STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition :

of :

PATRICK MURPHY :

for Redetermination of a Deficiency or for Refund of :
Personal Income Tax under Article 22 of the Tax Law
and the New York City Administrative Code for the :
Year 2006.

DECISION
DTA NO. 825277

:

In the Matter of the Petition

:

of

:

KATHLEEN MURPHY

:

for Redetermination of a Deficiency or for Refund of
Personal Income Tax under Article 22 of the Tax Law :
and the New York City Administrative Code for the
Year 2006. :

Petitioners, Patrick and Kathleen Murphy, filed an exception to the determination of the Administrative Law Judge issued on February 9, 2017. Petitioners appeared pro se. The Division of Taxation appeared by Amanda Hiller, Esq. (Jennifer L. Hink-Brennan, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in opposition. Petitioners filed a reply brief. Neither party requested oral argument. The six-month period for the issuance of this decision began on September 6, 2017, the date that petitioners' reply brief was received.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision. Commissioner Giardina took no part in the consideration of this matter.

ISSUES

I. Whether the Division of Tax Appeals lacks subject matter jurisdiction based on the preemption provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

II. Whether the notice of deficiency must be canceled based on the preemption provisions of ERISA.

III. Whether the Division of Taxation correctly attributed a gain obtained by JJF Associates LLC under Internal Revenue Code (IRC) (26 USCA) § 1231 to petitioners under the economic substance or sham trust theory.

IV. Whether petitioners were denied due process of law.

V. Whether the notice of deficiency is time barred by Tax Law § 683.

VI. Whether petitioners have demonstrated reasonable cause for the abatement of penalties.

VII: Whether the notice of deficiency had a rational basis.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except that we have modified findings of fact 7, 8, 19, 20, 25, 27, 28, 29, 31, 39, 40, 41, 45, 47 and 52. We make these changes to more fully reflect the record. The Administrative Law Judge's findings of fact and the modified findings of fact appear below.

1. The Division of Taxation (Division) issued notice of deficiency number L-035037360-3, dated November 22, 2010, to petitioners, Patrick and Kathleen Murphy, asserting personal income tax due of $229,057.00, plus negligence and substantial understatement of tax penalties,

and interest, under article 22 of the Tax Law and the New York City Administrative Code for the year 2006.

2. The activity that gave rise to the subject notice was the August 16, 2006 sale of real property located at 948 Second Avenue in Manhattan (Property) for $5,500,000.00. The seller of the Property was JJF Associates LLC (JJF Associates), a limited liability company that was created in 1996 and treated as a partnership for tax purposes. Thus, its New York State tax attributes flowed through to its partners under Tax Law § 601 (f). The Property was purchased by 952 Associates LLC, an entity unrelated to JJF Associates. The Property had 12 rent-controlled residential units and a commercial tenant (a restaurant) on the first floor.

3. JJF Associates realized a gain of $2,268,774.00 on the sale of the Property.

4. JJF Associates reported the gain from the sale of the Property on its 2006 New York State partnership return (form IT-204). The return was signed on October 13, 2007 by petitioner Patrick Murphy as "general partner" without further designation or qualification.

5. At the time of the sale, JJF Associates was owned by two members, JJF Realty Employees Stock Ownership and Plan Trust (JJF ESOP), which owned 99%, and Triune Foundation, Inc. (Triune), which owned 1%.

6. Petitioner Patrick Murphy was the trustee of JJF ESOP at the time of the sale, having succeeded Triune in that capacity. Petitioners were the sole participants and beneficiaries of JJF ESOP.

7. Triune was incorporated in 1994 under Not-for-Profit Corporation Law § 402. At all relevant times, Triune was a tax-exempt entity under IRC (26 USCA) § 501 (c) (3). Petitioner Patrick Murphy was also the president of Triune. Triune contributed the Property to JJF Associates by deed in June 1996. Petitioner Patrick Murphy testified that the Property was

transferred from Triune to JJF Associates to allow for its management and generation of income for Triune. He explained that Triune was established to create educational programs such as funding scholarships. Triune funded college scholarships for three or four years during the 1990s, but subsequently engaged in no other activities. Its tax-exempt status was revoked in August 2011, effective May 15, 2010, as it failed to file tax returns for the prior three years.

8. Petitioners maintain that JJF ESOP was a tax-exempt pension trust established in 1999 for the benefit of the employees of JJF Realty Management, Inc. (JJF Realty). Petitioners take the position that they were employees of JJF Realty during the applicable period. Petitioners Patrick and Kathleen Murphy were also the president and secretary, respectively, of JJF Realty. There were no other officers or employees of JJF Realty as of 2006.

9. JJF Realty was incorporated in 1999, under New York's Business Corporation Law. Pursuant to its certificate of incorporation, JJF Realty's purpose was to own and operate the Property. There is no evidence of JJF Realty's involvement with any other property.

10. JJF Realty was wholly owned by JJF ESOP. Petitioners were the only members of the board of directors of JJF Realty. No minutes or dates of any board meetings, to the extent that they occurred, were placed into evidence.

11. JJF Realty was dissolved by proclamation of the Secretary of State of New York on June 25, 2003.

12. Despite its 2003 dissolution, on April 17, 2007, JJF Realty filed a request for a six-month extension to file a New York State franchise tax return (form CT-5) for the year 2006. The form was signed by petitioner Patrick Murphy without any reference to title or capacity. No computation or payment of tax accompanied the form. The record does not contain a filed New York State return for JJF Realty for 2006 or for any previous year.

13. JJF Realty filed a 2006 U.S. corporation income tax return (form 1120) dated October 14, 2008, listing an address of 40 Wall Street, New York, New York. On this return, JJF Realty indicated that it was the corporation's initial return filed. JJF Realty also reported that its business was "real property investor" and that JJF ESOP owned 100 percent of its corporate voting stock. JJF Realty reported that at the beginning of 2006, it had total assets of $900.00, while at the end of 2006, it had total assets of $2,852,009.00. JJF Realty also deducted $247,706.00 in legal and management fees, but did not identify the payee or payees. JJF Realty also reported that it paid no compensation to officers or wages to employees for that year. JJF Realty ultimately reported a loss of $154,106.00 for 2006. The return was signed by petitioner Patrick Murphy as JJF Realty's president.

14. JJF Realty filed a New York State general business corporation franchise tax return (form CT-4) for the year 2007, also dated October 14, 2008. The 2007 return was signed by petitioner Patrick Murphy as its president and listed as its address "c/o PJ Murphy, 40 Wall St. 33rd Floor, NYC, NY 10005." As was the case on its 2006 federal return, JJF Realty reported $900.00 in total assets at the beginning of 2007 and $2,852,009.00 at the end of 2007. JJF Realty reported an entire net income (ENI) base of minus $154,106.00, however, and a tax on an ENI base of zero. The return also indicated that there was one outstanding share of stock valued at $900.00, and that its gross payroll was zero. Finally, JJF Realty reported that it did not do business or maintain an office in New York County during 2007.

15. JJF Associates' 2006 New York State partnership return (***see*** finding of fact 4) listed "40 Wall Street, NYC NY" as the place where it carried on business. JJF Associates reported a net gain under IRC (26 USCA) § 1231 of $2,268,774.00. It also listed as its partners, Triune and JJF ESOP, both with addresses of 40 Wall Street, New York, New York.

16. JJF Associates filed a U.S. return of partnership income (form 1065) for the year 2006, signed on October 13, 2007 by petitioner Patrick Murphy as general partner or limited liability company member manager. The return indicated rental income of $24,217.00, interest income of $116,682.00, and income from a distribution from bankruptcy of $23,207.00. It also reported a net gain of $2,268,774.00 from the sale of the Property. Among its deductions, it reported management fees of $77,999.00 and legal fees of $177,086.00. There is no indication on the return as to whom the fees were paid. The schedule K-1 attached to JJF Associates' 2006 federal return indicated that JJF ESOP's share of the partnership income for 2006 included a capital gain of $2,268,774.00. In relating JJF ESOP's capital account analysis, JJF Associates reported a beginning capital account balance of $72,143.00, capital contributed during the year of $1,146,169.00, an additional current year increase of $2,171,903.00, and an ending capital account balance of $3,390,218.00.

17. In February 2009, the Division commenced an audit of JJF Associates. The primary focus of the audit was the treatment of the gain from the sale of the Property. By letter, the Division specifically informed JJF Associates that the results of the audit might apply to its members, and requested documents to verify the basis, sale proceeds, and gain computation for the Property. The audit was completed in November 2010 with a recommendation of no additional tax due from JJF Associates.

18. In April 2010, the Division commenced an audit of JJF ESOP. By letter dated April 29, 2010, the Division specifically informed JJF ESOP that the results of the audit might apply to its beneficiaries, and requested the following documents: i) a federal audit history; ii)

copies of all annual returns (including forms 5500 or 5500-EZ)[1] filed with the Internal Revenue Service (IRS); iii) copies of all annual reports; iv) a list of all plan participants; and v) any valuation studies done when formed.

19. In response to the April 2010 request, petitioner Patrick Murphy, on behalf of JJF ESOP, provided the Division with JJF ESOP's forms 5500-EZ for 2006 and 2008. Both returns indicated that JJF ESOP first became effective on May 31, 2005, listed JJF Realty as the employer, and were signed by petitioner Patrick Murphy as plan administrator. Additionally, both the 2006 and 2008 returns indicated that the plan had no assets at the beginning of each year, but had $2,000,500.00 at the end of the year. Mr. Murphy testified that entry on the 2008 return indicating no assets at the beginning of the year may have been technically correct because the funds were held in JJF Associates' account at that time. He further testified that JJF ESOP controlled the JJF Associates account in which the funds were held. JJF ESOP stated on the 2006 return that it held real estate during 2006 and that it participated in the sale of property during that year. JJF ESOP attached to its 2006 return JJF Associates' form 4797 for the sale of business property, on which the latter reported a gain of $2,268,774.00 from the sale of the Property. Finally, JJF ESOP's 2006 return stated that, other than petitioners, JJF Realty had no employees.

20. The record lacks any returns filed by JJF ESOP prior to 2006, although there is also no evidence that JJF ESOP was required to file any such returns. Additionally, there is no form 5500-EZ or other return for JJF ESOP for 2007.

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[1] Form 5500-EZ is the annual return of one-participant (owners and their spouses) retirement plan.

21. During the audit, JJF ESOP also provided the Division with a document entitled "JJF Realty, Inc. Employee Stock Ownership Trust" (ESOP Trust Agreement). The ESOP Trust Agreement states that it was "made and entered into this 1st day of January, 1999" between JJF Realty, as the employer, and Triune, as the trustee. It provides that JJF Realty established an employee stock ownership plan (ESOP Plan) for the exclusive benefits of eligible employees of JJF Realty. The ESOP Plan was to be administered by a committee appointed by the board of directors of JJF Realty. The trustee of JJF ESOP was to report to the committee and to JJF Realty on the last day of each year the then net worth of the trust fund and:

> "[F]urnish to the [c]ommittee and [JJF Realty] an annual written account and accounts for such other periods as may be required under the [ESOP Plan], showing the Net Worth of the Trust Fund at the end of the period, all investments, receipts, disbursements and other transactions made by the Trustee during the accounting period . . . in order to comply with Section 103 of the Employee Retirement Income Security Act of 1974, as amended (ERISA). . . ."

The ESOP Trust Agreement was signed by petitioner Patrick Murphy on behalf of both parties, both in his capacity as president of JJF Realty and as trustee of Triune. His signatures were attested to by petitioner Kathleen Murphy,[2] as secretary of both entities. The signature page is undated.

22. Petitioner Patrick Murphy could not recall during his testimony if a committee was formed to administer JJF ESOP. There is no separate evidence supporting the existence of a committee.

23. Petitioners did not provide the Division with any written annual reports for JJF ESOP for the years 1999 through 2005, 2007, or 2013 through 2015, nor were any placed in the record.

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[2] Petitioner Kathleen Murphy is also known as "Kathleen O'Connell" and signed the document under that name.

24. The Division concluded through its audit of JJF ESOP that JJF Realty did not have any employees, that JJF ESOP was not eligible for tax-exempt status, and that the income derived by JJF ESOP from its interest in JJF Associates was taxable to petitioners as the participants and beneficiaries of JJF ESOP.

25. Petitioners did not report the gain from the sale of the Property on their 2006 New York State personal income tax return, which was jointly filed on October 15, 2007.

26. Neither petitioner made any contributions to or received any distributions from JJF ESOP in 2006.

27. Based on the audits of JJF Associates and JJF ESOP, the Division commenced an audit of petitioners' 2006 and 2007 personal income tax returns in August 2010. In order to allow for more time to perform the audit, the Division provided petitioners with a proposed consent to extend the period of limitations for assessment (waiver) to October 15, 2011. Petitioners signed and returned the waiver in August 2010, but limited the extension to December 15, 2010 rather than the later deadline requested by the Division. An authorized representative of the Division countersigned the waiver on September 2, 2010. Petitioners refused the Division's subsequent efforts to obtain further waivers.

28. In October 2010, petitioners were informed by the Division of its preliminary determination that the income derived by JJF ESOP from its interest in JJF Associates was taxable to petitioners as the participants and beneficiaries of JJF ESOP. Specifically, the Division stated that petitioners were "found to be ineligible participants of [JJF ESOP] due to lack of employee-employer relationship between you and [JJF Realty]." A letter, dated October 22, 2010, sent with a detailed proposed audit adjustment, advised petitioners to contact the auditor by November 8, 2010 if they "disagree with the findings and would like to discuss them

in greater detail." When petitioners told the Division on November 8, 2010 that they opposed the results, they were informed that, given the impending expiration of the statute of limitations, an additional waiver would be necessary in order to allow the Division sufficient time to review any additionally submitted materials. The Division added that should the waiver not be received, a notice of deficiency would be issued based on the documents already provided.

29. On November 12, 2010, petitioner Patrick Murphy sent a letter to the Division stating that the original waiver was revoked "eo instanti." The letter stated that the waiver was obtained in violation of petitioners' due process rights and their rights under the New York State taxpayer bill of rights, and was also contrary to the Division's audit guidelines. The Division responded to petitioners by letter of November 15, 2010, reiterated its efforts to obtain additional information, the necessity to obtain a further waiver, and stated the following in bold type:

> "Nevertheless, you can still provide substantiation for your position and we [will] meet with you to discuss the case. The re[sults] of our meeting may reduce or cancel the assessment. Please call me to schedule such meeting."

30. Petitioner Patrick Murphy testified that during this period he made several requests for a meeting and that the Division refused unless an additional waiver was executed.

31. After issuance of the statutory notice on November 22, 2010, petitioners requested a conciliation conference, which was held on June 9, 2011. Petitioners did not meet with the Division's auditors prior to their requested conciliation conference. The statutory notice was sustained by conciliation order of July 20, 2012. Petitioners subsequently became aware that the auditors and the conferee had substantive discussions regarding this matter without their involvement.

32. As part of the audit process, the Division provided petitioners with a copy of publication 130-F, entitled "The New York State Tax Audit - Your Rights and Responsibilities." Regarding field audits, the publication states, in part:

> "We schedule field audits in advance to give you enough time to assemble the required records. . . . If you need a longer period of time to gather the necessary records, you can usually request an extension of up to 30 days . . . ."

Regarding audit findings or changes, the publication states, in part:

> "If there are changes, the auditor will meet with you to explain the findings . . . as well as the audit methods and procedures, in simple, nontechnical terms. . . . We then give you a reasonable period of time to disprove any of the audit findings."

33. In response to a subpoena duces tecum issued to JJF ESOP as part of this proceeding,[3] petitioners submitted a statement of participants' accounts that identified Patrick Murphy as president and 50% shareholder and Kathleen O'Connell Murphy as secretary and 50% shareholder of JJF Realty. They also attached a copy of a document entitled "JJF Realty Management Inc. Employee Stock Option Plan & Trust" (JJF ESOP Plan), which contains the following sections:

> "Effective January 1, 1999, [JJF Realty] formed the [JJF ESOP], which trust document is incorporated by reference herein. This Plan shall take effect as of the same date."

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[3] The Division sought through subpoenas duces tecum, issued in this forum, to access information and materials germane to the structure and operation of JJF Associates, JJF ESOP, and JJF Realty in 2006. In particular, the Division subpoenaed documents from petitioners demonstrating their ownership of and contributions, distributions, and forfeitures to and from JJF ESOP during the year at issue. Additionally, the Division subpoenaed documents from the three related entities concerning 1) the operation of JJF Realty, 2) total contributions to and from JJF ESOP, 3) securities that were allocated, either directly or indirectly, to JJF ESOP for the benefit of petitioners, 4) federal forms claiming exemption filed by JJF ESOP, 5) any lists of plan participants and vesting schedules for JJF ESOP, and 6) the determination of the basis of the Property that serves as the genesis of the gain in question. After judicial challenge by petitioners, the subpoenas were upheld, and the responses were provided at the hearing.

> "All those who shall have been employed on a full time basis by [JJF Realty] or shall have been actively engaged in the business of the corporation for at least 1,000 hours of each year of service performed for [JJF Realty], shall be considered eligible employees and shall be eligible to participate as beneficiaries of the [JJF ESOP] created herein."
>
> "Eligibility to participate in the JJF ESOP shall begin for eligible employees after one year of continuous employment or active engagement in the business of the corporation and shall continue until termination of such services or employment and participation in the JJF ESOP, as more fully set forth below."
>
> "[JJF Realty] shall make such contributions in [JJF Realty] stock/and or cash or other property, which, in its sole discretion it shall decide to make to the JJF ESOP. Employees shall not be required to make any contribution to the JJF ESOP."

Additionally, according to the JJF ESOP Plan, benefits vested to the account of each participating employee after one year of continuous employment, and the trustee was required to provide each covered employee with a copy of the annual valuation of plan assets filed in accordance with ERISA law. The JJF ESOP Plan was signed by petitioner Kathleen Murphy as secretary. The signature page is undated, although petitioner Patrick Murphy testified that it was created sometime after the ESOP Trust Agreement.

34. JJF Realty made no contributions to JJF ESOP in 2006.

35. JJF Realty had no operating agreement.

36. There were no annual valuations of plan assets for JJF ESOP.

37. Petitioners did not maintain separate individual pension accounts within JJF ESOP.

38. The deed evidencing the August 2006 sale of the Property identifies JJF Associates as the seller and was signed by petitioner Patrick Murphy as its managing member. The Real Estate Transfer Tax (RETT) filing summary associated with the sale of the Property lists JJF Associates, c/o petitioner Patrick Murphy, as the seller. Similarly, the real property transfer

report (form RP-5217NYC), signed by petitioner Patrick Murphy without designation, lists JJF Associates as the seller of the Property.

39. Petitioners provided a document entitled "Amendment to Agreement" dated February 28, 2006, between JJF ESOP and the purchaser of the Property (Amended Agreement).[4] Contrary to the information on the documents referenced in finding of fact 38, the Amended Agreement identified JJF ESOP as the seller of the Property and was signed by petitioner Patrick Murphy without designation.

40. In an attempt to explain the differences between the deed, RETT filing summary and the Amended Agreement, petitioner Patrick Murphy testified that title to the Property was transferred from JJF Associates to JJF ESOP prior to its sale in 2006. He added that it was done by contract as a "common practice in the real estate industry," and further stated:

> "that for the matter of the real estate records, you don't deed these things in and out of the organization when you're in control, you would be incurring unnecessary transfer taxes. So, when it came time to sell the property, the title was sold by the ESOP and directed its subsidiary, you know, JJF Associates, accordingly" (T-224).

The record lacks any deed, contract or other similar document evidencing transfer of title to the Property from JJF Associates to JJF ESOP.

41. Petitioner Patrick Murphy also testified that the Property was transferred to JJF Realty and then back to JJF Associates prior to its sale as part of a "practical merger." He added that "[i]t's done admittedly in a very simplified way through corporate resolutions and other agreements, et cetera, rather than the bulkier statutory merger procedure operated by the Business

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[4] The actual substance of the document deals with the date of the closing, treatment of existing tenants, and disposition of vacant apartments.

Corporation Law of the State of New York, which is hugely unwieldy, et cetera." Petitioners did not present any of the referenced resolutions or agreements in support of this statement.

42. The Internal Revenue Service (IRS) can provide, upon request, a favorable determination letter confirming the qualification and tax-exempt status of a retirement plan under IRC (26 USCA) §§ 401 (a) and 501 (a) (***see*** IRS publication 794). The IRS states on its website that such a letter is generally not required, but that having a favorable determination letter provides an employer with reliance that the plan is qualified and that the trust is exempt from taxation under IRC § 501 (a). Petitioners did not present a favorable determination letter from the IRS regarding JJF ESOP's status.

43. Petitioner Patrick Murphy testified that the proceeds from the sale of the Property were initially held in an investment account at Citibank owned by JJF Associates. Ultimately, he said they were moved into an account owned by JJF ESOP without giving a firm date. He also testified that, during the period of 2006 through 2008, the proceeds from the sale of the Property were either held directly by JJF ESOP in its own account or through a controlled account. The record, however, lacks any documentary evidence of the existence of any bank accounts for JJF Associates, JJF Realty or JJF ESOP in 2006 or 2007. There is also no record of petitioners' personal bank accounts during those years.

44. Petitioners opened a checking account with Chase Bank in November 2008 on behalf of JJF ESOP (the Chase account). On November 21, 2008, JJF Realty provided a check in the amount of $2,000,000.00 from a Citibank account to petitioner Patrick Murphy, as trustee of JJF ESOP. The check was deposited in the Chase account on November 25, 2008.

45. On December 4, 2008, $2,000,000.00 was withdrawn from the Chase account. Petitioner Patrick Murphy testified that these funds were deposited into a securities account. The

Chase account statement in the record identifies this withdrawal as an "intra-bank" debit. There is no further documentation in the record regarding the withdrawal or the subsequent disposition of the funds.

46. The record contains copies of JJF ESOP's forms 5500-EZ filed for 2009 through 2012. Each of the returns identify JJF Realty as the employer sponsoring the plan and indicate that the JJF ESOP plan first became effective in May of 2005.[5] Only the copy of the 2012 return is signed and dated.

47. In response to a subpoena duces tecum dated March 6, 2014 and issued in the course of this matter, petitioners stated in writing that JJF ESOP made no distributions to them "to date."[6] Petitioner Patrick Murphy testified at the hearing that he and his wife had "recently" taken some distributions "in the last couple of years." The exact dates or amounts of the distributions were unstated.

48. JJF ESOP's forms 5500-EZ for the years 2011 and 2012 show a reduction in total plan assets for each year.

49. On numerous occasions, while testifying on cross-examination, petitioner Patrick Murphy was asked for various documents to support certain of his statements. Rather than produce the requested documents, he repeatedly responded with a statement to the effect that "we weren't asked for them" or "we don't volunteer documents, ok."

50. In an affirmation placed in the record, petitioner Patrick Murphy described his

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[5] The 2009 and 2010 returns indicate that the plan became effective on May 31, 2005, while the 2011 and 2012 returns indicate the effective date as May 30, 2005.

[6] See footnote 3.

responsibilities as president of JJF Realty:[7]

> "negotiating and contracting leases for all of the tenants in the [P]roperty, including the major lease, the restaurant business on the street level floor of the [P]roperty . . . . I also negotiated and oversaw servicing of the senior prime mortgage on the [P]roperty with the mortgagee, East River Savings Bank. I also filed all tax returns required for [JJF Realty]."

He also described petitioner Kathleen Murphy's responsibilities:

> "[she] supervised day to day financial operations of the [P]roperty, including billing for monthly rentals, maintaining rent roll records, assuring compliance with rent stabilization rules, dealing with local agencies including the Dept. of Buildings and Dept. of Environmental Protection."

Petitioner Patrick Murphy added in a separate affirmation:

> "[a]s officers/employees of [JJF Realty], we also arranged for building maintenance, tenant repairs, plumbing services, sidewalk and building cleaning services, apartment repairs, garbage and snow removal, and responded to tenant complaints and building violations."

51. Petitioners reported other income of $77,999.00 identified as a management fee on their 2006 New York State personal income tax return. The source of the fee was not identified. There was no indication of any wage income received by petitioners from JJF Realty.

52. As part of this proceeding, the Division filed its second amended answer on March 17, 2014. In its second amended answer, the Division asserted for the first time that JJF ESOP should be treated as a sham entity with no economic substance and, thus, its gain should be attributed to petitioners. Petitioners filed a reply to the second amended answer on March 26, 2014 denying the Division's assertions. The hearing before the Administrative Law Judge was held on February 23 and 24, 2016.

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[7] Petitioner Patrick Murphy submitted affirmations in support of various procedural matters in the course of this proceeding. Those affirmations are part of the record pursuant to State Administrative Procedure Act (SAPA) § 302.

53. At all relevant times, JJF Realty, JJF Associates and JJF ESOP did not have any principals other than petitioners.[8] According to petitioner Patrick Murphy's testimony, Triune had other persons involved in its operation prior to 2006, but their roles and titles were not identified.

54. Petitioner Kathleen Murphy did not testify at the hearing in this matter.

55. Petitioner Patrick Murphy was born in 1933.

56. Petitioner Kathleen Murphy was born in 1938.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge first denied a motion for dismissal or for summary determination brought by petitioners because he found many material and triable issues of fact in the record. He noted, however, that the issues raised in the motion would be addressed in the determination.

Next, the Administrative Law Judge addressed petitioners' contention that the Division's assertion of tax due from petitioners in this matter is preempted by ERISA. Following a review of federal case law, the Administrative Law Judge concluded that the notice of deficiency in the present matter was not preempted by ERISA.

The Administrative Law Judge then examined whether the Division properly attributed the gain from the 2006 sale of the Property to petitioners. The Administrative Law Judge agreed with the Division that JJF ESOP was a sham trust to be disregarded and that the gain from the sale should be attributed to petitioners. In reaching this conclusion, the Administrative Law Judge applied a four-part test developed by federal courts. He noted that: (1) petitioners alone

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[8] Petitioner Patrick Murphy testified that John Fitzsimons was president of JJF Associates in 1996, but left the corporation shortly thereafter, and long before the 2006 sale of the Property.

beneficially owned and controlled the Property both before and after the creation of JJF ESOP and that they alone controlled the gain from the sale; (2) petitioner Patrick Murphy was not an independent trustee, as Mr. Murphy was in control of JJF Realty, the creator of the trust, and was also a primary beneficiary of the trust; (3) only petitioners benefitted from the sale of the Property, as there were no other beneficiaries; and (4) petitioners disregarded restrictions imposed by the trust itself or the law of trusts and petitioners were unrestricted in their use of the funds from the sale of the Property. The Administrative Law Judge also found that an absence of documentation of trust activity in the record indicated a sham trust. Specifically, he noted the lack of a bank or investment account owned by JJF ESOP in 2006 or 2007; the lack of a favorable determination letter from the IRS regarding JJF ESOP's qualified status as a retirement plan; and a lack of evidence tracing the sale proceeds from JJF Associates to JJF ESOP. The Administrative Law Judge also found unexplained inconsistencies among documents that were entered in evidence. He further determined that petitioner Patrick Murphy's testimony was "confusing, evasive and contradictory." In sum, the Administrative Law Judge concluded that, given petitioners' control over the trust, the Property and the gain from the sale, coupled with their failure to adhere to trust formalities, petitioners failed to meet their burden to show that JJF ESOP was not a sham and, accordingly, that the statutory notice was improperly issued.

The Administrative Law Judge next addressed several due process arguments raised by petitioners. In response to petitioners' complaint that the auditor acted contrary to audit guidelines and the Taxpayer Bill of Rights (Tax Law § 3000 et seq.) by refusing to meet with them, or to review their documents, and by performing a superficial audit, the Administrative Law Judge noted that the audits of petitioners and the related entities occurred over a nearly two-year period; that the Division requested numerous documents over that time; and that petitioners

were aware of the audit and had several opportunities to substantiate their position. The Administrative Law Judge was thus unpersuaded by petitioners' claim that the audit process violated their right to due process.

The Administrative Law Judge also rejected petitioners' contention that they were denied due process in the Bureau of Conciliation and Mediation Services (BCMS) as a consequence of ex parte communications between the conciliation conferee and the auditors by which, according to petitioners, the auditors induced the conferee to sustain the statutory notice. The Administrative Law Judge found that such actions, even if true, are immaterial in a Division of Tax Appeals proceeding.

The Administrative Law Judge further rejected petitioners' contention that the Division's multiple amended answers (***see*** finding of fact 52) raised new arguments that undermined the basis for the notice of deficiency. The Administrative Law Judge determined that the Division was permitted to change its legal theory of liability by amending its answer; that petitioners were aware of the Division's new theory in advance of the hearing; and that, accordingly, petitioners were not surprised by the Division's assertion of its theory of liability at the hearing.

Additionally, the Administrative Law Judge rejected petitioners' contention that the notice of deficiency was issued beyond the statutory limitations period. In reaching this conclusion, the Administrative Law Judge determined that Mr. Murphy's attempt to unilaterally revoke the waiver extending the limitations period (***see*** finding of fact 29) was of no consequence.

Finally, the Administrative Law Judge found no evidence of reasonable cause for petitioners' failure to report the gain from the sale of the Property and thus sustained the imposition of penalties.

SUMMARY OF ARGUMENTS ON EXCEPTION

Petitioners continue to contend that the Division's assertion of tax due is preempted by ERISA preemption doctrine and that, therefore, the Division of Tax Appeals is without subject matter jurisdiction in this matter. According to petitioners, preemption is required because the issues presented relate directly to the existence of a valid employee retirement plan, i.e., JJF ESOP, and the plan's compliance with ERISA law.

For the first time on exception, petitioners contend that the notice of deficiency lacked a rational basis. That is, as indicated in the statement of proposed audit changes, the basis for the notice was the audit determination that petitioners were not employees of JJF Realty and therefore were ineligible participants of JJF ESOP. As more fully developed in the Division's first answer, this audit determination led to the findings that JJF ESOP was not eligible for tax-exempt status; that it therefore should be treated as a grantor trust; and that, consequently, the gain realized by JJF ESOP on the sale of the property should flow through to petitioners. Petitioners contend that each of these audit findings was erroneous. Specifically, petitioners contend that they were in an employer/employee relationship with JJF Realty and thus were eligible participants in JJF ESOP; that JJF ESOP was a tax-exempt entity; and that there was no basis to impose a flow-through of the capital gain income at issue to them on the grounds that they were beneficiaries of JJF ESOP. Petitioners assert that the legal theory underlying the notice of deficiency was so fraught with error that the Division subsequently abandoned it, turning to its sham trust argument first enunciated in the Division's second amended answer. Under such circumstances, petitioners contend, the notice of deficiency "can hardly be regarded as having a rational basis."

Petitioners also dispute the Administrative Law Judge's conclusion that JJF ESOP was a sham trust. Petitioners contend that the evidence presented establishes that JJF ESOP was a bona fide employee retirement trust properly organized and operated under ERISA laws. Petitioners thus contest the Administrative Law Judge's interpretation of the evidence in the record and seek to distinguish the case law upon which the determination relies.

Petitioners also continue to assert that they were denied due process during the audit, following the BCMS conference, and at the hearing. With respect to the audit, petitioners contend that they were not given an opportunity to meet with the auditor to discuss or to provide documents to substantiate their position that they were employees of JJF Realty ESOP prior to the issuance of the proposed field audit adjustment statement on October 22, 2010. Petitioners further contend that the Division denied them the opportunity to submit documents following the issuance of the proposed audit adjustment statement. Petitioners specifically contend that the Division conditioned the submission and consideration of any such documents on petitioners' consent to a further extension of the statute of limitations. Petitioners assert that such action by the Division was contrary to the audit procedures discussed in publication 130-F.

With respect to the BCMS process, petitioners contend that they were denied due process by numerous ex parte communications between the conferee and the Division's auditor following which the Division's theory of liability shifted from whether petitioners were employed by JJF Realty to whether ESOP was validly created. Petitioners note that they were not given an opportunity to respond to this new theory of liability at the conference level. Petitioners contend that such ex parte communications are contrary to the purpose of BCMS, i.e., a means to provide an impartial resolution of taxpayer disputes.

Petitioners also contend that the Division's changing theories of liability deprived them of their right to a fair hearing. Petitioners note the different theories expressed in the statement of proposed audit changes, the Division's initial answer and its second amended answer. Petitioners also assert that the Division raised a third theory of liability for the first time at the hearing by alleging in its opening statement that the proceeds from the sale of the property were "not properly in the ESOP." Petitioners contend that this issue was not addressed during the audit process and that the auditor made no request for bank records. While petitioners assert that such proceeds had been held in trust for the ESOP at all times, they contend that they had little time to offer testimony or to produce evidence tracing the proceeds of the sale and thereby proving this contention. Petitioners also contend that they offered to provide documentation to show that the proceeds from the sale were transferred to JJF ESOP, but that no such opportunity was accorded them. Petitioners thus argue that they were denied their full due process rights at the hearing.

Petitioners also continue to assert that the November 22, 2010 notice of deficiency was time-barred by the three-year statute of limitations (***see*** findings of fact 1, 25 and 27). Specifically, petitioners assert that they revoked their waiver extending the statute by letter dated November 12, 2012 (***see*** finding of fact 29). Petitioners reason that such revocation was justified given the Division's purported refusal to permit petitioners to submit evidence to refute the audit findings. Petitioners also contend, for the first time on exception, that their unilateral revocation was made before the Division signed the consent form as required, thereby rendering any such waiver void. In support of this point, petitioners note the auditor's testimony that the signature and date, while concededly difficult to read, was dated January 2, 2011.

Finally, petitioners contend that there is no basis for imposing penalties against them because they are not liable for any part of the tax asserted due.

The Division asserts that the Administrative Law Judge correctly analyzed the preemption provisions of ERISA and the corresponding case law to determine that the present matter was not preempted. More specifically, the Division contends that the Tax Law provisions implicated herein are laws of general application that do not refer to ERISA. The Division contends that ERISA is relevant here simply to determine whether JJF ESOP is a sham. The Division concedes that if petitioners show that JJF ESOP is a bona fide trust and plan, then petitioners will prevail. The Division also contends that if petitioners prevail on the preemption argument, then the Division will be unable to determine the validity of any ESOP trusts, even if such trusts are shams.

The Division agrees with the Administrative Law Judge's finding that JJF ESOP was a sham trust. The Division asserts that petitioners failed to establish that they were employees of JJF Realty; that JJF ESOP was a tax-exempt ESOP trust; that JJF ESOP was invested primarily in JJF Realty's stock; that JJF Realty ever issued any stock or that JJF ESOP ever purchased any of it; that JJF ESOP was funded before November 2008; that JJF ESOP owned and sold the Property; or that the $2,000,000.00 that was withdrawn from the account on December 4, 2008 was ever reinvested in the ESOP. The Division also agrees with the Administrative Law Judge's finding regarding Mr. Murphy's testimony, asserting that such testimony lacked credibility. The Division thus agrees with the Administrative Law Judge's finding that the record shows that petitioners had control over the trust, the Property and the gain from the sale and that they failed to follow trust formalities. Accordingly, the Division asserts that petitioners failed to meet their burden of proof and that the statutory notice was properly issued.

The Division also denies petitioners' contentions that their due process rights were violated. The Division asserts that petitioners were aware of the Division's examination of the sale of the Property by the audits of JJF Associates and JJF ESOP and argues that petitioners could have submitted evidence in support of their position in connection with those audits. The Division contends that any inability to submit documents before the issuance of the notice of deficiency was the result of petitioners' refusal to extend the statute of limitations. With respect to the conciliation process, the Division echoes the Administrative Law Judge's conclusion that defects in that process are immaterial in the present proceeding. The Division also contends that petitioners received due process in the hearing before the Administrative Law Judge. The Division agrees with the Administrative Law Judge's conclusion that the Division's amended answers do not violate due process. The Division also rejects petitioners' contention that they were unfairly deprived of an opportunity to produce evidence regarding the proceeds of the sale of the Property.

The Division contends that petitioners agreed to extend the limitations period for assessment to December 15, 2010 and that the November 22, 2010 notice of deficiency was thus not time-barred. The Division asserts that Mr. Murphy had no right to cancel or revoke the consent agreement "eo instanti."

Finally, the Division notes that petitioners offered no evidence of reasonable cause for the tax deficiency and asserts, accordingly, that penalties should be sustained.

OPINION

We begin by addressing petitioners' statute of limitations claims. Tax Law § 681 (a) provides that "[i]f upon examination of a taxpayer's return . . . [the Division] determines that there is a deficiency of income tax," it may issue a notice of deficiency to the taxpayer. With

certain exceptions not relevant here, the Division must issue such a notice within three years after the return was filed (Tax Law § 683 [a]). The limitations period may be extended by written agreement between the Division and the taxpayer before the period expires (Tax Law § 683 [c] [2]). Petitioners' 2006 return was filed on October 15, 2007. Hence, the three-year period would normally expire on October 15, 2010. In August 2010, however, petitioners agreed in writing to extend the limitations period to December 15, 2010. The waiver was countersigned by the Division on September 2, 2010. Accordingly, given the parties' agreement to extend the limitations period pursuant to Tax Law § 683 (c) (2), the notice of deficiency issued on November 22, 2010 was timely.

We agree with the Administrative Law Judge that petitioner Patrick Murphy's attempt to unilaterally revoke the agreement "eo instanti" by letter dated November 12, 2012 is of no consequence. We thus reject petitioners' contention that such revocation was justified given the Division's purported refusal to permit petitioners to submit evidence to refute the audit findings. On this point, we note that the waiver itself contains no language regarding the submission of evidence. We note also that the Division is not required to request and examine a taxpayer's books and records, i.e., evidence, before issuing a notice of deficiency of income tax (***see Matter of Ragozin***, Tax Appeals Tribunal, July 22, 1993; ***see also Matter of Giuliano v Chu***, 135 AD2d 893, 895 [3d Dept 1987]). We also reject petitioners' evidentiary claim, raised for the first time on exception, that the Division did not sign and thus did not agree to the waiver until January 2, 2011. Although the handwriting is poor, we are satisfied that the date written by the Division official who countersigned the waiver is September 2, 2010. We observe that this date matches the stamped date of the Division's receipt of the signed waiver forms from petitioners. We note

also that January 2, 2011 was a Sunday and not a normal business day.[9] Additionally, we note that, although the Division's witness at the hearing first testified that the date of the signature was January 2, 2011, she later changed her testimony to September 2, 2010.

We turn next to petitioners' claim that the notice of deficiency lacked a rational basis. As noted, the basis for the notice was the audit determination that petitioners were not employees of JJF Realty and were thus ineligible participants of JJF ESOP. The Division's first answer expands on this audit determination to assert that JJF ESOP was not eligible for tax-exempt status; that it therefore should be treated as a grantor trust; and that, therefore, the gain realized by JJF ESOP on the sale of the property should flow through to petitioners. Petitioners contend that each of these contentions is erroneous and that the Division effectively acknowledged such error by subsequently turning to its sham trust argument.

"[T]he question to be asked in determining the validity of an assessment in the first instance is whether the assessment is rational, not whether it is correct" (***Matter of Bernstein***, Tax Appeals Tribunal, December 24, 1992). Here, petitioner's argument is simply that the initial rationale underlying the notice of deficiency was based on erroneous audit findings, not that it was irrational. Accordingly, we find that the notice of deficiency had a rational basis.

We begin our analysis of the preemption issue with a general discussion of the tax consequences arising from the transaction that led to the asserted deficiency. The gain from the sale of the Property resulted in long term capital gain pursuant to IRC (26 USCA) § 1231 and was reported as such on JJF Associates' 2006 partnership return (***see*** finding of fact 15). The full amount of the gain was reported on its 99%-member JJF ESOP's K-1 and thus was passed

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[9] We take official notice of the fact that January 2, 2011 was a Sunday (***see*** SAPA § 306 [4]).

through to JJF ESOP (***see*** finding of fact 16). Generally, of course, liability for income tax also passes through to an LLC member (Tax Law § 601 [f]). However, an ESOP trust qualified under IRC (26 USCA) § 401 (a) is exempt from tax pursuant to IRC (26 USCA) § 501 (a). Responsibility for tax on a qualified ESOP trust's income ultimately falls to the trust's beneficiaries, as distributions from the trust are taxable to the distributee in the year of distribution (IRC [26 USCA] § 402 [a]).

Turning directly now to the question of preemption, an ESOP trust that is qualified under IRC (26 USCA) § 401 (a) is an employee benefit plan as defined in ERISA (***see*** 29 USCA § 1002 [3]). Such an entity would thus fall within the scope of the ERISA preemption clause, which states that ERISA's provisions "supercede any and all State laws insofar as they may now or hereafter *relate to* any employee benefit plan" (29 USCA § 1144 [a], emphasis added). "State law" as used in the preemption clause includes "all laws, decisions, rules, regulations, or other state action having the effect of law, of any State" (29 USCA § 1144 [c] [1]). "State" includes a State agency (29 USCA § 1144 [c] [2]). The notice of deficiency at issue, by which the Division seeks to assess income tax against petitioners, and the instant administrative proceeding, by which petitioners protest the notice, are both thus "State law" for purposes of ERISA preemption (***see Murphy v New York State Division of Tax Appeals***, Sup Ct, Albany County, January 8, 2016, McDonough, J., index no. 4379-15 [subpoenas issued to petitioners in the present matter were deemed "state law," albeit "not the type of 'state law' preempted by ERISA"].

Ascertaining the meaning of ERISA's preemption clause is a matter of congressional intent (***New York State Conference of Blue Cross & Blue Shield Plans v Travelers Insurance Co.*** [***Travelers***], 514 US 645, 655 [1995]). We start with the presumption that Congress generally does not intend to preempt state laws (***De Buono v NYSA-ILA Med. & Clinical Serv. Fund***, 520

US 806, 813 [1997]; ***Maryland v Louisiana***, 451 US 725, 746 [1981]). This presumption is particularly strong where, as here, the state law to be preempted is in an area of "traditional state regulation" (***Travelers*** at 655). Nevertheless, the ERISA statute expressly provides that state tax laws are not exempt from preemption (***see*** 29 USCA § 1144 [b] [5] [B] [i]). Statutory language is often the clearest indicator of legislative intent (***DaimlerChrysler Corp. v Spitzer***, 7 NY3d 653, 660 [2006]). Accordingly, the Supreme Court has defined "relates to" in its "normal sense" and has held that an ERISA plan preempts a state law if the law has a "connection with or reference to such a plan" (***Shaw v Delta Air Lines, Inc.***, 463 US 85, 97 [1983]). This rule has been the subject of much litigation. As the Administrative Law Judge noted, the Supreme Court most recently summarized the state of the law regarding the ERISA preemption standard in ***Matter of Gobeille v Liberty Mutual Ins. Co.*** [***Gobeille***] (577 US ___ , 136 S Ct 936, 943 [2016]), as follows:

> "[T]he Court's case law to date has described two categories of state laws that ERISA pre-empts. First, ERISA pre-empts a state law if it has a "'reference to'" ERISA plans. [***Travelers*** at 656]. To be more precise, '[w]here a State's law acts immediately and exclusively upon ERISA plans . . . or where the existence of ERISA plans is essential to the law's operation . . . , that 'reference' will result in pre-emption.' [***California Div. of Labor Std. Enforcement v. Dillingham Constr., N.A., Inc.*** [***Dillingham***], 519 US 316, 325 (1997)]. Second, ERISA pre-empts a state law that has an impermissible 'connection with' ERISA plans, meaning a state law that 'governs . . . a central matter of plan administration' or 'interferes with nationally uniform plan administration.' ***Egelhoff v. Egelhoff***, 532 U.S. 141, 148 (2001). A state law also might have an impermissible connection with ERISA plans if 'acute, albeit indirect, economic effects' of the state law 'force an ERISA plan to adopt a certain scheme of substantive coverage or effectively restrict its choice of insurers.' ***Travelers*** at 668. When considered together, these formulations ensure that ERISA's express pre-emption clause receives the broad scope Congress intended while avoiding the clause's susceptibility to limitless application."

The Court has also considered Congress' objectives in enacting ERISA to determine whether preemption applies and has described those objectives, in part, as follows:

> "[The ERISA preemption provision] was intended to ensure that plans and plan sponsors would be subject to a uniform body of benefits law; the goal was to minimize the administrative and financial burden of complying with conflicting directives among States or between States and the Federal Government" (***Ingersoll-Rand Co. v McClendon***, 498 US 133, 142 [1990]).

Although broadly worded, ERISA's preemption provision is not unlimited, and preemption will not occur unless the state law in issue affects an ERISA plan "in more than a tenuous, remote or peripheral way" (***Shaw v Delta Air Lines, Inc.***, 463 US at 96-97).

As the Supreme Court noted in ***Gobeille***, "'where the existence of ERISA plans is essential to the law's operation . . . , that "reference" will result in pre-emption'" (136 S Ct at 943 quoting ***Dillingham***, 519 US at 325). This rule is premised, in part, on the Court's earlier decision in ***Ingersoll-Rand Co. v McClendon***. In that case, a former employee brought a common law action for wrongful discharge under Texas state law against his former employer. The employee sought damages for lost wages, mental anguish and punitive damages, but did not seek lost pension benefits. The employee claimed that he was fired primarily because of the employer's desire to avoid contributing to or paying benefits under a plan covered by ERISA (498 US at 140). The Court observed that "in order to prevail, a plaintiff must plead, and the court must find, that an ERISA plan exists and the employer had a pension-defeating motive in terminating the employment" (***id.***). The Court also observed that, because "the existence of a pension plan is a critical factor in establishing liability," the "[trial] court's inquiry must be directed to the plan" (***id.*** at 139, 140). Hence, there would be "*no* cause of action if there is no plan" (***id.*** at 140). Accordingly, considering that the "cause of action relates not merely to pension benefits, but to the essence of the pension *plan* itself," it "relate[s] to" an ERISA plan (***id.***). The Court thus found that preemption of the former employee's state law cause of action was appropriate.

The Court also noted that its conclusion was supported by the purposes of the preemption clause:

> Allowing state based actions like the one at issue here would subject plans and plan sponsors to burdens not unlike those that Congress sought to foreclose through [the ERISA preemption provision]. Particularly disruptive is the potential for conflict in substantive law. It is foreseeable that state courts, exercising their common law powers, might develop different substantive standards applicable the same employer conduct, requiring the tailoring of plans and employer conduct to the peculiarities of the law of each jurisdiction. Such an outcome is fundamentally at odds with the goal of uniformity that Congress sought to implement" (***id.*** at 142).

Ingersoll-Rand strongly supports a finding in favor of preemption in the present matter. As in ***Ingersoll-Rand***, the existence of a plan subject to ERISA regulation is a "critical factor" in determining liability in the present matter. Specifically, petitioners seek to prove that JJF ESOP exists and is qualified under IRC (26 USCA) § 401 (a). Accordingly, similar to ***Ingersoll-Rand***, this administrative proceeding relates to the "essence" of JJF ESOP, the putative ERISA plan, and therefore relates to ERISA. Furthermore, from a policy perspective, it is plainly contrary to the preemption clause's "goal of uniformity" for the Division of Tax Appeals to determine whether a trust is qualified under IRC (26 USCA) § 401 (a). As noted in ***Ingersoll-Rand***, without preemption, state courts "might develop different substantive standards applicable to the same employer conduct, requiring the tailoring of plans and employer conduct to the peculiarities of the law of each jurisdiction" (***id***.). As a consequence of an administrative decision in the present matter, New York could develop its own standard regarding the qualification of a trust under IRC (26 USCA) § 401 (a). Such an outcome would be "particularly disruptive" (***id***.) and inconsistent with the purpose of the preemption provision to "eliminat[e] the threat of conflicting and inconsistent State and local regulation" (***Travelers*** 514 US at 657).

Although ***Ingersoll-Rand*** points the way toward preemption, resolution of the present matter is complicated by the defensive posture in which the preemption claim has been raised. That is, although petitioners have the burden of proof in the present proceeding, the Division asserted liability against petitioners in the first instance by the issuance of the notice of deficiency. The Administrative Law Judge rightly noted the potential for abuse if the mere claim of the existence of an ERISA plan were to create a shield of preemption against an assessment.

We agree with the Administrative Law Judge that a taxpayer's mere claim that an ERISA plan exists should not give rise to preemption. But that is not the case here. The record contains the JJF ESOP Trust Agreement, JJF ESOP Plan, JJF ESOP's forms 5500-EZ for the years 2006 and 2008 through 2012, and JJF ESOP's 2006 form K-1. Importantly, the authenticity of these documents is not in question. Additionally, the record shows that JJF ESOP had a trustee at all times relevant, and that petitioners were the sole participants and beneficiaries of JJF ESOP. The record also shows that neither petitioner received any distributions from JJF ESOP during the year at issue (***see*** finding of fact 26). We find that the record thus contains prima facie evidence of the existence of JJF ESOP. We believe that such a level of proof is sufficient to prevent abuse. At the same time, by hewing to such a prima facie standard, the Division of Tax Appeals will not develop its own rules regarding the qualification of a trust under IRC (26 USCA) § 401 (a).

As we are preempted from addressing the issue of whether JJF ESOP is a trust qualified under IRC (26 USCA) § 401 (a), and as petitioners have presented prima facie evidence of JJF ESOP's existence, we must grant the petition and cancel the notice of deficiency.

We do not address the Division's sham trust argument because to do so would require us to rule on the validity of JJF ESOP and, as discussed, we are preempted from doing so.

In light of the foregoing, the remaining issues are moot.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Patrick Murphy and Kathleen Murphy is granted;
2. The determination of the Administrative Law Judge is reversed;
3. The petition of Patrick Murphy and Kathleen Murphy is granted; and
4. The notice of deficiency dated November 22, 2010 is canceled.

DATED: Albany, New York
March 6, 2018

/s/ Roberta Moseley Nero
Roberta Moseley Nero
President

/s/ Dierdre K. Scozzafava
Dierdre K. Scozzafava
Commissioner