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THIRD DEPARTMENT AND TRIBUNAL STRIKE DOWN RETROACTIVE APPLICATION OF APRIL 2009 QEZE STATUTORY AMENDMENTS

By Hollis L. Hyans

The Appellate Division, Third Department, has reversed the New York State Tax Appeals Tribunal and held that statutory amendments enacted in April 2009 narrowing the Qualified Empire Zone Enterprise ("QEZE") tax credit cannot constitutionally be retroactively applied to the tax year beginning January 1, 2009. *Mackenzie Hughes LLP v. N.Y.S. Tax Appeals Trib.*, No. 527595, 2019 NY Slip Op. 09337 (3d Dep't, Dec. 26, 2019). Separately, the Tribunal has now also held—contrary to its own previous decision in the *Mackenzie Hughes LLP* case—that the amendments cannot be applied retroactively. *Matter of NRG Energy, Inc.*, DTA No. 826921 (N.Y.S. Tax App. Trib., Dec. 17. 2019).

The *Mackenzie Hughes LLP* Case

Facts. Mackenzie Hughes LLP ("Mackenzie Hughes"), a New York limited liability partnership, is a law firm that was formed out of a predecessor law firm, Mackenzie Smith Lewis Mitchell & Hughes, LLP ("MSLMH"). In 2001, MSLMH had entered into a 15-year lease for office space in Syracuse, after having been advised by representatives of the City of Syracuse that the firm could receive QEZE credits if it remained in its long-time location. Mackenzie Hughes was formed as a successor in 2002, assumed the lease, and became QEZE-certified in 2003, effective as of June 14, 2002.

In June 2009, Mackenzie Hughes was notified that its QEZE certification was being revoked effective January 1, 2008, due to the new amendments to the law. Mackenzie Hughes and approximately 20 of its partners and their spouses (the "Partners") challenged the revocation, but it was upheld by the Empire Zone Designation Board, which oversees the QEZE program.

On either their original or amended 2009 returns, the Partners claimed QEZE tax credits based upon their partnership interests in Mackenzie Hughes. The refunds were issued, but the Department of Taxation and Finance subsequently issued notices of deficiency to reclaim the amounts previously refunded, and Mackenzie Hughes and the Partners challenged the assessments before the Division of Tax Appeals.

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Background on the QEZE Credits and Amendments. On April 7, 2009, the statute creating the QEZE credits was amended to impose new criteria for continued certification under the Empire Zones program (the "2009 Amendments"). The change was intended to prevent a perceived abuse caused by existing businesses reincorporating or transferring employees among related entities to create the appearance of having created new jobs or made new investments. In 2010, the statute was further amended to explicitly provide that the 2009 Amendments were retroactive to years beginning on or after January 1, 2008.

In 2013, the New York Court of Appeals held that retroactive application of the 2009 Amendments to the year beginning January 1, 2008, violated the Due Process Clause and was unconstitutional. *James Square Assocs. LP v. Mullen*, 21 N.Y.3d 233 (2013). The court applied a test set forth in *Replan Development, Inc. v. Department of Housing Preservation & Development*, 70 N.Y.2d 451 (1987), *appeal dismissed*, 485 U.S. 950 (1988), which looks at three factors: whether the taxpayer had been forewarned of the change in law and the reasonableness of reliance on the old law; the length of the retroactive period; and the public purpose of the retroactive application. In *James Square*, the Court of Appeals found that the taxpayers had not been forewarned of the legislative change, that the period of retroactivity back to January 1, 2008, was excessive, and that the retroactive application did not serve an important public purpose.

Decisions Below. Mackenzie Hughes and the Partners argued that the 2009 Amendments could not be retroactively applied back to January 1, 2009. An ALJ rejected this argument, finding that application of statutory changes enacted in April 2009 to the 2009 tax year itself was not a retroactive application of the law, and that even if it was, there was no violation of due process rights because the period of retroactivity was very short, Mackenzie Hughes and the Partners were aware of the likely changes, and the 2009 Amendments were enacted with the "clearly acceptable" public purposes of curtailing abuses of the Empire Zones program and achieving budget savings.

On exception, the Tax Appeals Tribunal, while finding that there was indeed a retroactive application of the law, and acknowledging that the Court of Appeals in *James Square* found that there was no acceptable public purpose served by the retroactive application, still upheld the application back to January 2009. The Tribunal relied on the short period of retroactivity—97 days—and its conclusion that there was no action that could have been taken by Mackenzie Hughes in 2008 or 2009 that would have altered the result, since the lease was signed and Mackenzie Hughes was formed in 2001 and 2002, respectively.

The Appellate Division reversed the Tribunal and held that the retroactive application violated the taxpayers' due process rights.

Appellate Division Decision. The Appellate Division reversed the Tribunal and held that the retroactive application violated the taxpayers' due process rights. Applying the same three factors discussed in *Replan Development* and *James Square*, the court found that no public purpose was served by the retroactive application, but that the short period of retroactivity weighed against the taxpayers, as they conceded at oral argument. However, the court found that the factor concerning forewarning of the change in the law and whether reliance on the old law was reasonable weighed in favor of the taxpayers. The court rejected the Department's argument that the Partners were on notice of the new law as of January 7, 2009, when the 2009 Amendments were introduced, holding that the "mere fact that legislation is being introduced does not mean that such legislation would ultimately be passed." The court also found that the factor concerning adequate forewarning does not focus on the actions that the parties could have taken, but rather on whether the parties' reliance was justified "under all the circumstances of the case and whether [their] expectations as to taxation have been unreasonably disappointed." The court noted that in 2001, MSLMH had been considering various plans to relocate but chose to remain in the Empire Zone and enter into a 15-year lease, invested approximately $800,000 in equipment and furnishings, and took other actions in reliance on receiving QEZE credits. The court therefore concluded that the Partners' reliance on the old law was reasonable. After "viewing all factors holistically," the court concluded that the 2009 Amendments could not be applied retroactively to the beginning of 2009.

The *NRG Energy, Inc.* Case

Facts. NRG Energy, Inc. ("NRG") owns and operates power plants that generate power from various fuel sources, including coal, natural gas, solar, and wind. It is the sole owner and member of Oswego Harbor Power LLC, which owns and operates the Oswego Generating Station in Oswego County, New York (the "Plant"). NRG

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and Oswego Harbor Power LLC were originally certified as eligible under the New York State Empire Zones Act for the Plant effective in 2002, which entitled NRG to QEZE tax credits, including the refundable credit for real property taxes.

NRG claimed 2009 QEZE credits with regard to two facilities in other Empire Zones and received a refund of approximately $24 million. In June 2009, it was notified that its certification for eligibility for the Plant was being revoked, retroactive to January 1, 2008. After the decision in *James Square*, NRG received its refunds of the QEZE credits for the Plant for 2008, but its claim on an amended 2009 return for an additional credit of approximately $5.9 million for the Plant was denied, because the certificate of eligibility for the Plant had been revoked in 2009, in reliance on the 2009 Amendments to the statute. NRG challenged the denial, arguing that the retroactive application of the 2009 Amendments to the year beginning January 1, 2009, was impermissible under *James Square*, and that the Department's "selective enforcement" of the statute violated its rights to equal protection under the Constitution.

[T]he Appellate Division makes it clear that, when taxpayers have made important business and financial decisions based on existing law, and their reliance was reasonable, new laws cannot be applied retroactively.

Previous Decisions. An ALJ had rejected NRG's arguments, finding that application of the 2009 Amendments to the 2009 tax year itself was not retroactive application of the law, just as a different ALJ had found in the *Mackenzie Hughes* case. The ALJ also rejected NRG's argument that there was any violation of NRG's equal protection rights, finding that NRG had failed to demonstrate any "selectivity of enforcement" arising from "an intentional invidious plan of discrimination" on the part of the Department. The Tribunal reversed the ALJ's determination that no retroactive application of a statute had occurred, and remanded the case to the ALJ to determine whether that retroactive application was constitutional under the factors set forth in *James Square* and *Replan Development*. On remand, the ALJ again sustained the retroactive application of the amendments, finding that there was no action NRG could have taken to avoid the decertification, and that the short retroactive period was not enough to violate NRG's due process rights.

The case then went back to the Tribunal on a second exception.

Tribunal Decision. This time, the Tribunal found that NRG's due process rights had been violated by the retroactive imposition. With regard to the first part of the three-factor test—whether the taxpayer's reliance was justified and whether its expectations have been unreasonably disappointed—the Tribunal found that NRG, had it known that changes would have been required, could have taken actions that might have avoided the revocation of its certification. Even though the decertification was based upon reports filed prior to 2008, the Tribunal expressly found that NRG could have taken steps, such as changing its budget in a way that might have allowed it to still qualify, when it adopted its budget in December 2008. Therefore, the Tribunal found that the first factor weighed in favor of NRG, and that, in the absence of a public purpose for the retroactive application, weighing the competing factors resulted in the conclusion that NRG's due process rights were violated by retroactive application of the 2009 Amendments.

ADDITIONAL INSIGHTS

Taken together, these decisions demonstrate a welcome development in the law regarding retroactive application of tax imposition statutes. In *Mackenzie Hughes*, the Appellate Division makes it clear that, when taxpayers have made important business and financial decisions based on existing law, and their reliance was reasonable, new laws cannot be applied retroactively, and that the test does not focus on what actions could have been taken, but only on whether the taxpayers had adequate forewarning of a change and whether they justifiably relied on the existing law. In *NRG*, decided nine days *before* the Appellate Division decision in *Mackenzie Hughes*, the Tribunal found that there were actual actions that could have been taken by the taxpayer that it did not have the opportunity to take—arguably a higher standard than the one found relevant by the Appellate Division, but certainly consistent with the court's decision.

It is unclear whether the Department will seek leave to appeal to the Court of Appeals in *Mackenzie Hughes* (it cannot appeal the *NRG* decision). In light of both these decisions, however, circumstances in which new laws are retroactively applied to the detriment of taxpayers should be carefully reviewed and may well be subject to challenge.

GOVERNOR PROPOSES 2020–21 NEW YORK STATE EXECUTIVE BUDGET

By Irwin M. Slomka

On January 21, 2020, New York State Governor Andrew M. Cuomo released his proposed New York State 2020–21 Executive Budget, applicable to the State's fiscal year beginning April 1, 2020. Overall, the tax proposals are relatively modest in scope and, other than reintroducing last year's proposal to legalize and tax adult-use marijuana, contain no "big ticket" items. Among the Governor's proposals are the following:

1. **Enact the Cannabis Regulation and Taxation Act** (Part BB). As he did last year, the Governor is again proposing to legalize adult-use cannabis, and to impose a new three-part tax on adult-use cannabis products. One tax would be imposed on the cultivation of cannabis, a second tax on the sale to a retail dispensary (at 20% of the invoice price), and a third tax on the same sale to the retailer (at 2% of the invoice price, but collected in trust for the county where the dispensary is located). Tax revenues would be deposited into a "cannabis revenue fund" to be used for prescribed purposes, including administration of the regulated cannabis program and a "social and economic equity plan." The Governor failed to garner sufficient legislative support last year, and the proposal remains controversial.

2. **Small Business Tax Relief** (Part D). The Governor proposes reducing the corporate franchise tax rate on business income from 6.5% to 4% for qualifying small businesses, effective for tax years beginning after 2020. Also proposed is the elimination of the estimated tax underpayment penalty for New York S corporations, which are treated as pass-through entities for New York State tax purposes.

3. **Authorization for the Tax Department to Allow Unclaimed Tax Benefits** (Part F). The Governor's proposal would authorize the Tax Department to compute and issue refunds relating to earned income credits—available to low-income individuals—even if not claimed on a tax return. (The law already requires the Department to periodically alert potentially eligible individuals to the availability of the earned income credit.) It would also allow the Department, on its own volition, to reverse a taxpayer's New York election to itemize deductions and allow instead a standard deduction if greater. The memorandum in support of the proposal does not explain why this latter authority is not allowed under existing law.

4. **Revise Criminal Tax Fraud Statutes** (Part K). Referring to "judicial confusion" over a provision in the existing New York tax fraud statutes, the Governor proposes to make clear that an individual does not actually have to underpay tax to commit criminal tax fraud, and that criminal tax fraud can also result where an individual has received a "fraudulent refund" or applied for one as a result of the commission of the crime. The proposal also includes a new criminal tax preparer provision for tax preparers who file or cause to be filed 10 or more New York tax returns within a 365-day period where the preparer knows they contain materially false information or omit material information intended to evade or reduce tax liability, or to "effect or inflate a refund."

5. **Reform the New York Film Tax Credit** (Part M). In the face of rising concerns about the costs and fairness of allowing tax credits for the film industry, the Governor proposes modest reductions in the film production credit and post-production credit (from 30% to 25% of qualified production costs at a qualified facility within the Metropolitan Commuter Transportation District, and from 35% to 30% at a qualified facility located elsewhere in New York State), as well as limitations on what constitutes a "qualified film" for purposes of the film credit.

The Governor's proposed budget does not include conforming the New York City corporate tax treatment of GILTI to its treatment under Article 9-A.

The New York State Senate and Assembly are expected to release their own tax proposals. The deadline for enactment of the New York State budget is April 1, 2020.

INSIGHTS IN BRIEF

APPELLATE COURT UPHOLDS DENIAL OF SOLAR ENERGY SYSTEM EQUIPMENT TAX CREDIT

The Appellate Division, Third Department, has upheld a decision of the Tax Appeals Tribunal, finding that the Tax Department properly denied a solar energy system equipment tax credit for geothermal heating systems. *Suozzi v. Tax Appeals Trib.*, No. 528466, 2020 NY Slip Op. 00193 (3d Dep't, Jan. 9, 2020). The court found that the Department's interpretation of the term "solar radiation" as not including a geothermal system that harvests heat from the ground was not unreasonable. It also noted that 2015 legislation that would have expressly permitted the credit for geothermal systems, but that was vetoed by the Governor, strongly supports the Department's position that the existing law did not include those heating systems.

TAX DEPARTMENT'S REFUSAL TO ISSUE SALES TAX CERTIFICATE OF AUTHORITY UPHELD

A notice of proposed refusal to issue a sales tax certificate of authority to an LLC because of substantial amounts of sales taxes owed by its sole member and president was sustained by an ALJ. *Matter of 34th Street GNG LLC*, DTA No. 829239 (N.Y.S. Div. of Tax App., Jan. 9, 2020). The ALJ was not swayed by the taxpayer's argument that without a certificate of authority he would be unable to generate sufficient income to pay off the outstanding sales tax liabilities. The ALJ also rejected his argument that the Department has demanded too high an installment payment arrangement, noting that she did not have the authority to mandate any particular payment arrangement. Therefore, the ALJ concluded that the Department acted within its authority under Tax Law § 1134(a)(4)(B) in refusing to issue a certificate of authority.

SECURITY SERVICES PROVIDED AT CAPITAL IMPROVEMENT SITE ARE SUBJECT TO SALES TAX

An ALJ has sustained the denial of a refund for sales tax paid on protective services, finding that the services were taxable despite being provided in connection with the construction of a New York City building that was treated as a capital improvement. *Matter of Evergreen Gardens, LLC*, DTA No. 828403 (N.Y.S. Div. of Tax App., Jan. 9, 2020). Although the parties agreed that the building qualified as a capital improvement, and that the project was of a large enough size that the law mandated the use of protective services, the ALJ found that the Appellate Division had held more than 20 years ago that protective services purchased in connection with capital improvements were nonetheless independently taxable under Tax Law § 1105(c)(8), which imposes sales tax on detective and protective services. *Robert Bruce McLane Assocs., Inc. v. Urbach*, 232 A.D.2d 826 (3d Dep't, 1996). The ALJ rejected what she described as the taxpayer's "novel arguments" that recent developments since the *McLane* decision, involving such areas as guidance from the Department concerning contractor services and interior design services in connection with capital improvements, changed the result mandated by the Appellate Division in *McLane*.

ADDITIONAL SALES TAX DUE ON SALES OF GASOLINE

An ALJ has sustained the Department's assessment of sales tax imposed on the full price of motor fuel sold by a chain of gas stations, agreeing that tax was due on the full retail price of the gasoline, despite the fact that customers paid a discounted price in accordance with an agreement between the gas stations and the Price Chopper grocery chain. *Matter of GRJH, Inc.*, DTA No. 827617 (N.Y.S. Div. of Tax App., Dec. 19, 2019). The ALJ found that the Price Chopper Fuel Advantage Program, which involved a loyalty card issued to Price Chopper customers that the customers used to obtain a discounted price for gasoline at the pump, was analogous to a manufacturer's coupon, since the gas stations received reimbursement via a credit, and that sales tax is due on the full price of property purchased with manufacturers' coupons pursuant to Tax Law § 1101(b)(3). The ALJ also refused to allow the gas stations to offset the full purchase price by the costs they incurred to participate in the Price Chopper program, finding that the regulation, 20 NYCRR 526.5(e), expressly disallows the deduction of expenses incurred by a retailer in making a sale.

CREDIT AGAIN DENIED FOR PERSONAL INCOME TAXES PAID TO ANOTHER STATE ON CAPITAL GAINS

An ALJ has denied the request of a married couple, who were domiciliaries of Connecticut but statutory residents of New York, for a credit against their New York State personal income tax liability for taxes paid to Connecticut on capital gains from the sale of securities, finding that a credit for taxes paid to other states is not required because the intangible assets giving rise to the income in question were not employed in a business carried on in another state. *Matter of David Russekoff & Amanda Nutile*, DTA Nos. 827740 & 827741 (N.Y.S. Div. of Tax App., Dec. 19, 2019). The ALJ relied on the decisions in *Chamberlain v. N.Y.S. Dep't of Taxation & Fin.*, 166 A.D. 3d 1112 (3d Dep't, 2018), *lv. denied and appeal dismissed*, 32 N.Y.3d 1216, *cert. denied*, 140 S. Ct. 133 (2019) and *Edelman v. N.Y.S. Dep't of Taxation & Fin.*, 162 A.D.3d 574 (1st Dep't, 2018), *lv. denied and appeal dismissed*, 32 N.Y.3d 1216, *cert. denied*, 140 S. Ct 134 (2019), which had rejected similar challenges and found that the U.S. Supreme Court's 2015 decision in *Wynne* does not affect the constitutionality of

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New York's statutory residency scheme. Although the petitioners were paying tax to two states on the same income, the ALJ relied on *Tamagni v. Tax Appeals Trib.*, 91 N.Y.2d 530 (1998), to determine that the taxation of intangible income earned by New York statutory residents did not result in constitutionally impermissible double taxation.

ALJ UPHOLDS IMPOSITION OF MANDATORY NEW YORK S CORPORATION ELECTION

An ALJ has upheld application of the mandatory New York S corporation election for an eligible S corporation with investment income of more than 50% of its federal gross income for the year. *Matter of Albert R. LePage, et al.*, DTA No. 828035, et al. (N.Y.S. Div. of Tax App., Dec. 19, 2019). The dispute principally involved one of statutory interpretation, specifically whether the statute's reference to the S corporation's "federal gross income" for the investment income ratio test refers to the actual federal S corporation income amounts (as the Department maintained) or instead to the income amounts reflected in the S corporation's pro forma Article 9-A return, computed as if the S corporation were a federal C corporation (as the taxpayer asserted). The ALJ concluded that the Department's interpretation was the most supportable and he upheld the mandatory New York S corporation election. As a result, the resident and nonresident individual shareholders of the S corporation were individually taxable on their respective distributive shares of the S corporation's I.R.C. § 338(h)(10) gain.

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Astoria Financial Corp. v. New York City (NYC Tax App. Trib. 2016)

Clorox Products Manufacturing, Co. v. New Jersey (NJ App. Div. 2008)

Crestron Electronics, Inc. v. New Jersey (NJ Tax Ct. 2011)

Daimler Investments US Corp. v. New Jersey (NJ Tax Ct. 2019)

Dollar Tree Stores Inc. v. Pennsylvania (PA Bd. of Fin. & Rev. 2015)

Duke Energy Corp. v. New Jersey (NJ Tax Ct. 2014)

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EchoStar Satellite Corp. v. New York (NY Ct. of App. 2012)

Former CFO of Fortune 500 Co. v. New York (NYS Div. of Tax App. 2017)

frog design, inc. v. New York (NYS Tax App. Trib. 2015)

Hallmark Marketing Corp. v. New York (NYS Tax App. Trib. 2007)

Kohl's Department Stores, Inc. v. Virginia (VA Sup. Ct. 2018)

Lorillard Licensing Co. v. New Jersey (NJ App. Div. 2015)

Lorillard Tobacco Co. v. New Jersey (NJ Tax Ct. 2019)

MeadWestvaco Corp. v. Illinois (U.S. 2008)

Meredith Corp. v. New York (NY App. Div. 2012)

Nerac, Inc. v. New York (NYS Div. of Tax App. 2010)

Rent-A-Center, Inc. & Subsidiaries v. Oregon (OR Tax Ct. 2015)

Reynolds Innovations Inc. v. Massachusetts (MA App. Tax Bd. 2016)

Reynolds Metals Co. v. Michigan (MI Ct. of App. 2012)

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Wendy's International, Inc. v. Illinois (IL App. Ct. 2013)

Wendy's International, Inc. v. Virginia (VA Cir. Ct. 2012)

Whirlpool Properties, Inc. v. New Jersey (NJ Sup. Ct. 2011)

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