STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
HAROLD A. AND KATHARINE R. BATTY, JR.	:	
for Redetermination of a Deficiency or Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 2006, 2007 and 2008.	:	
		DETERMINATION
		DTA NOS. 824061
In the Matter of the Petition	:	AND 824063
of	:	
JAMES E. AND TINA L. PENNEFEATHER	:	
for Redetermination of a Deficiency or Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 2006, 2007 and 2008.	:	

Petitioners, Harold A. and Katharine R. Batty, Jr., and James E. and Tina L. Pennefeather, filed petitions for redetermination of deficiencies or for refund of New York State personal income taxes under Article 22 of the Tax Law for the years 2006, 2007, and 2008.

A hearing was held before Herbert M. Friedman, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, Agency Building One, Empire State Plaza, Albany, New York, on April 26, 2012, with all briefs to be submitted by October 22, 2012, which date commenced the six-month period for the issuance of this determination. Petitioners appeared by Hiscock & Barclay LLP (Kevin R. McAuliffe, Esq., and David G. Burch, Jr., Esq., of counsel).

The Division of Taxation appeared by Amanda Hiller, Esq. (Christopher O'Brien, Esq., of counsel).

ISSUE

Whether petitioners properly calculated the Empire Zone tax reduction credit pursuant to Tax Law § 16 on their personal income tax returns for the years 2006 through 2008.

FINDINGS OF FACT

1. Petitioners Harold A. Batty, Jr. and James E. Pennefeather[1] were, at all relevant times, shareholders of Buckingham Group, Inc. (Buckingham Group), a New York corporation that elected, effective December 17, 2001, to be taxed as a subchapter S corporation pursuant to the Internal Revenue Code and Tax Law § 660.

2. During the years at issue, Buckingham Group was the sole shareholder in three separate subsidiaries: Buckingham Manufacturing, Inc. (Buckingham Manufacturing), Lineman's Supply, Inc. (Lineman's Supply), and Hydron, Inc (Hydron). Buckingham Manufacturing, Lineman's Supply and Hydron were all qualified subchapter S subsidiaries of Buckingham Group pursuant to elections made in late 2001. As a result, the three subsidiaries were disregarded for federal and state tax purposes, and their tax attributes flowed through to petitioners.[2]

3. Buckingham Group, and its subsidiary Buckingham Manufacturing, became certified under Article 18-B of the General Municipal Law as a Qualified Empire Zone Enterprise (QEZE) within the Triple Cities of Broome County Empire Zone as of December 28, 2001.

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[1] Petitioners Katharine R. Batty and Tina L. Pennefeather's names appear herein by virtue of having filed joint federal and New York State personal income tax returns with their respective husbands. Unless otherwise specified or required by context, references to "petitioners" shall mean petitioners Harold A. Batty, Jr. and James E. Pennefeather.

[2] Lineman's Supply, a distribution subsidiary, is located within New York State but not within the Empire Zone. Hydron, a small retail operation, is located out of state. Neither company's production is at issue in this case.

4. During the years at issue, Buckingham Manufacturing was a manufacturer of a wide variety of arborist and lineman safety equipment, and its products were made exclusively in its facility in Binghamton, a city in the Triple Cities of Broome County Empire Zone. The customers of Buckingham Manufacturing included telephone, cable and electric companies from all over the United States and abroad. From 2006 through 2008, approximately 90% of Buckingham Manufacturing's product was exported outside of New York State.

5. By all accounts, Buckingham Manufacturing has been a successful enterprise. Mr. Batty first became involved with Buckingham Manufacturing in 1984, and at that time, the company had approximately 38 employees. By the time of its certification in the Empire Zone in 2001, that number had increased to 135 employees and now has grown to 208. In 1984, the combined gross sales of the entire Buckingham Group was $2.5 million. At present, Buckingham Manufacturing alone has gross sales of $40 million.

6. Petitioners each filed New York State resident personal income tax returns for the years 2006, 2007 and 2008. As shareholders of Buckingham Group, petitioners reported and paid tax to New York on all income that flowed through to them from Buckingham Manufacturing.

7. Neither petitioner paid tax to any other state on the income from Buckingham Manufacturing during the years at issue.

8. Petitioners, as shareholders of Buckingham Group, claimed the QEZE tax reduction credit found in Tax Law § 16 on their returns for each of the years at issue. The tax reduction credit is calculated on the Division of Taxation's (Division's) Form IT-604.

9. Petitioners' returns were prepared by Matthew Parrilli, CPA, a partner with PricewaterhouseCoopers. Mr. Parrilli testified at hearing on behalf of petitioners and explained

that he calculated the tax reduction credit on their returns by applying the four-factor formula found in Tax Law § 16.

10. Pursuant to Tax Law § 16(b), the tax reduction credit is the product of multiplying four factors: the benefit period factor, the employment increase factor, the zone allocation factor, and the tax factor. The parties do not dispute petitioners' calculations of the first three factors and, thus, they are not at issue in this matter.

11. Petitioners' calculation of the fourth factor, the tax factor, however, is at issue. The tax factor, in the case of a shareholder of a New York S corporation, is the product of the ratio of the shareholder's income from the certified QEZE allocated within New York State divided by the shareholder's New York State adjusted gross income, multiplied by the shareholder's New York State income tax. In essence, it is the portion of the shareholder's New York State income tax resulting from income from the QEZE allocated to New York.

12. Petitioners applied the tax factor formula to their individual returns and claimed the resulting tax reduction credits. For 2006, the Battys entered $1,691,646.00, or all of their non-wage income from Buckingham Manufacturing as the amount of their income from the QEZE allocated within New York State. As a result, 87.26% of their New York adjusted gross income came from Buckingham Manufacturing, giving them a tax factor of $114,117.76, which, when multiplied by the other statutory factors, resulted in a tax reduction credit of $108,263.52 for that year. Likewise, for 2007, the Battys entered $2,657,315.00, or all of their non-wage income from Buckingham Manufacturing as the amount of their income from the QEZE allocated within New York State. As a result, 87.54% of their New York adjusted gross income came from Buckingham Manufacturing, giving them a tax factor of $181,073.86, which, when multiplied by the other factors, resulted in a tax reduction credit of $158,765.56. Finally, for 2008, the Battys

entered $3,709,215.00, or all of their income from Buckingham Manufacturing as the amount of their income from the QEZE allocated within New York State. As a result, 91.25% of their New York adjusted gross income came from Buckingham Manufacturing, giving them a tax factor of $252,418.49, which, when multiplied by the other factors, resulted in a tax reduction credit of $227,832.93.

13. The Pennefeathers similarly computed their tax reduction credits. For 2006, they entered $360,429.00, or all of their non-wage income from Buckingham Manufacturing as the amount of their income from the QEZE allocated within New York State, and, therefore, 71.96% of their New York adjusted gross income. This gave them a tax factor of $24,690.20, which, when multiplied by the other factors, resulted in a tax reduction credit of $23,423.59. Similar computations, using all of their non-wage income from Buckingham Manufacturing, were performed for 2007 and 2008, giving the Pennefeathers tax reduction credits of $35,272.49 and $50,515.74 for those years, respectively.

14. Buckingham Group filed New York S corporation franchise tax returns under Tax Law Article 9-A for the years 2006 through 2008 (Franchise Tax Returns). Each Franchise Tax Return included its qualified subchapter S subsidiary Buckingham Manufacturing and indicated its retention of its election of S corporation treatment.

15. In 2010, the Division performed a field audit of petitioners' personal income tax returns for 2006 through 2008 after completion of an audit of Buckingham Group. The audit of petitioners included a review of all aspects of their claimed Empire Zone credits. After examination, the Division recalculated the tax reduction credit that was claimed by petitioners for each of the years at issue, stating that they improperly allocated all of Buckingham Manufacturing's business income to New York State in calculating the tax factor. Instead, the

Division maintained, petitioners should have used only Buckingham Manufacturing's income allocated within New York State, which the Division defined as the company's income reported on petitioners' forms K-1, multiplied by Buckingham Manufacturing's business allocation percentage as reported on the Franchise Tax Returns.

16. In reaching its determination, the Division recalculated each petitioner's tax factor by applying Buckingham Manufacturing's business allocation percentage, as reported on the Franchise Tax Returns. Buckingham Group reported a business allocation percentage of 41.5% on its 2006 return, 11.2% on its 2007 return, and 10.9% on its 2008 return. As a result, the Batty's tax reduction credit for 2006 was reduced by 60.9% to $42,354.00; for 2007, by 88.3% to $18,722.00; and, for 2008, by 89.1% to $25,015.00. Likewise, the Pennefeather's tax reduction credit for 2006 was reduced by 60.3% to $9,303.00; for 2007, by 88.4% to $4,106.00; and for 2008, by 89% to $5,568.00.

17. On September 20, 2010, following the audit, the Division issued to Harold A. and Katharine R. Batty, Jr., Notice of Deficiency number L-034566435-3, which asserted $380,531.00 in additional personal income taxes due, plus interest, for the years 2006 through 2008. The deficiency emanated from the Division's reduction of the Batty's claimed tax reduction credits.

18. On September 20, 2010, following the audit, the Division also issued to James and Tina L. Pennefeather, Notice of Deficiency number L-034565085-6, which asserted $90,889.00 in additional personal income taxes due, plus interest, for the years 2006 through 2008. The Pennefeather's deficiency was likewise attributed to the Division's reduction of the claimed tax reduction credits.

19. According to the Division, the adjustments were required in order to fairly allow the tax reduction credit to residents and nonresidents alike.

20. The instructions to form IT-604 do not mention application of the business allocation percentage in describing the procedure for calculating the tax factor as part of the tax reduction credit on returns prepared for shareholders of New York S corporations that are QEZEs. The instructions do, however, state that the tax factor "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. . . . The income allocable to New York State is the QEZE S corporation's income from New York State sources."

21. In 2006, the Division issued a Technical Services Bureau Memorandum addressing QEZE tax credits (***see*** Technical Services Bureau Memorandum, TSB-M-06[1]C and TSB-M-06[2]I, February 2, 2006). The section of the TSB-M discussing calculation of the tax factor by shareholders of New York S corporations that are QEZEs states that "[t]he income from the QEZE S corporation allocable to New York State is the QEZE S corporation income from New York State sources." Again, there is no mention of application of the business allocation percentage under the applicable section in the document.

22. The Division had performed a prior audit on earlier returns of petitioners and approved the tax reduction credit as calculated on the returns without use of a business allocation percentage.

23. Petitioners submitted 39 proposed findings of fact and 29 proposed conclusions of law. In accordance with State Administrative Procedure Act (SAPA) § 307(1), petitioners' proposed findings of fact have been generally accepted and made a part of the Findings of Fact herein, with the following exceptions:

(i) proposed findings of fact 16, 25 and 34 are argument or conclusions of law;

(ii) the last two sentences of proposed finding of fact 10 are unnecessary in rendering this determination; and

(iii) proposed findings of fact 15, 30, 31 and 37 have been modified to more accurately reflect the record.

SAPA does not require rulings to be made upon proposed conclusions of law and none are made herein.

SUMMARY OF THE PARTIES' POSITIONS

24. Petitioners argue that they calculated the tax reduction credit on their 2006 through 2008 returns consistent with the clear language and spirit of Tax Law § 16 and the instructions to form IT- 604. Petitioners maintain that as shareholders of a subchapter S corporation that was a QEZE, Buckingham Manufacturing's income and credits flowed through to them and were to be reported on their New York State personal income tax returns. They emphasize that as residents, under the law, all of their income from Buckingham Manufacturing was allocated to New York State and, therefore, was to be used in calculating the tax factor. Additionally, petitioners point out that the Division's use of the business allocation percentage was without statutory or regulatory authority and incorrect as the taxpayers involved did not file returns under Article 9-A. Petitioners also assert that the Division's interpretation of Tax Law § 16 violates the Equal Protection Clauses of the United States and New York State constitutions. Finally, petitioners believe the legislative intent of the Empire Zones Program was to offer various incentives to businesses that agree to create employment and make investments in areas that are economically depressed. One such reward for such businesses, or shareholders, members, or partners of pass-through businesses is a tax reduction credit. Petitioners insist that there was never an intent by

the Legislature to reduce the tax reduction credit because the QEZE's products, while manufactured at the certified location, were shipped out of New York State.

25. The Division asserts that in order to properly determine the income allocated to New York State for purposes of the tax factor, Tax Law § 16 and the Privileges and Immunities Clause of the United States Constitution required application of Buckingham Manufacturing's business allocation percentage to its income. In addition, the Division maintains that, as the agency charged with enforcement of Tax Law § 16, its interpretation should be given significant weight and judicial deference, as long as its interpretation is not irrational, unreasonable or inconsistent with the governing statute.

CONCLUSIONS OF LAW

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. Tax Law § 16, which was part of the Act, allows for a credit, known as the QEZE tax reduction credit, against corporate and personal income taxes of a QEZE, or as is applicable here, a shareholder of a New York S corporation that is a QEZE.

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." Neither party disputes petitioners' calculations of the first three factors for the years at issue.

C. At issue in this case is the method of calculation of 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 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.

Tax Law § 16(f)(1) states that:

> [t]he tax factor shall be, in the case of article nine-A of this chapter, the larger of the amounts of tax determined for the taxable year under paragraphs (a) and (c) of subdivision one of section two hundred ten of such article. The tax factor shall be, in the case of article twenty-two of this chapter, the tax determined for the taxable year under subsections (a) through (d) of section six hundred one of such article.

Simply put, the tax factor is the product of 1) the shareholder's New York State income tax, multiplied by 2) a fraction, the numerator of which is the shareholder's income from the QEZE allocated to New York State, and the denominator of which is the shareholder's New York State adjusted gross income. Determination of the shareholder's tax, according to Tax Law § 16(f)(1), is to be made pursuant to Articles 9-A or 22, depending on the filing nature of the taxpayer claiming the credit.

D. Petitioners were shareholders of Buckingham Group, a subchapter S corporation and the QEZE. In turn, Buckingham Group was the sole shareholder in Buckingham Manufacturing, its qualified subchapter S subsidiary. It is uncontroverted that Buckingham Manufacturing was a disregarded entity for federal and state tax purposes, and that its tax attributes flowed through to petitioners, both of whom filed 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). As such, petitioners'

New York State tax was computed based on all of their nonexcluded income from Buckingham Manufacturing pursuant to Article 22, and not Article 9-A.

Tax Law § 16 clearly requires use of the shareholder's portion of income from the QEZE that is allocated to New York State in calculating the tax factor. As New York State residents, all of petitioners' income from Buckingham Manufacturing was allocated to New York, and their tax determined under Tax Law § 601. Consequently, consistent with the statute, petitioners' tax factor was the amount of their tax that was attributable to the income from Buckingham Manufacturing, which, for the years at issue, was as they reported.

E. The Division went a step further than the statute provides, however, by applying a business allocation percentage to Buckingham Manufacturing's income, thereby reducing petitioners' income allocated to New York State and, correlatively, their tax factor. Petitioners correctly point out that there is no mention in Tax Law § 16 of application of the business allocation percentage when the tax reduction credit is claimed by resident shareholders of subchapter S corporations under Article 22. Similarly, it is not discussed in a regulation on point. Instead, without such necessary authority, the Division erroneously applied the Article 9-A principles discussed in the first sentence of Tax Law § 16(f)(1) to Article 22 taxpayers.

Tax Law § 16(f)(2) plainly states that when the taxpayer seeking the tax reduction credit is a shareholder of an S corporation, the *shareholder's* tax factor is the portion of his tax as determined under Tax Law § 16(f)(1), which in this case, was pursuant to Article 22. It is petitioners', and not Buckingham Manufacturing's tax factor that must be determined in this case and, therefore, the Division's insistence on calculating the tax factor under Article 9-A was incorrect. Because it did so, the Division incorrectly allocated only a portion of Buckingham

Manufacturing's income to New York, and not the entire income to which petitioners' tax liability was attributable, as Tax Law §16 requires.

F. The authority that the Division points to in support of its adjustments is misplaced. First, it argues that the plain meaning of Tax Law § 16(f)(2) supports its case because the allocation language therein "has to mean something, and under . . . [p]etitioners' interpretation, it becomes meaningless." On the contrary, that language has clear meaning that supports petitioners' case, as discussed in Conclusions of Law D and E. The Division also relies on the language in the instructions to form IT-604, which reads that "[t]he income allocable to New York State is the QEZE S corporation's income from New York State sources." To the extent that this language in form IT-604 could be interpreted to support the Division's position and adds the requirement of application of a business allocation percentage, it differs from or expands the statute. The Tribunal has strongly cautioned that such addition must be created by the legislative or regulatory processes, and not simply through memoranda or instructions (***see Matter of Stuckless***, ***Tax Appeals Tribunal***, August 17, 2006). Finally, Tax Law §§ 631 and 632, also cited by the Division as authority, discuss the use of a business allocation percentage in determining the New York source income of a *nonresident* shareholder of an S corporation, not resident taxpayers, such as petitioners. Simply put, there is no statutory or directory authority for the use of the business allocation percentage in the instant case.

G. Interestingly, the use of a business allocation percentage is discussed in the Technical Services Bureau Memorandum on point (***see*** TSB-M-06[1]C and TSB-M-06[2]I). It is raised, however, in the context of instructions for calculating the tax factor for corporate partners. That situation is not present here. Such language is glaringly missing from the instructions for

calculating the tax factor for personal income tax taxpayers, including shareholders of S corporations.

H. The Division further argues that its adjustment was warranted by the Privileges and Immunities Clause of the United States Constitution as a matter of fairness to nonresident taxpayers. The Privileges and Immunities Clause, found in Article IV of the Constitution, requires that "[t]he Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States." "The object of the Privileges and Immunities Clause is to 'strongly . . . constitute the citizens of the United States one people,' by 'plac[ing] the citizens of each State upon the same footing with the citizens of other States, so far as the advantages resulting from citizenship in those States are concerned'" (***Matter of Lunding v. New York Tax Appeals Tribunal***, 522 US 287, 296 [1998][citations omitted]).

As petitioners correctly state, the case law in this area does not bar their calculations pursuant to Tax Law § 16, which fairly and constitutionally limits the benefit of the tax reduction credit to New York tax liability attributable to a QEZE's activities within an Empire Zone (***see Matter of Lunding***; ***Shaffer v. Carter***, 252 US 37 [1920]; ***Travis v. Yale & Towne Mfg. Co.***, 252 US 60 [1920]). Both residents and non-residents benefit from the credit in a proportionate manner. Indeed, under petitioners' interpretation of Tax Law § 16, both resident and nonresident taxpayers calculate the tax factor and, thus, receive the tax reduction credit proportionately based on their income from the QEZE allocated to New York. They both receive the same percentage of tax abatement. Conversely, as petitioners rightly argue, the Division's position actually treats nonresident taxpayers more favorably than resident taxpayers, as nonresident taxpayers could receive a credit for 100 percent of their tax paid on the income from the QEZE while residents in

the same situation could receive credit for a smaller percentage of their tax liability. Clearly, the Privileges and Immunities clause does not support this type of result.

I. A tax credit is a particularized species of exemption from tax (***Matter of New York Fuel Terminal Corp.***, Tax Appeals Tribunal, August 27, 1998). Statutes creating exemptions from tax are to be strictly construed (***see Matter of Grace v. New York State Tax Commn.***, 37 NY2d 193, 371 NYS2d 715 [1975], ***lv denied*** 37 NY2d 708, 375 NYS2d 1027 [1975]; ***Matter of Blue Spruce Farms v. New York State Tax Commn.***, 99 AD2d 867, 427 NYS2d 744 [1984], ***affd*** 64 NY2d 682, 485 NYS2d 526 [1984]). Statutory rules of construction provide that "[t]he legislative intent is to be ascertained from the words and language used, and the statutory language is generally construed according to its natural and most obvious sense, without resorting to an artificial or forced construction" (McKinney's Cons Laws of NY, Book 1, Statutes § 94). Where the statute is clear, the courts must follow the plain meaning of its words, and "there is no occasion for examination into extrinsic evidence to discover legislative intent . . ." (McKinney's Cons Laws of NY, Book 1, Statutes § 120; ***see Matter of Raritan Dev. Corp. v. Silva***, 91 NY2d 98, 667 NYS2d 327 [1997]; ***Matter of Schein***, Tax Appeals Tribunal, November 6, 2003). Where, as here, words of a statute have a definite and precise meaning, it is not necessary to look elsewhere in search of conjecture so as to restrict or extend that meaning (***Matter of Erie County Agricultural Society v. Cluchey***, 40 NY2d 194, 386 NYS2d 366 [1976]). As the language of the statute is clear, it is appropriate to interpret its phrases in their ordinary, everyday sense (***Matter of Automatique v. Bouchard***, 97 AD2d 183, 470 NYS2d 791 [1983]).

J. The Division correctly asserts that it is generally recognized that the interpretation of a statute by an agency charged with its enforcement is entitled to great weight to the extent that its

interpretation relies on its special competence. (***Matter of Jennings v. Commissioner of Social Services***, 71 AD3d 98, 893 NYS2d 103 [2010].) Moreover, the construction given statutes and regulations by the agency responsible for their administration, if not irrational or unreasonable, should be upheld. (***Matter of Garofolo v. Rosa***, 26 Misc3d 969, 891 NYS2d 899 [Sup Ct, Kings Cty 2009].) However, a pure legal interpretation of clear and unambiguous statutory terms requires no deference to interpretation of an agency charged with the statute's enforcement, inasmuch as there is little or no need to rely on any special expertise on the agency's part. (***Matter of Lewis Family Farm, Inc. v. New York State Adirondack Park Agency***, 64 AD3d 1009, 882 NYS2d 762 [2009].) In fact, "[a]n administrative practice contrary to or inconsistent with the statute is without legal effect and will be disregarded by the courts." (***In re Billings' Estate***, 70 NYS2d 191, 194 [1947].)

In the instant matter, the Division applied the incorrect statutory method for calculating the tax factor, thereby reducing petitioners' claim for a credit that they were entitled to under the clear and unambiguous language of the statute. As discussed above, petitioners' tax factor was the portion of their tax attributable to the income of the S corporation, Buckingham Manufacturing. As the ultimate issue in this case is one of pure, legal interpretation, deference to the Division is not required, and this forum is charged with the responsibility of construing the clear and unambiguous statutory language as to give effect to the plain meaning of the words used. (***Matter of Brown v. New York State Racing and Wagering Board***, 60 AD3d 107, 871 NYS2d 623, 629 [2009].) Hence, it is determined that the clear language contained in Tax Law § 16 supports petitioners' calculation of the tax reduction credit as reported on their 2006 through 2008 returns.

K. As petitioners' application of Tax Law § 16 is deemed correct, their alternative argument that the Division's application of the statute violates the Equal Protection Clauses of the United States and New York State constitutions is moot.

L. The petitions of Harold A. Batty, Jr. and Katharine R. Batty, and James E. Pennefeather and Tina L. Pennefeather are granted, and the notices of deficiency, dated September 20, 2010, are canceled.

DATED: Albany, New York
April 4, 2013

/s/ Herbert M. Friedman, Jr.
ADMINISTRATIVE LAW JUDGE