest income, but provides guidance on how taxpayers account for the investment cost associated with taxable bond interest income. This regulation forces taxpayers to offset their investment costs by calculating an above-the-line "amortized bond premium adjustment" (*see* IRS Publication 550, p. 36). While the definition of interest income remains the same as in the Code, the Tax Law imposes a different statutory scheme for addressing bond premiums, which is a below-the-line deduction (*see* Tax Law § 615[d][3]). In essence, petitioner objects to the New York statutory scheme that treats amortized bond premiums as below-the-line deductions. These objections are more appropriately directed to the Legislature. As such, we reject the argument that the Code provides a definition for interest income that includes amortized bond premium.

Accordingly, we affirm the determination of the Administrative Law Judge as consistent with the foregoing rationale.²

² We specifically do not adopt the language regarding double-benefit (*i.e.*, both above-the-line adjustments and below-the-line deductions) in the determination below. We find this language to be over-broad, as it gives the impression that double-benefit situations are invalid and determinative of the issues herein. As correctly pointed out by petitioner, the Legislature provides double-benefit situations within the Tax Law. Therefore, we find that a

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Howard Solomon is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of Howard Solomon is denied; and
4. The Notice of Deficiency dated February 19, 2008, is sustained.

DATED: Troy, New York
June 2, 2011

/s/ James H. Tully, Jr.
James H. Tully, Jr.
President

/s/ Carroll R. Jenkins
Carroll R. Jenkins
Commissioner

/s/ Charles H. Nesbitt
Charles H. Nesbitt
Commissioner

double-benefit may not be determinative of similar issues without further evidence.