

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
HOWARD SOLOMON : DETERMINATION
for Redetermination of a Deficiency or for Refund of New : DTA NO. 822845
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 a petition 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.

On June 23, 2009 and July 17, 2009, respectively, petitioner, appearing by Christopher L. Doyle, Esq., and the Division of Taxation, by Daniel Smirlock, Esq. (Kevin R. Law, Esq., of counsel), waived a hearing and agreed to submit this matter for a determination based on documents and briefs submitted by December 7, 2009, which date began the six-month period for the issuance of this determination. After review of the evidence and arguments presented, Timothy Alston, Administrative Law Judge, renders the following determination.

ISSUE

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

FINDINGS OF FACT

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

2. 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).

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

4. 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.

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

6. 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.

7. 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.

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

9. 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).

10. 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.

11. 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.

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

13. Petitioner submitted proposed findings of fact numbered 1 through 11. These findings are accepted and are set forth above, except that proposed finding of fact 9 has been modified to better reflect the record.

CONCLUSIONS OF LAW

A. 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 (Tax Law §

611[a]). Petitioner's New York AGI equals his federal AGI with specific modifications both increasing and decreasing federal AGI (Tax Law § 612[a]).

B. Included among the modifications increasing federal AGI for purposes of computing New York AGI is interest income on bonds of states other than New York (including political subdivisions of such other states) to the extent not properly includible in federal AGI (Tax Law § 612[b][1]). There is no dispute in the present matter that interest income on petitioner's federally exempt municipal bonds was subject to New York income tax under this add-back modification. The question is whether the amortized bond premiums allocable to the year at issue may be offset against gross interest payments in an above-the-line adjustment in calculating petitioner's interest income for purposes of the add-back modification of Tax Law § 612(b)(1).

C. Petitioner notes, correctly, that the Tax Law contains no definition of interest income and asserts, therefore, that pursuant to Tax Law § 607(a), principles of federal conformity require that interest income in respect of the bonds is properly determined by reference to Internal Revenue Code (IRC) § 171 and the regulations promulgated thereunder. Such regulations provide that, generally, with respect to a taxable bond, a bondholder offsets interest payments on a bond for an accrual period with the bond premium allocable to that period (*see* IRC § 171[e]; Treas Reg § 1.171-2). Taxpayers thus report as interest income payments of interest net of the allocable bond premium. With respect to tax-exempt bonds, the regulations indicate a similar method of calculating and reporting tax-exempt interest income (*see* Treas Reg § 1.171-2[c][Example 4]).

D. IRC § 171(e) in its present form was enacted in 1988 as part of the Technical and Miscellaneous Revenue Act of 1988 (Pub L 100-647). Prior to that time, interest income on federally taxable bonds equaled gross interest payments without any offset for the amortized

bond premium. Prior to 1986, amortizable bond premium was treated as an itemized deduction. Indeed, IRC § 171(a)(1) provides for a deduction for amortized premium for taxable bonds and remains in effect. The premium offset of IRC § 171(e) is elected “in lieu of” the deduction (IRC § 171[e][2]).

E. New York itemized deductions are federal itemized deductions with specific modifications (Tax Law § 615[d]). Added in 1963 (L 1963, ch 921), Tax Law § 615(d)(3) provides for a modification increasing federal itemized deductions for the amount of:

amortizable bond premium for the taxable year on any bond the interest on which is subject to tax under this article but exempt from federal income tax, to the extent that such . . . premiums are not deductible in determining federal adjusted gross income and are not subtracted from federal adjusted gross income pursuant to [Tax Law § 612(c)(10)].

F. As neither of the two exceptions to this modification are applicable in the present matter,¹ Tax Law § 615(d)(3) provides for an itemized deduction for amortized bond premiums for petitioner for the year at issue. It does not appear from the record that petitioner claimed this deduction.

G. Given the Tax Law § 615(d)(3) deduction, petitioner’s proposed interpretation would allow for both an above-the-line income adjustment and a below-the-line deduction with respect to the same expense. There is no rational justification for this result by which a taxpayer would gain the benefit of accounting for the same expense twice. Federal conformity does not extend to circumstances “where a different meaning is clearly required” (*see* Tax Law § 607[a]). Here, avoidance of this anomalous result requires that interest income for purposes of the Tax Law § 612(b)(1) add-back means gross interest payments and not interest payments net of amortized

¹ Specifically, bond premiums in respect of tax-exempt bonds are not deductible (IRC § 171[a][2]) and Tax Law § 612(c)(10), which provides an above-the line adjustment to federal AGI, is applicable only with respect to bond dealers (i.e., such premiums must be “attributable to a trade or business carried on by the taxpayer”).

bond premium. The amortized bond premium may be deducted from New York AGI pursuant to Tax Law § 615(d)(3). Such an interpretation properly accounts for the bond premium expense but once.

H. The petition of Howard Solomon is denied and the Notice of Deficiency dated February 19, 2008 is sustained.

DATED: Troy, New York
June 3, 2010

/s/ Timothy Alston
ADMINISTRATIVE LAW JUDGE