

More Battles in New York's Empire Zones

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Around 10 years ago, when the New York governor's annual budget was issued, we were surprised to see various provisions regarding a new "Empire Zone" program, in large part because of the significant benefits afforded to qualifying taxpayers and the many different ways for taxpayers to become qualified. Indeed, as partners in a law firm located within one of those Empire Zones, we can attest to the importance of the program and the significant benefits it provides. (This is another way of our saying the Empire Zone program reduces our New York taxes, which makes us fans of the program.)

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But as the state giveth, the state taketh away. In years of amendments to Empire Zone legislation, the State Legislature took various steps to limit the scope of the program and close perceived loopholes. More recently, though, the New York Department of Taxation and Finance's Audit Division has gotten into the act, and as a result we have seen a parade of

new cases in which a taxpayer's claimed Empire Zone benefits have been challenged. And as this article goes to press, it appears that the Empire Zone program as we know it is going to end and be replaced with a much less glitzy "Excelsior Jobs" program, which we will undoubtedly address in a later column.

Whatever the case, there is obviously a lot of activity surrounding those Empire Zone issues. Given the state's recent focus on those issues in audits, we can expect a lot more in the next couple of years. This article will review what has been happening in some of the more recent cases and discuss the tax department's enforcement action in that area.

Empire Zones for Dummies

Before getting into some of the specifics of the new cases, here is a brief overview of how New York's Empire Zone program was designed to work.

Benefits under the Empire Zone program enacted in 2000 covered three basic areas. First, for sales and use tax purposes, qualifying taxpayers received a sales tax exemption for purchases of tangible personal property or services consumed within the zone.¹ In addition to undergoing various other changes over the years, just last year that exemption was changed to a credit, so that qualifying taxpayers were first required to pay tax on all purchases and later claim a credit or refund at a later date.² Another quirk often arising in this area was that many local taxing jurisdictions didn't provide for the sales tax exemption, so in some jurisdictions, such as Nassau and Suffolk counties, the sales tax exemption under the Empire Zone program was only a partial exemption.

Second, qualifying taxpayers also were entitled to a refundable income tax credit for real property taxes paid by the qualifying taxpayer or its owners

¹Tax Law section 1115(z).

²Tax Law section 1119(d); *see also* TSB-M-09(12)S.

in the case of a look-through entity such as a limited liability company, partnership, or S corporation.

Third, the program allowed for a nonrefundable tax reduction credit applied against the New York state income tax liability of the qualifying enterprise or its individual owners, partners, and so forth.³ All of those provisions have various qualifying thresholds measured by employment numbers, employment increases, capital expenditures, and so forth.

If you would like a more detailed summary of the program (or a headache), give us a call to discuss it, or check out our article last year on the 2009 changes to the program.⁴ But unless you or your client was certified before June 30, 2010, the information you are likely to receive will have only slightly more relevance for you than our explanation of how the National Football League's Buffalo Bills will choose their next starting quarterback.

Recent Administrative Developments

As said above, New York's administrative courts have been busy addressing open Empire Zone issues. Taxpayers have, for example, debated whether special district assessments like sewer district surcharges constitute "eligible real property taxes" for which the Empire Zone's real property tax credit is available. On April 8 an administrative law judge with New York's Division of Tax Appeals determined in *Matter of Milton Stevenson* that such special district assessments were eligible real property taxes for which a credit might be obtained. The ALJ reasoned that the failure of the Legislature to specify that the term "eligible real property taxes" should be construed in a manner consistent with the definition of deductible real property taxes in the Internal Revenue Code meant that the term should be defined as an ordinary person would interpret it. Because the definition of creditable real property taxes included those that "become a lien on the real property during the taxable year," and because special district assessments and other similar surcharges become liens on the real property if they remain unpaid, the ALJ determined that special district assessments were creditable real property taxes under the law.

But not so fast! Just a month later, on May 13, a different ALJ came to the opposite conclusion in *Matter of Elayne Herrick*. Because ALJ determinations are not precedent setting, the issue will remain open until there is a ruling from a higher authority — probably the New York State Tax Appeals Tribunal. In the meantime, taxpayers should consider filing protective refunds claiming additional real

property tax credits for special district assessments and other similar charges.

In another case, *Matter of Roger Burdick*, the ALJ on May 13 considered the application of the Empire Zone program's new business limitations. Under the program, the juiciest benefits are reserved for new businesses. In 2002 the statute was changed to clarify that a business could not be a new business if it was substantially similar in *ownership* and *operation* to a preexisting New York business. In *Burdick*, the owner of several New York auto dealerships merged the dealerships into a single corporation and claimed that the corporation was a new business eligible to claim refundable Empire Zone wage tax credits. The taxpayer conceded that the surviving entity was substantially similar in ownership to the preexisting entities but argued that the operations of the merged entity were significantly different. In ruling in favor of the taxpayer, the ALJ found it persuasive that in addition to merging the legal entities, the taxpayer relocated separate dealerships to a central location and instituted centralized management, payroll, and accounting functions. The difference in the operations of the surviving entity compared with the separate operations of the predecessor entities compelled the ALJ to conclude that the merged entity was indeed a new business under the law and therefore entitled to enhanced empire zone benefits.

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Matter of Graphite Metalized Holdings, Inc., decided April 29, presented another twist on the new business test. Under a set of 2005 law changes, a business certified as an Empire Zone enterprise before August 1, 2002, but having a limited existence before certification would not constitute a new business unless it was formed for a valid business purpose and not solely to gain Empire Zone benefits. In this case, a new subsidiary was formed on July 31, 2002. The timing of its formation was clearly motivated by a desire to maximize Empire Zone benefits, but corporate records indicated that a general corporate restructuring had been contemplated for several years before 2002. As a consequence, the ALJ determined that the subsidiary was not formed solely to gain Empire Zone benefits and thus could constitute a new business entitled to enhanced Empire Zone benefits.

Most recently, on May 20, an ALJ ruled in *Matter of Contract Pharmaceuticals* that the initial New York tax year of a foreign corporation did not begin

³Tax Law section 15.

⁴Timothy P. Noonan and Christopher L. Doyle, "Striking Back on Empire Zones," *State Tax Notes*, July 6, 2009, p. 49, Doc 2009-14758, or 2009 STT 126-4.

until it closed its purchase of business assets in New York state. The taxpayer in question was formed March 1, 2005, in Delaware and chose an October 31 end for its tax year. Before its acquisition of assets and employees of a preexisting business on August 26, 2005, the business had negligible assets and no employees in New York state, but it was engaged in substantive negotiations to purchase a business in New York. On August 26, 2005, it did, in fact, acquire the operating assets of a preexisting, unrelated New York business. On the next day, the taxpayer began employment of the individuals formerly employed by the business it acquired. In preparing its returns for the year, the taxpayer claimed Empire Zone credits based on the position that the employees it hired as a result of the August 26 transaction worked for the taxpayer for more than half of its initial New York tax year, which, according to the taxpayer, began August 26, 2005, and ended October 31, 2005. Because most Empire Zone benefits are unavailable if a business does not have employees for at least half of the tax year, the tax department argued that the corporation's tax year began when it was formed on March 1 and initiated active negotiations in New York for the acquisition of the operating assets and the employees from the preexisting New York business. But the ALJ found the taxpayer's arguments more persuasive and ruled the taxpayer was entitled to a full year's worth — \$683,357 — of Empire Zone credits, including \$282,000 of refundable wage tax credits for its tax year, which ended October 31, 2005.

Again, all the cases discussed above are ALJ determinations, which are not precedent setting. However, it is interesting to see that many of the antitaxpayer positions asserted by the New York state tax department are not being sustained after full evidentiary hearings.

Retroactive Changes?

Finally, a recent state supreme court case issued by a Syracuse judge addressed one of the more controversial pieces of Empire Zone legislation passed last year and calls into question some recent legislation looking to take away benefits retroactively.⁵ In that case, the plaintiffs were a group of businesses that were decertified as Empire Zone businesses under legislation enacted on April 7, 2009. The 2009 legislation consisted of amendments to the Empire Zone program. The two amendments at issue in this case adopted new criteria under which a business could be decertified and required a review of all certified businesses to determine their eligibility under those criteria. On June 29, 2009,

the plaintiffs each received letters from the New York State Department of Economic Development (DED) decertifying them from the Empire Zone program and noting their decertification was retroactive to January 1, 2008.

The two amendments at issue were codified at section 959(a)(v)(5) and (a)(v)(6) of the General Municipal Law. The tax department announced on April 15, 2009, that it was construing these sections as being retroactive to January 1, 2008, even though there was nothing that explicitly provided for retroactivity in the amendments themselves. The DED on June 17, 2009, also issued regulations saying that the decertification criteria would apply retroactively to January 1, 2008.

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The judge ruled that there was no legal authority allowing the DED to decertify the plaintiffs retroactively to January 1, 2008. Saying that “statutes are presumptively prospective only, absent an express legislative intent to the contrary,” he found nothing in the legislation itself or in the legislative history authorizing retroactive application.⁶ Nothing in the language of the amendments themselves indicated the intent to apply the criteria retroactively. The section of the 2009-2010 budget bill containing the Empire Zone program amendments stated that “this act shall take effect immediately,” except as provided for in certain subsections. Although some subsections of the act were stated to be applicable “to taxable years beginning on and after January 1, 2008,” nothing in the decertification amendments denoted retroactivity. The judge ruled that the “Legislature could not have intended [that the decertification amendments] would apply retroactively absent an explicit effective date.” Meanwhile, the legislative history behind section 959(a)(v)(5) and (a)(v)(6) revealed that the Legislature had *removed* retroactivity language from the amendments as they were originally proposed. The judge noted that Gov. David Paterson (D) acknowledged the removal of the January 1, 2008, retroactive date from the amendments, because Paterson's 2010-2011 budget bill currently attempts to rectify that removal. Thus, “not only is there no express language in the 2009

⁵*James Square Associates LP et al. v. Mullen*, New York Supreme Court, June 11, 2010.

⁶*Morales v. Gross*, 230 A.D.2d 7, 9.

amendments permitting retroactive legislation . . . but it is clear from the legislative history of the amendments that the Legislature specifically omitted such language.”

Here again, as with some of the ALJ cases, we are seeing that the department's aggressive enforcement in this area has not been successful.

Conclusion

As noted at the outset, because of the tax department's increased enforcement in this area, expect to see lots of these types of cases coming out. From a policy prospective, one might view that development as frustrating, because many well-intentioned taxpayers seeking to take advantage of incentive programs designed to increase business activities in New York are faced with continuing audits and litigation. However, the tax department obviously

has to make sure that folks aren't taking undue advantage of their programs or misusing them in inappropriate ways. It is clear from our experience that the tax department or Legislature severely underestimated the overall benefits of the Empire Zone program that we noticed as soon as we saw the new legislation for these zones more than 10 years ago. And although the program is soon going away, we can expect litigation on this issue to continue for quite some time. ☆

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