STATE OF NEW YORK

DIVISION OF TAX APPEALS

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.	:

DETERMINATION
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 petitions[1] 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.

A hearing was held before Herbert M. Friedman, Jr., Administrative Law Judge, in New York, New York, on February 23 and 24, 2016, with all briefs to be submitted by August 31,

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[1]Petitioners, Patrick and Kathleen Murphy, filed separate petitions challenging the same Notice of Deficiency, which was issued to them jointly as they filed a joint personal income tax return for the year at issue. Petitioner Kathleen Murphy also filed an amended petition. For purposes of judicial economy, the petitions have been consolidated under DTA Number 825277.

2016, which date began the six-month period for the issuance of this determination. Petitioners appeared pro se. The Division of Taxation appeared by Amanda Hiller, Esq. (Marvis A. Warren, Esq., and Charles Fishbaum, Esq., of counsel).

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) § 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.

FINDINGS OF FACT

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 Internal Revenue Code (IRC) § 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 stopped operating sometime after 1996, but prior to the 2006 sale,

and its tax exempt status was revoked in August 2011, 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, shareholders or employees of JJF Realty.

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 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 § 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)[2] 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.

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[2] Form 5500-EZ is entitled "Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan."

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 identified that the plan had no assets at the beginning of each year, but had $2,000,500.00 at the end of the year. There was no explanation for the vacillation in the amount of funds as reported. 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. It also lacks a Form 5500-EZ or other return for JJF ESOP for 2007.

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 [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,[3] 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.

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 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

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

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. 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]." When petitioners told the Division that they opposed the results, they were informed both telephonically and in writing that in order to allow for review of any additionally submitted materials, given the impending expiration of the statute of limitations, an additional waiver would be necessary. 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 petitioners' due process rights were not honored and that the original waiver was revoked "eo instanti." 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.

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." Publication 130-F contains the following statements:

> "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 . . . ."

and

> "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,[4] petitioners submitted a statement of participants' accounts that identified Patrick Murphy as president and 50 percent shareholder and Kathleen O'Connell Murphy as secretary and 50 percent shareholder of JJF Realty. They also attached a copy of a document entitled "JJF Realty

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[4]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.

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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> * * *
>
> "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, signed by petitioner Patrick Murphy without designation, lists JJF Associates as the seller of the Property.

39. In an attempt to demonstrate contribution to JJF ESOP, petitioners provided a document entitled "Amendment to Agreement" dated February 28, 2006, between JJF ESOP and the purchaser of the Property (Amended Agreement).[5] 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 contradiction 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."

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

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

41. In a further contradiction, 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 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 IRS can provide, upon request, a favorable determination letter confirming the qualification and tax exempt status of a retirement plan under IRC §§ 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. 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.[6] Only the copy of the 2012 return is signed and dated.

47. In response to a subpoena duces tecum issued in the course of this matter, petitioners stated in writing that JJF ESOP made no distributions to them up to the date of the hearing.[7] Nevertheless, 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

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[6] 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.

[7] ***See*** footnote 4.

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 responsibilities as president of JJF Realty:[8]

> "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, for the first time, asserted that JJF ESOP should be treated as a sham entity with no economic substance and, thus, its gain should be

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[8] 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 § 302.

attributed to petitioners. Petitioners filed a reply to the second amended answer on March 26, 2014 denying the Division's assertions.

53. At all relevant times, JJF Realty, JJF Associates and JJF ESOP did not have any principals other than petitioners.[9] 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.

SUMMARY OF THE PARTIES' POSITIONS

57. Petitioners challenge the Notice of Deficiency on several grounds. First, petitioners argue that the Division of Tax Appeals lacks subject matter jurisdiction based on the preemption language in section 514(a) of the Employment Retirement Income Security Act of 1974 (ERISA). Additionally, petitioners state that JJF ESOP was a properly created and legitimate pension plan for their benefit as employees of JJF Realty. Moreover, petitioners maintain that the income from the sale of the Property cannot be attributed to them as they were not flow-through beneficiaries of the gain reported by JJF Associates. Finally, petitioners maintain that they were denied their rights under the taxpayers bill of rights (Tax Law § 3000 et seq.) and due process under the United States and New York Constitutions.

58. The Division takes the position that ERISA does not preempt this matter simply because petitioners called JJF ESOP a pension plan. Additionally, the Division asserts that

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[9] 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.

petitioners failed to demonstrate that JJF ESOP had tax exempt status or that JJF Realty actually had employees in 2006. Instead, the Division maintains that JJF ESOP was a "sham entity with no economic substance" and that petitioners were the sole participants and beneficiaries in JJF ESOP. Hence, according to the Division, the gain from the sale of the Property should flow through to petitioners as JJF ESOP's only participants and beneficiaries.

CONCLUSIONS OF LAW

A. Prior to the hearing in this matter, petitioners filed a motion for dismissal or summary determination.[10] As grounds, petitioners assert a lack of subject matter jurisdiction based on federal preemption under ERISA and the Division's erroneous attempt to construe JJF ESOP, disregard their employee status, and attribute flow-through income to them.

Pursuant to the Tax Appeals Tribunal's Rules of Practice and Procedure, a motion for summary determination is properly granted:

> "if, upon all the papers and proof submitted, the administrative law judge finds that it has been established sufficiently that no material and triable issue of fact is presented and that the administrative law judge can, therefore, as a matter of law, issue a determination in favor of any party" (20 NYCRR 3000.9[b][1]).

Numerous material and triable issues of fact have been created throughout this proceeding and, as a result, summary determination is inappropriate and petitioners' motion is denied. The issues raised in petitioners' motion with regard to subject matter jurisdiction, preemption, and petitioners' liability, however, are addressed in this determination.

[10] Petitioners filed their motion within two months of the original hearing date in 2014. Given the proximity in time, it was decided that the issues raised in the motion would be addressed at the hearing and become part of this determination (***see*** 20 NYCRR 3000.5[e]). Intervening procedural motions, appeals, a state court action, and unexpected health related adjournments caused the hearing to be delayed until 2016. Petitioners restated their motion at the hearing and it was taken under advisement at that time. Consequently, petitioners' motion is decided herein.

Subject Matter Jurisdiction and ERISA Preemption

B. This case involves the protest of a Notice of Deficiency issued by the Division pursuant to Article 22 of the Tax Law, which clearly falls within the subject matter jurisdiction of the Division of Tax Appeals (***see*** Tax Law §§ 2000, 2008). Petitioners maintain, however, that the aforementioned jurisdiction is preempted by ERISA due to the presence of a pension plan (JJF ESOP). In order to properly analyze this issue, an in-depth discussion of the preemption provisions of ERISA and relevant case law is warranted.

Section 514(a) of ERISA (29 USC § 1144[a]) provides in relevant part that "the provisions of [ERISA] shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan . . . ." Section 514(c) of ERISA (29 USC 1144[c]) defines "State law" and "State" as follows:

> "(1) The term 'State law' includes all laws, decision, rules, regulations, or other State action having the effect of law, of any State . . . .
>
> (2) The term 'State' includes a State, any political subdivisions thereof, or any agency or instrumentality of either, which purports to regulate, directly or indirectly, the terms and conditions of employee benefit plans covered by [ERISA]."

Courts that have addressed the issue of ERISA preemption have ultimately concluded that the statutory text of the preemption provision, and specifically the phrase "relate to," is essentially unhelpful. Indeed, the U.S. Supreme Court has progressively narrowed the scope of section 514(a), observing that "[i]f 'relate to' were taken to extend to the furthest stretch of its indeterminacy, then for all practical purposes preemption would never run its course" (***New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance Co.***, 514 US 645, 655 [1995]). Consequently, the Supreme Court has rejected "uncritical literalism" and directed an analysis that looks "to the objectives of the ERISA statute as a guide to the scope of the state law that Congress understood would survive [preemption]" (***Id.*** at 656; ***see De Buono v NYSA-ILA Medical & Clinical Services Fund***, 520 US 806 [1997]). The Supreme Court has described the Congressional intent underlying ERISA's preemption provision as follows:

> "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 between States and the Federal Government . . . , [and to prevent] the potential for conflict in substantive law . . . requiring the tailoring of plans and employer conduct to the peculiarities of the law of each jurisdiction" (***Travelers*** at 656-657).

C. Though very 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 85, 96-97 [1983]; ***Morgan Guaranty Trust Company of New York v. Tax Appeals Tribunal***, 80 NY2d 44, 50 [1992]). The Supreme Court in the past has "addressed claims of preemption with the starting presumption that Congress does not intend to supplant state law" (***Travelers*** at 644-645). Nevertheless, Congress has made it clear that state tax laws are not exempt from preemption (***see*** ERISA § 514[b][5][B]). The courts have also concluded that there is no greater or stricter standard applied in preemption analysis simply because a state tax law, as opposed to some other state law, is involved (***see De Buono***).

D. In analyzing the question, the Supreme Court has held that a state law "relates to" a covered ERISA plan for purposes of preemption under ERISA § 514(a) if the state law either "has a connection with or reference to such a plan" (***Shaw v. Delta Air Lines, Inc.***; ***California Div. of Labor Standards Enforcement v. Dillingham Construction, N.A., Inc.***, 519 US 316, 324 [1997)]). The Supreme Court most recently elaborated on this two part test in the ***Matter of Gobeille v. Liberty Mutual Insurance Co.*** (577 US ___ , 136 S Ct 936 [2016]).

> "Implementing these principles, the 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 644-645]. 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.' [***Dillingham*** at 325]. 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." (***Gobeille*** at 943).

In finding that a Vermont statute that required disclosure of health care information from ERISA plan participants was subject to preemption, the Court emphasized that ERISA "seeks to make the benefits promised by an employer more secure by mandating certain oversight systems and other standard procedures" (***Gobeille*** at 943, quoting ***Travelers*** at 651). Essential to this goal were the detailed and comprehensive reporting and disclosure requirements of ERISA. Vermont's plan compelled a similar reporting regime that intruded upon "a central matter of plan administration" and "interfere[d] with nationally uniform plan administration" (***Gobeille*** at 943, quoting ***Egelhoff*** at 148). "ERISA pre-empts a state law that regulates a key facet of plan administration even if the state law exercises a traditional state power" (***Gobeille*** at 946). Consequently, the Vermont statute had an impermissible connection with ERISA plans and was preempted.

The Court in ***Gobeille***, however, took great pains to point out that "[t]he analysis may be different when applied to a state law, such as a tax on hospitals, (citing ***De Buono***), the enforcement of which necessitates incidental reporting by ERISA plans . . ." (***Gobielle*** at 946).

This citation is significant as it reinforces the difference between a state law that directly regulates the heart of ERISA plan administration and one that only touches on those aspects peripherally (***see Self-Insurance Institute of America, Inc. v. Snyder***, 827 F3d 549 (6th Cir 2016). Hence, two essential points must be taken away from ***Gobeille***: "first, ***Gobeille*** held that only direct regulations of fundamental functions are preempted, and second, state laws imposing incidental burdens may need to be evaluated under the principles established by ***De Buono*** and ***Travelers***" (***Snyder*** at 557).

In both ***De Buono*** and ***Travelers***, the Supreme Court rejected ERISA preemption of state laws. In ***De Buono***, the Supreme Court did not preempt New York State's imposition, under Public Health Law § 2807(d), of a tax on gross receipts from patient services at hospitals, residential health care facilities and diagnostic and treatment centers, including hospitals owned and operated by an ERISA qualified plan. The Supreme Court held that the tax, implemented to reduce the State's Medicaid deficit, was a tax of general application which did not impact the calculation of ERISA benefits or impact the determination of an employee's eligibility for such benefits. The Supreme Court also held that the existence of an ERISA plan was not a critical element of a state cause of action, and that no provision in the tax expressly referred to an ERISA plan. Similarly, in ***Travelers***, the New York statute at issue required hospitals to collect surcharges from patients, some of whose plans were covered under ERISA. In noting that "[t]he basic thrust of the pre-emption clause, then, was to avoid a multiplicity of regulation in order to permit the nationally uniform administration of employee benefit plans" (***Travelers*** at 657), the Court denied preemption based on the purpose and effects of the New York statute that had an indirect economic effect on the plans' costs and reporting requirements. Hence, both ***De Buono*** and ***Travelers*** hold that where the state law at issue has peripheral requirements that incidentally touch on ERISA, preemption is unwarranted.

E. Applying the principles enunciated in ***Gobeille*** and its predecessors to the matter herein, it must be determined that ERISA preemption of Tax Law § 601, the Division's issuance of the Notice of Deficiency under Tax Law § 681, and this proceeding, is unwarranted. First, a state law is said to impermissably relate to ERISA "by reference" if it imposes requirements by reference to ERISA plans, or if it acts immediately and exclusively on ERISA plans, or if an ERISA plan is essential to the state law's operation (***see Mackey v. Lanier Collection Agency & Serv.***, 486 US 825 [1988]; ***District of Columbia v. Greater Washington Board of Trade***, 506 US 125 [1992]). Here, Tax Law § 601, cited by the Division as a basis for its notice, does not have a "reference to" ERISA plans. Instead, it is a law of general applicability that does not act immediately and exclusively on ERISA plans. Further, an ERISA plan is not essential to the operation of Tax Law § 601, as it is not a tax on ERISA plans, per se, but a tax on individuals (***see De Buono***). Petitioners' argument that the mere mention of ERISA in the Division's pleadings warrants preemption has been rebuffed (***see Snyder***, quoting ***Associated Builders & Contractors v. Michigan Dept of Labor & Economic Growth,*** 543 F3d 275, 284 [6th Cir 2008]). In sum, Tax Law § 601 and its application here does not impermissably relate to ERISA "by reference."

F. Second, the state law in issue here is not "connected with" an ERISA plan in more than a tenuous, remote or peripheral manner. Tax Law § 601 and the Notice of Deficiency do not require additional ERISA record retention or conflicting oversight procedures. The Supreme Court in ***Travelers*** reasoned that the "basic thrust of the preemption clause, then, was to avoid multiplicity of regulation in order to permit the nationally uniform administration of employee benefit plans" (***Travelers*** at 657). In this case, like in ***Travelers*** and ***De Buono***, determination of whether petitioners gained taxable income from the sale of the Property by JJF Associates does not impinge upon the federal regulation of an ERISA plan. Tax Law § 601 does not attempt to regulate ERISA plans. Instead, this case incidentally touches on ERISA. Therefore, petitioners fail to meet the second prong of the preemption test as well.

G. The Division's reliance on ***Hattem v. Schwarzenegger*** (449 F3d 423 [2d Cir 2006]) is particularly compelling. In ***Hattem***, the U.S. Court of Appeals, Second Circuit, addressed the question of whether California's unrelated business taxable income tax statutes were preempted when they affected an ERISA plan as they either had an impermissible "connection with" or "reference to" ERISA. In finding against preemption, the court emphasized that it was mindful that "taxation is a realm of historic state control" (***Id.***, at 431). The court justified its holding that there was not an impermissible connection with ERISA by asserting that 1) the law at issue was one of general applicability; 2) it did not force trust fiduciaries to act in a certain manner; and 3) the law did not govern one of the areas that has been found to be the kind that ERISA was intended to control exclusively. Furthermore, the California law did not have a "reference to" ERISA, but functioned irrespective of the existence of ERISA plans. The statute in our case, Tax Law § 601, and its enforcement under the Division's Notice of Deficiency, fit directly within the court's rationale for rejecting preemption in ***Hattem***.

H. The Division also correctly points out that both the Albany County Supreme Court (***Matter of Murphy v. New York State Div of Tax Appeals***, Sup Ct, Albany County, 1/8/16, McDonough, J., index No. 4378-15) and the Tax Appeals Tribunal (***Matter of Murphy***, Tax Appeals Tribunal, July 2, 2015) rejected petitioners' attempt to quash the subpoenas duces tecum issued in this matter on the basis of preemption. Petitioners argued in those prior efforts, as they do now, that this entire case, including the Notice of Deficiency at issue, is barred by preemption. Nevertheless, both the Albany County Supreme Court and Tribunal refused to quash the subpoenas and allowed this case to proceed in this forum after considering petitioners' preemption argument. Although not dispositive of the entire preemption issue, those decisions have a persuasive impact on this determination and buttress a finding against preemption.

I. Petitioners primarily rely on three cases in support of preemption that are distinguishable from the case at bar. The first, ***Ingersoll-Rand Co. v. McClendon*** (498 US 133 [1990]), involved a lawsuit by a former employee against his former employer for wrongful discharge under Texas state law. The plaintiff claimed that he was discharged in order to prevent him from attaining his ERISA plan benefits. In finding that preemption of the state's wrongful discharge law was appropriate, the Supreme Court stated that "[i]n order to prevail on the cause of action, a plaintiff must plead, and the trial court must find, that an ERISA plan exists and the employer had a pension-defeating motive in terminating the employment" (***Ingersoll-Rand*** at 483). Petitioners in our case specifically point to the Supreme Court's finding that "[b]ecause the existence of a plan is a critical factor in establishing liability, and the trial court's inquiry must be directed to the plan, this judicially created cause of action 'relate[s] to' an ERISA plan" (***id.***). In the instant case, however, the existence of an ERISA plan is not an essential element in order to find liability under Tax Law § 601 and sustain the Division's Notice of Deficiency. ***Ingersoll-Rand*** stands for the proposition that a party is preempted from a state action where the existence of an ERISA plan is a necessity under the state law at issue. Crucially, the plaintiff in ***Ingersoll-Rand*** needed an ERISA plan to succeed in his cause of action for wrongful discharge under the Texas statute. Here, petitioners instead defensively argue that their mere claim of the existence of an ERISA plan in this matter must give rise to required preemption. That overreaching position has been repeatedly rebuffed by case law (***see Gobeille***; ***De Buono***; ***Travelers***; ***see also Fort Halifax Packing Co. v. Coyne***, 482 US 1 [1987][where a state law that required payment of severance benefits was not preempted because the statute did not require the establishment or maintenance of an ongoing plan]). Furthermore, the Supreme Court in ***Ingersoll-Rand*** pointed out that ERISA does not preempt a general garnishment statute, even if it is applied to collect against plan participants or might burden the administration of a plan (***see Ingersoll-Rand,*** citing ***Mackey***). Indeed, in rejecting preemption of such a law, the Supreme Court in ***Mackey*** noted that many state civil actions can be maintained against ERISA plans without invoking preemption. Additionally, unlike here, the employer and employee in ***Ingersoll-Rand*** were unquestionably separate and distinct. Finally, the Supreme Court in ***Ingersoll-Rand*** specifically stated that it was "not dealing . . . with a generally applicable statute that makes no reference to, or indeed functions irrespective of, the existence of an ERISA plan" (***Id.*** at 139). Such is the case with Tax Law § 601 and the Notice of Deficiency at issue.

J. The second case relied upon by petitioners, ***Gobeille***, also found preemption was required. However, as discussed in Conclusion of Law D, a careful reading of ***Gobielle*** shows that the instant matter is the exact type of case that the Supreme Court suggested preemption should not occur. The state law at issue in ***Gobielle*** had a direct regulation of and interference with fundamental ERISA functions. On the other hand, the Supreme Court in ***Gobeille*** emphasized that state laws that imposed incidental burdens on ERISA plans, such as is the case here, need to be evaluated in light of ***Travelers*** and ***De Buono***. When that analysis is performed, contrary to petitioners' argument, it is clear that the Division's notice does not interfere with the uniform administration of pension plans.

K. Petitioners also heavily rely on ***Morgan Guaranty***, a lead New York tax case involving ERISA preemption. In ***Morgan Guaranty***, the New York Court of Appeals held that application of the gains tax imposed under Tax Law former Article 31-B on the gain from the sale of real property owned by the plan "relat[ed] to" benefit plans in more than a tenuous, remote or peripheral way. The court emphasized that the gains tax was preempted "because it affects the structure, administration and economics of a covered plan, and therefore 'relate[s] to' it in more than a tenuous, remote or peripheral way" (***Morgan Guaranty*** at 54). The gains tax required reporting and recordkeeping by the plan that was not required in other jurisdictions and, thus, interfered with ERISA. Even more significant in the court's opinion was the economic impact of the gains tax on the plan. The court found that the former gains tax directly depleted plan assets and thus necessarily influenced the plan's investment strategy. Crucially, however, the tax in ***Morgan Guaranty*** was on a plan asset itself, rather than the income derived from the sale of an asset owned by another entity, as is the case here. Petitioners have not shown that application of Tax Law § 601 to the income derived from the sale of the Property had to deplete plan assets (***see Matter of Net Realty Holding Trust***, Tax Appeals Tribunal, December 26, 1996). Moreover, as was the case in ***Ingersoll-Rand*** and ***Gobeille***, there was no dispute as to the legitimacy of a covered plan in ***Morgan Guaranty***. In the case at bar, the legitimacy of the purported trust is in issue. In sum, unlike the gains tax, Tax Law § 601 and its application here have "only a tenuous, remote, or peripheral connection" to JJF ESOP (***see Travelers***).

L. Given the narrowing of the ERISA preemption doctrine over time, the presumption against preemption, and the facts presented, a careful analysis compels the conclusion that the instant matter is more in line with ***De Buono***, ***Travelers*** and ***Hattem*** than the cases relied on by petitioners. To find otherwise would permit potential abuse of the preemption doctrine and the

Tax Law by taxpayers simply calling an entity an ERISA plan and hiding behind the preemption shield if faced with an assessment on income derived elsewhere. Consequently, ERISA does not preempt Tax Law § 601 or the Notice of Deficiency issued thereunder, and petitioners' motion to dismiss for lack of subject matter jurisdiction is denied.

Attribution of Income to Petitioners

M. The next issue to be addressed is whether the Division properly attributed the income from the sale of the Property by JJF Associates to petitioners. At the outset, it must be stated that a presumption of correctness attaches to a properly issued notice of deficiency (***see Matter of Hickey***, Tax Appeals Tribunal, August 12, 2004; ***Matter of Atlantic & Hudson Ltd. Partnership***, Tax Appeals Tribunal, January 30, 1992). In proceedings for review of such a notice, the burden of proof is on the taxpayer to demonstrate that the deficiency is erroneous (***see*** Tax Law § 689[e]).

N. Pursuant to Tax Law § 601(f), persons carrying on business as partners, including a limited liability company that reports as a partnership, are liable for New York State income tax only in their separate or individual capacities. Since the New York State personal income tax law is patterned after the federal income tax laws, the IRC provides guidelines with respect to the treatment of income and the deductibility of various expenses. IRC § 1231 gain arises from the sale or exchange of property used in a trade or business. Generally, "property used in a trade or business" is that which is held for more than one year and subject to an allowance for depreciation, or real property held for more than one year, and which is not included in inventory or held for sale to customers in the ordinary course of business (IRC § 1231[b]). The net section 1231 gain for any taxable year is treated as long term capital gain.

O. In the case at bar, the Property was owned by JJF Associates for more than one year at the time of its sale in 2006. As a limited liability company that treated itself as a partnership for federal and state tax purposes, JJF Associates' income, including any section 1231 gain, flowed through to its partners (***see*** Tax Law § 601[f]). JJF Associates had two members/partners at the time of the sale - Triune, which owned 1%, and JJF ESOP, which owned 99%. Petitioners maintain that the proceeds from the sale of the Property went to JJF ESOP, which they claim was a tax exempt ERISA trust operated for the employees of JJF Realty. Thus, according to petitioners, the income from the sale of the Property is tax exempt.

Sham Trust

P. According to the Division, however, petitioners failed to prove by clear and convincing evidence that JJF ESOP was a tax exempt ERISA trust in substance and not just in name. In fact, the Division goes further and argues that JJF ESOP was actually a sham trust to be disregarded and that its income must be attributed to petitioners, its controlling participants, who solely benefitted from the gain. "It has long been the law that a transaction with no economic effects, in which the underlying documents are a device to conceal its true purpose, does not control the incidence of taxes" (***Sacks v. Commr.***, 69 F3d 982, 986 [9th Cir 1995]; ***see Gregory v. Helvering***, 293 US 465 [1935]). This doctrine flows from the principle that income taxes are due from "those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid" (***Helvering v Horst***, 311 US 112, 119 [1940]). It is imperative to look to the substance, and not the form, of the transaction (***see Gregory v Helvering***).

Q. The courts have developed a four-part test to identify the existence of sham trusts, i.e., lack of economic substance:

> "(1) whether the taxpayer's relationship to the transferred property differed materially before and after the trust's creation; (2) whether the trust had an independent trustee; (3) whether an economic interest passed to other trust beneficiaries; and (4) whether the taxpayer respected the restrictions placed on the trust's operation as set forth in the trust documents."

(***Sparkman v. C.I.R.***, 509 F3d 1149, 1155 [9th Cir 2007], quoting ***Markosian v. Commr.***, 73 TC 1235, 1243-44 [1980]).

R. Applying this test to the facts of the instant matter, it must be concluded that JJF ESOP was a sham trust properly disregarded by the Division. First, petitioners' relationship to the Property did not differ materially before and after the trust's creation. At all relevant times, there was an identity in ownership and control of the Property and the ensuing gain from its sale. Petitioner Patrick Murphy, as president of Triune and the trustee of JJF ESOP, controlled the two members of JJF Associates. Moreover, he, along with petitioner Kathleen Murphy, were the sole beneficiaries and participants of JJF ESOP. They were also the sole owners and officers of JJF Realty. Petitioner Patrick Murphy went so far as to sign federal and New York State tax returns on behalf of JJF Associates as its "general partner."[11] In short, petitioners were the only principals identified as owners or officers in each of the entities involved. Hence, as the only principals involved, they alone beneficially owned and controlled the Property and the fruits of its sale both before and after the creation of JJF ESOP.

S. Additionally, the JJF ESOP did not have an independent trustee. Initially, Triune, an entity controlled by petitioner Patrick Murphy, was its trustee. Prior to the sale of the Property, petitioner Patrick Murphy himself became the trustee of JJF ESOP. Pursuant to the trust documents, a separate committee was to be responsible for review of the trustee's actions. There

[11] Indeed, this signature has no reference whatsoever to petitioner Patrick Murphy's capacity with either JJF ESOP or Triune, the stated members of JJF Associates.

is no evidence, however, of the existence of such an independent committee. On the contrary, the evidence shows that petitioner Patrick Murphy simply had oversight of himself in completing his fiduciary duties as trustee. He also was a beneficiary of JJF ESOP and controlled the settlor. Clearly, there was no meaningful restriction on petitioners' use of trust property for their own purposes, and no independent trustee, thereby meeting the second prong of the sham trust test.

T. Third, an economic interest did not pass to other beneficiaries of the trust as there were none. To the extent that assets were transferred to JJF ESOP, their beneficial interest already belonged to petitioners, the only two principals in that entity, JJF Associates, and JJF Realty. At no point did the economic interest in the Property and its proceeds benefit anyone other than petitioners. Consequently, the Division prevails on this element as well.

U. The fourth prong of the test asks whether the petitioners felt bound by any restrictions imposed by the trust itself or the law of trusts. Again, the evidence demonstrates that petitioners had unrestricted use of the Property and the gain from its sale. A review of the various returns in the record bears out commingling of income. For instance, both 2006 and 2008 JJF ESOP returns identified that the plan had no assets at the beginning of each year, but had $2,000,500.00 at the end of each year. The record is unclear as to what happened to the funds in the interim. It is also unclear as to what happened to the difference between the $2,000,500.00 reported and the remainder of the $2,268,774.00 gain. Meanwhile, there is no evidence of a bank account for JJF ESOP in 2006 or 2007. The only evidence of a deposit into a JJF ESOP account occurred in 2008, or two years after the sale of the Property, when JJF Realty (and not JJF Associates, the seller of the Property) provided a check in the amount of $2,000,000.00 to JJF ESOP. Based on the record, any money coming into JJF ESOP cannot be traced from the sale of the Property without commingling with other entities completely owned and controlled by petitioners.

Indeed, it appears that JJF Associates may have retained the proceeds for a period after the sale. Additionally, numerous requirements from the trust agreements were directly ignored by petitioner Patrick Murphy in his role as trustee of JJF ESOP. There were no annual reports prepared for several years nor was there an oversight committee formed, as required by the ESOP Trust Agreement. Also, there is no evidence that tax returns were filed on behalf of JJF ESOP prior to 2006 despite its earlier inception. The trustee also failed to provide the requisite annual valuation of plan assets for all years. Finally, there is no evidence of a distribution to either petitioner upon reaching the age of 70 ½ or retirement from JJF Realty.[12] In sum, petitioners disregarded the trust requirements and were unrestricted in their use of the funds by the creation of JJF ESOP.

V. The record is laden with contradictions and other evidence that further support the finding of a sham trust. At the outset, the actual effective date of JJF ESOP is unclear. Petitioners assert that the trust was created in 1999, and it received its tax identification number in that year, but they reported on numerous tax returns that JJF ESOP's effective date was 2005. Additionally, JJF Associates' 2006 federal tax return listed JJF ESOP as having $3,000,000.00 in assets, while JJF ESOP's own return for the same year listed assets of only $2,000,500.00. These discrepancies were never clearly explained by petitioners. Furthermore, there is no documentary evidence of the existence of a bank or investment account owned by JJF ESOP in 2006 or 2007. As a result, if JJF ESOP had possession of the funds from the sale of the Property during those

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[12] ***See*** IRC § 401(a)(9), which requires a qualified pension plan to disburse upon the latter of the employee reaching age 70 ½ or retirement. Petitioners argue that the Division failed to prove the event of their retirement. This position ignores the applicable burden of proof. Additionally, JJF Realty's sole business, according to petitioners, was to manage the Property. Upon its sale in 2006, JJF Realty apparently had no further business. Nevertheless, the record shows that no distributions were made to petitioners until 2013, at the earliest, long after the aforementioned statutory deadline.

years, petitioners failed to prove it. Petitioners similarly chose not to obtain and present a favorable determination letter from the IRS regarding JJF ESOP's qualified status as a retirement plan under IRC § 401(a). The IRS states that such a letter is generally not required, but given petitioners' burden of proof in this matter, and its ease of access, its absence is telling.

The evidence concerning the involvement of JJF Realty as a legitimate sponsor of JJF ESOP is particularly damaging on the issue of a sham trust. First, the ESOP Trust Agreement creating JJF ESOP was signed only by petitioner Patrick Murphy on behalf of both parties - in his capacity as president of JJF Realty and "trustee" of Triune. Further, his signature was attested by petitioner Kathleen Murphy, as "secretary" of both entities. This cozy relationship refutes any appearance of arms-length legitimacy to the ESOP Trust Agreement and underscores the complete control petitioners had at all times over the proceeds of the sale of the Property, within and without JJF ESOP. Additionally, there is no documentary evidence tracing the funds from the sale of the Property from JJF Associates to JJF Realty. Instead, petitioner Patrick Murphy explained that the Property and resultant funds were transferred between the entities as part of an undocumented "practical merger" that allowed for the avoidance of various taxes. Of course, transfer of title to real property in New York is accomplished only by the delivery and acceptance of an executed deed (***Matter of Cahill***, 264 AD2d 480 [2d Dept 1999]; ***McLoughlin v. McLoughlin***, 237 AD2d 336 [2d Dept 1997]). Moreover, JJF Realty had no payroll. Although petitioners insist that they were technically "employees" of JJF Realty under the IRC definition,[13] according to the tax returns in the record, it appears they were compensated for their purported efforts as independent contractors and not wage employees. Further, JJF Realty's 2006

[13] ***See*** 26 USC § 3121, which includes officers of a corporation in the definition of employees.

federal return was its first filed return, raising questions as to the extent of its actual operation in prior years. Finally, JJF Realty, a business corporation formed in 1999 under New York's Business Corporation Law, was dissolved by proclamation of the Secretary of State of the State of New York on June 25, 2003, three years before the sale of the Property. Business Corporation Law § 1005 states that, after dissolution, "[t]he corporation shall carry on no business except for the purpose of winding up its affairs" (BCL § 1005[a][1]). In that regard, the record lacks New York State tax returns filed on behalf of JJF Realty for any year prior to 2007.[14] Consequently, at the time of the sale of the Property in 2006, JJF ESOP was sponsored by, and petitioners claimed to be officers and employees of, a corporation that could not legally conduct business and did not file tax returns, further undermining the legitimacy of the trust.

In addition, there was the oddity of the Amended Agreement dated February 28, 2006 between JJF ESOP and the purchaser of the Property. The Amended Agreement identified JJF ESOP as the seller of the Property (in direct contradiction to the operative deed and recording documents) and was signed by petitioner Patrick Murphy on its behalf but without designation. The record is devoid, however, of the necessary documentary evidence of a transfer of title to the Property from JJF Associates to JJF ESOP (***see Matter of Bagdan***, Tax Appeals Tribunal, December 23, 2004). Instead, petitioner Patrick Murphy attempted to explain away the discrepancy by describing it as another "practical merger." In fact, what the evidence actually shows is a complete disregard for transactional and business formalities on the part of petitioners and their complete control of the funds at all times.

[14] The record contains a New York State form CT-5, Request for Extension to File for JJF Realty for 2006, but no return for that year. Oddly, the record has a 2007 form CT-4 General Business Corporation Franchise Tax Return for JJF Realty. On it, JJF Realty reported an increase in assets from $900.00 to $2,852,009.00.

W. Lastly, petitioner Patrick Murphy's testimony in support of petitioners' case was confusing, evasive, and contradictory. At times he insisted that JJF ESOP sold the Property, while at other times corroborated the documentary evidence that showed that the seller was JJF Associates. On another occasion, he curiously testified that JJF Realty was the seller. He also could not accurately or consistently explain the disposition of the proceeds from the sale of the Property. Meanwhile, when pressed on cross-examination for documentary proof to support his testimony, rather than use the opportunity to provide such documents, he repeatedly responded with confrontational statements like, "[w]e don't volunteer documents, okay" and "it could have been produced, but you didn't properly ask for it and so we don't volunteer things." Finally, his testimony alleging the Division's auditors' uncooperative interaction is contradicted by the record. In reality, the Division made numerous attempts over a two-year period to obtain relevant documentation from petitioners and their wholly-owned entities. Unequivocally, petitioner Patrick Murphy's testimony fell short of meeting the clear and convincing standard required to prevail. Meanwhile, petitioner Kathleen Murphy, who may have been able to clarify some of these issues, did not testify.

X. In conclusion, petitioners seek the benefit of organizational formalities yet fail to establish that they observed them. Such disregard is one of the hallmarks of a sham trust. As in all tax controversies, the "economic reality" drives this analysis (***Matter of Muraskin v. Tax Appeals Trib.***, 213 AD2d 91, 95 [1995], ***lv denied*** 87 NY2d 806 [1996]). "A fundamental principle of tax law is that income is taxed to the person who earns it" (***Commissioner v. Culbertson***, 337 US 733, 739-740 [1949]). "An assignment of income to a trust is ineffective to shift the tax burden from the taxpayer to a trust when the taxpayer controls the earning of the income" (***Vnuk v. Commr.***, 621 F2d 1318, 1320 [8th Cir 1980]). Petitioners, whether in the guise of shareholders, officers or trustees, at all relevant times had complete control, dominion and benefit of the Property and the gain derived from its sale. As evidence of that control, on numerous occasions, petitioner Patrick Murphy signed documents without regard to identification of his capacity or even the participating entity itself. Meanwhile, the record shows that JJF ESOP eschewed trust formalities and simply existed to allow petitioners to attempt to avoid taxation. As the earners, controllers and beneficiaries of the income, petitioners are faced with the tax effects arising therefrom. In light of the cumulative weight of the evidence, it must be determined that petitioners have failed to clearly and convincingly demonstrate that the statutory notice was erroneously issued.

Due Process Claims

Y. Petitioners also argue that they were not afforded due process throughout the course of the audit, during the conciliation process, and in the Division's conduct in this proceeding. They face a heavy burden in proving that point (***see Matter of R.A.F. General Partnership***, Tax Appeals Tribunal, November 9, 1995). First, they maintain that the auditor refused to meet with them, review their documents, and performed a superficial audit in the limited time provided, all in contravention of audit guidelines and the Taxpayer Bill of Rights. On the contrary, the record shows that petitioners' related entities, all of which they wholly-operated and controlled, were the subject of a nearly two-year audit during which numerous records were requested by the Division. Petitioners themselves were well aware of the audit and were offered several opportunities to substantiate their claims. At any point in that procedure, petitioners could have met with the Division's auditor and produced the documentation necessary to bolster their position and, in fact, were invited and eventually subpoenaed to do so. Instead, they unsuccessfully attempted to discredit the auditors and the process. Those efforts are unpersuasive.

Z. Petitioners similarly suggest that the BCMS process was tainted. They point to notes in the auditor's log suggesting that the conferee found merit in petitioners' argument but succumbed to ex parte pressure from the auditors. Even if accurately characterized, petitioners' BCMS experience, which ultimately resulted in the notice being sustained, has no bearing on proceedings in the Division of Tax Appeals. BCMS is an informal process conducted by the Division of Taxation that is intended to resolve taxpayer disagreements with statutory notices (***see*** 20 NYCRR 4000.5 [c]). The issue of whether the conferee improperly changed his or her rationale in denying a request is immaterial in Division of Tax Appeals proceedings (***see Matter of Sperl***, Tax Appeals Tribunal, May 8, 2014).

AA. Furthermore, petitioners maintain that the Division's multiple amended answers raised new arguments that undermined the basis for the statutory notice. This argument has no merit (***see Matter of Rochester Amphibian Airways, Inc.***, Tax Appeals Tribunal, August 6, 2009). The Division was entitled to change its legal theory at the point that it did. Prior to the hearing, each side was aware of the legal theories of its adversary, and neither party was surprised by additional theories at hearing or unable to freely offer evidence, either in support of its own position or as a defense to its adversary's position (***see Matter of Janus Petroleum, Inc.***, Tax Appeals Tribunal, April 24, 1997). Thus, petitioners suffered no violation of their due process rights and were accorded the fundamental considerations of fairness.

Statute of Limitations

BB. Petitioners also argue that the Notice of Deficiency is time barred by the statute of limitations. Tax Law § 683(a) generally allows for the issuance of a notice of deficiency within three years of the date of filing of a return. This period can be extended by agreement of the parties, as was the case here. In this matter, the notice was issued on November 22, 2010, or before the parties' extended deadline of December 15, 2010. Petitioner Patrick Murphy's attempt to unilaterally revoke the agreement "eo instanti" is of no moment (***see*** Tax Law § 683[c][2]). Indeed, to deem the consent ineffective under the present circumstances would run contrary to the well-established public policy that "favors full and uninhibited enforcement of the Tax Law" (***Matter of Turner Constr. Co. v. State Tax Commn***., 57 AD2d 201, 203 [1977]; ***see also Matter of Goetz Energy Corp***., Tax Appeals Tribunal, November 18, 1999). Therefore, petitioners' argument concerning the statute of limitations fails.

CC. Petitioners also question the propriety of the penalties, imposed by the Division pursuant to Tax Law § 685(b)(1), (2); (p). Tax Law § 685(b)(1), (2) provides for the imposition of penalties if any part of a deficiency is due to negligence or intentional disregard of Article 22 of the Tax Law or the regulations promulgated thereunder and an addition based on the interest on the underpayment. Tax Law § 685(p) provides for the imposition of a penalty where there is a "substantial understatement" of the amount of income tax required to be shown on a return.

The penalties may be cancelled if it is shown that the failure to timely file and pay was due to reasonable cause and not willful neglect. In establishing reasonable cause, the taxpayer faces an "onerous task" (***Matter of Philip Morris, Inc.***, Tax Appeals Tribunal, April 29, 1993). Petitioners did not address the issue in their briefs. Based on the record presented, petitioners have not met this burden and the penalties are sustained.

DD. The petitions of Patrick and Kathleen Murphy are denied and the Notice of Deficiency dated November 22, 2010 is sustained.

DATED: Albany, New York
February 9, 2017

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