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Empire Zone Litigation: Taking the 'Reduction' Out of the Tax Reduction Credit

by Timothy Noonan

Over the past few years, taxpayers in New York have argued with the New York Tax Department over the scope of benefits promised under the Empire Zone program, an economic development initiative put in place by the New York State Legislature in 2000.[1] Some of that litigation resulted from the perception — which sometimes turned out to be accurate — that some taxpayers were benefiting from the program by restructuring, or "shirt-changing," and not by creating jobs and expanding operations in economically depressed areas. But more recently, the department seems to have denied promised benefits based on arguably strained or narrow interpretations of the statutory provisions providing for benefits. The latter trend is more troubling because it usually affects taxpayers who relied on the statutory promise of benefits in good faith only to be denied those benefits years later on audit.

Over the past year or so, one issue like that has been generating a lot of audit activity, and a lot of frustration, for taxpayers. It involves what should be a fairly straightforward calculation of the tax reduction credit, designed to reduce or eliminate New York business or personal income taxes paid on income earned by taxpayers operating in Empire Zones. In this article, we'll outline the issue, discuss what's happened in recent cases, and address the policy implications created by what we believe to be the tax department's incorrect reading of the law.

Background

The idea behind the tax reduction credit is fairly simple: to reduce or eliminate taxes paid by a corporation or owners of a business operating in an Empire Zone. When the law was passed, government officials understood that the Empire Zones were intended to be tax free for the first 10 years following certification of a qualified Empire Zone enterprise (QEZE).[2]

This is tax law, though, so nothing is ever simple. The credit is calculated by multiplying four factors: the benefit period factor, the employment increase factor, the zone allocation factor, and the tax factor.[3] But it's the calculation of the tax factor that has proved most controversial recently, particularly for S corporations and partnerships.

For example, in the case of partnerships, the law provides that the shareholder's tax factor is based on the amount of tax the shareholder paid on income attributable to the S corporation.[4] And, as is particularly relevant here, the law provides that "such attribution shall be made in accordance with the ratio of the shareholder's income from the S corporation allocated within the State . . . to the [shareholder's] New York adjusted gross income."[5] The law goes on to say that the attribution could also be made in accordance with any other method outlined by the commissioner that provides an apportionment reasonably reflecting the portion of the shareholder's tax attributable to the income of the QEZE. In essence, the idea is that a shareholder's credit is based in part on the amount of tax it paid on income from the S corporation that is allocated within New York state.

So how to compute the amount of the shareholder's income allocated within New York state? For years, that wasn't a question. If the taxpayer was a resident of New York state, calculating the tax factor

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[1]For discussion of some of the cases, see Timothy P. Noonan and Christopher L. Doyle, "More Battles in New York's Empire Zones," *State Tax Notes*, July 19, 2010, p. 175.

[2]*See* Mem. of Assembly Rules Comm., Bill Jacket, L. 2000, ch. 63.

[3]Tax Law section 16(b).

[4]Tax Law section 16(f)(1).

[5]Tax Law section 16(f)(2)(C).

was seemingly easy: Because all of a resident's income would be allocated to New York state, resident shareholders of QEZEs treated all their tax on income from the S corporation as attributable to the Empire Zone business.

There seems to be nothing controversial about that, but the issue came to a head in a recent Division of Tax Appeals case.

In *Matter of Batty*,[6] the department said resident shareholders do not get to treat all of their income as attributable to the Empire Zone business. Instead, because the law speaks in terms of determining the amount of the shareholder's income that is allocated within New York state, the department took the new position that the credit is limited by application of the corporate apportionment rules. In other words, resident shareholders would not get credit for taxes paid on 100 percent of the income of the Empire Zone business, even though they paid tax on 100 percent of the income. Instead, the credit would be reduced to reflect only the income that would have been taxed as New York-source income under the three-factor (or, more recently, single-factor) apportionment regime for Article 9-A corporate taxpayers and nonresident shareholders of the state. So under the department's new view, the tax reduction credit wasn't designed to give credit for the taxes paid by the resident shareholders. Instead, it was designed to give credit for taxes paid by the resident shareholders as if they were nonresidents of the state.

Because the law speaks in terms of determining the amount of the shareholder's income that is allocated within New York state, the department took the new position that the credit is limited by application of the corporate apportionment rules.

In *Batty*, the taxpayers were shareholders of a New York S corporation that was a certified QEZE. They filed New York state resident personal income tax returns for 2006 through 2008 on which they reported and paid tax to New York on all income that flowed through to them from the company. On each return, the taxpayers claimed QEZE tax reduction credits based on the four-factor formula under Tax Law section 16. In computing their tax factor, they naturally treated all their income from the QEZE as income that was allocated within New York because all of it actually was reported on their resident tax returns. Following an audit, the department disagreed with the taxpayers' computation of the credit, asserting that they were entitled to use only the company's income apportionable to New York, determined by reference to the QEZE's formula apportionment (based on a three-factor formula in two audit years and a single-factor formula in the remaining year because of a change in the state's apportionment rules).

Before an administrative law judge in the Division of Tax Appeals, the taxpayers argued that as residents of New York, all of their income from the company was allocated to New York and that they therefore properly computed the tax factor. Moreover, because the returns at issue were filed under Article 22 (not Article 9-A), the taxpayers objected to the department's use of the QEZE's apportionment percentage to compute the tax factor because it had no statutory or regulatory authority to do so. The taxpayers also pointed out that in a previous audit, the department did not question their treatment of the credit or calculation of the tax factor.

The department again argued that it was required to use the corporate apportionment rules to determine the amount of the shareholders' income that should be allocated within New York. It also argued that the U.S. privileges and immunities clause requires application of the company's business allocation percentage in order to fairly allow the tax reduction credit to residents and nonresidents alike. Yes, that's right — the department argued that it would be violating the U.S. Constitution if it interpreted the law in the manner suggested by the taxpayers.

The ALJ rejected the department's position and held that because the taxpayers were residents of New York, all of their income from the company should be allocated within New York and used in calculating the tax factor. The ALJ also said that "without such necessary authority, the Division erroneously applied the Article 9-A principles discussed in the first sentence of Tax Law section 16(f)(1) to the Article 22 taxpayers." The ALJ added that because it was the taxpayers' — not the company's — tax factor being calculated, the department's "insistence on calculating the tax factor under Article 9-A was incorrect." Thus, the ALJ granted the taxpayers' petitions and canceled the department's notices of deficiency.

The Aftermath

The department chose not to appeal, but it is not going to acquiesce in the decision, either. It is arguing in ongoing audits and litigation that its view of the tax factor calculation is correct and that the determination in *Batty* is wrong. Several clients have received assessments on the issue and are being forced to appeal.

[6]Nos. 824061, 824063 (N.Y. Div. Tax App. 2013).

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However, the department has begun pursuing a slightly different strategy. Under New York's apportionment rules, an S corporation is required to apportion its income based on a single-factor formula using only the sales factor. For many QEZEs, that results in a low apportionment percentage because export sales create out-of-state receipts. Of course, that also means that when computing the tax factor for the tax reduction credit, resident shareholders of those QEZEs receive little benefit because the amount of their income that gets allocated within New York using single-factor apportionment is often very low.

Department auditors are now informing taxpayers — perhaps in a show of mercy — that using the department's discretionary authority, they will compute the tax factor by reference to the old three-factor analysis of property, payroll, and sales. Again, for QEZEs that have invested significant property and payroll in New York, that means the department's tax factor calculation will be higher than it would otherwise have been under the normal, single-factor apportionment rules.

How are taxpayers responding? "Thanks, but no thanks" seems to be the typical response. Most taxpayers think the department wouldn't need to exercise its discretion if it were interpreting the laws correctly in the first place. Moreover, although the new calculation provides some relief, taxpayers are still getting hit with huge assessments, so the minimal "benefit" offered isn't being felt all that much.

Striking Back?

This isn't the forum to litigate the merits of the respective positions — we'll leave that to the lawyers for the various parties. (Of course, if pressed, I'll tell you how I feel. I'm sure you can guess.)

This is the forum to question some of the underlying policy implications. One relates simply to process. The Division of Tax Appeals is charged with "providing the public with a just system of resolving controversies" and to "ensure that the elements of due process are present with regard to such resolution of controversies."[7] Here, the department took a position on the tax factor calculation not just against the taxpayers involved, but against many others in similar factual circumstances. It fought the good fight in *Batty* and lost at the ALJ level. Of course, that is why there is a two-step appeals process; the department had every right to appeal and to let the appeals process dictate the final result. Unfortunately, the department chose a different path, a path that now forces other taxpayers down the same long (and expensive) road as faced by the Battys.

[7]Tax Law section 2000.

Obviously, the department's litigation strategy is its own prerogative. Maybe it believes a better case is on the way; maybe there was something unique about *Batty* that it didn't like (although, anecdotally, all the cases we have seen appear to have similar facts and circumstances). Whatever the case, its litigation strategy creates significant confusion and difficulty for the very taxpayers the state should be looking out for: New Yorkers who are investing in businesses in economically depressed areas across the state.

> ***What's the policy reason behind limiting the amount of the tax reduction credit to the amount of tax a New York resident would have paid if he was a nonresident?***

The other issue is more substantive. What's the policy reason behind limiting the amount of the tax reduction credit to the amount of tax a New York resident would have paid if he was a nonresident? Is it really, as the department suggested with its constitutional argument in *Batty*, that the state needs to protect the rights of nonresident investors? The whole thing seems counterintuitive. The very purpose of the Empire Zone program was to create incentives for economic growth and new job creation in economically depressed areas of New York by increasing employment and encouraging investment in those areas.[8] That effort is largely undertaken by New Yorkers in their local communities, taxpayers who not only work there but who also raise their families there, support the community, and so on. The tax reduction credit was designed to encourage that kind of investment by minimizing or eliminating any personal income taxes paid by owners of those businesses as a result of their New York operations. It makes little sense to arbitrarily limit the credit based on hypothetical taxes the owners might pay if they lived somewhere else.

The oddity of that thinking from a policy perspective is illustrated best by a few examples. For instance, consider a QEZE with two shareholders, one who lives in New York and one who lives in Florida. The total income split between the two shareholders is $3 million, and the QEZE's apportionment percentage is 33 percent. The resident shareholder pays New York tax on his entire $1.5 million share — in other words, all his income gets allocated within New York. The nonresident pays tax on only 33 percent, or $500,000. Both receive a

[8]*See Matter of Hucko* (N.Y. Tax App. Tribunal 2013); General Municipal Law section 956.

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tax reduction credit, but what's the logic in limiting the resident shareholder's credit as if he paid tax on only $500,000? Here's a hint: There is none, except possibly in one limited circumstance.[9]

Another example: Take a consulting firm that's headquartered in a Buffalo Empire Zone and taxed as an S corporation. Both shareholders are residents and the total income split between the two is $3 million. As a service firm, even if the shareholders were nonresidents, all their income would be allocated to New York, assuming all the services were performed in New York. So even under the department's view, those shareholders would likely get the full benefit of the tax reduction credit on 100 percent of the tax they paid because all of the entity's income would be deemed allocated within New York under normal rules of apportionment. But what about the two-person company next door that sells T-shirts online? Because that company would have a low apportionment percentage (assuming most sales are outside New York), its shareholders would receive minimal benefit from the tax reduction credit. What's the logic in prohibiting the T-shirt sellers from receiving the same credit as the consulting firm? Again, a hint: There is none.

Conclusion

Expect skirmishes on this issue to continue, but there is hope that the problem will be resolved favorably at some point. Indeed, despite spending much time locked in battle with the department on one issue or another, we're usually pleasantly surprised to see the department eventually reach the right answer, particularly on difficult policy issues like this. Sometimes it takes litigation to get the right result, but usually it just takes time. For taxpayers, that often takes a lot of patience, too. ✰

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[9]The only possible time when that could make sense is when the resident shareholder receives a resident tax credit for taxes paid to other states on the same income — the idea being that the state should not have to provide credit for tax paid twice on the same income (once under the resident credit and again under tax reduction credit). But that wasn't the case in *Batty*.

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