

## Burying New York's 'Only Reasonable Construction' Standard

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In this article, the authors discuss the “only reasonable construction” standard applied in New York tax credit cases, comparing it with similar standards and arguing that it should be abandoned.

We practice before the New York Division of Tax Appeals (DTA) about as much as anyone. We find the judges to be open-minded and willing to entertain reasonable arguments we make for our clients, and New York’s tax appeals system usually scores pretty high in terms of fairness and transparency.<sup>1</sup> But there’s no denying that the rules of the game are tilted against taxpayers. Presumptions seem to always favor the Department of Taxation and Finance to the detriment of taxpayers: Department notices are presumed correct, while taxpayers are required to prove their points at a high “clear and convincing” level to prevail. Taxpayers are allowed only

limited discovery tools, while the department has administrative subpoena power — at least until the audit has concluded. And taxpayers almost always bear the burden of proof.

But the one rule that seems to be the most misplaced is the “only reasonable construction” standard the DTA applies to construe statutes permitting credits and exemptions.<sup>2</sup> Under this standard, unless the taxpayer can show that the department’s interpretation is irrational and that the taxpayer’s interpretation is the *only* reasonable interpretation, the DTA will apply the department’s interpretation of a credit statute. This is the case even if the judge finds the taxpayer’s interpretation of the statute more reasonable than the department’s.

Although this concept has been employed in many New York tax cases, it is time to revisit it, with the goal of allowing DTA judges to implement what they believe is the *most* reasonable interpretation of the statute. And we’re not alone in this view. Federal courts may now be less likely to defer to the IRS’s interpretation of its own rules following U.S. Supreme Court Justice Neil M. Gorsuch’s searing critique in a March 2019 dissent. In this article, we’ll talk through the “only reasonable construction” standard, discuss recent developments, and argue that it should find its way out of the great state of New York (and its great tax appeals system).

### The ‘Only Reasonable Construction’ Standard: An Example

Lawyers have a way of explaining things that sometimes makes it hard to understand what they are talking about. And don’t even get us started on tax lawyers! So here’s a more real-life example to

<sup>1</sup>See Douglas L. Lindholm, Ferdinand S. Hogroian, and Fredrick J. Nicely, “The Best and Worst of State Tax Administration: COST Scorecard on Tax Appeals & Procedural Requirements” (Dec. 2016).

<sup>2</sup>*Matter of Purcell v. New York State Tax Appeals Tribunal*, 167 A.D.3d 1101, 1103 (3d Dept. 2018).

outline what we think is the main problem with the “only reasonable construction” standard: It pushes interpretation authority down to a level where the personnel are not supposed to be exercising significant discretion, then ties the hands of those who should be exercising oversight.

The DTA currently enforces any department interpretation of a credit statute even if that interpretation is only minimally rational and minimally reasonable.

How would this work in a non-tax environment? Imagine that the manager of your local Sherwin-Williams store gets the following directive from corporate headquarters: “Starting Monday, *all* blue paint will be on sale at 20 percent off.” Before the manager goes home Sunday night, he instructs the sales clerk, Jay, to segregate all blue paint into a single display. When the manager arrives on Monday he is shocked to find that there are only eight cans of paint on the display. The manager asks Jay: “What gives? You were supposed to put on display *all* blue paint, and there are only eight cans here.” Jay replies: “In the entire store there are only eight cans of paint that are called ‘blue.’” So what about sky blue and robin egg blue? What about Caribbean Sea and cyan and navy and cobalt? “Boss, you said all blue paint. This is all of our paint called ‘blue,’” Jay replies.

The manager thinks that “*all* blue paint” was intended to mean all the different shades of blue paint that Sherwin-Williams sells. In particular, he thinks that the directive’s emphasis on “*all*” indicates an intention that every shade of blue should be on sale. But in the interest of being cautious (and wanting to show support for his employee), the store manager calls his Sherwin-Williams regional representative for guidance. The regional representative responds that her understanding was the same as the manager’s: The directive should be read as requiring that all shades of blue paint be put on sale. However, the regional representative recognizes that even if she disagrees, Jay’s interpretation of “*all* blue paint” to mean only those cans of paint called blue was rational. And because the regional representative’s interpretation that “*all* blue paint” includes all shades of blue paint is not the *only* reasonable interpretation, the regional

representative instructs all the stores in her region to put on sale only cans of paint called blue — not other cans of blue-shaded paint.

The following week, Sherwin-Williams HQ reviews sales figures and finds that every region except one has, as intended, sold through almost their entire inventories of blue-shaded paint. The outlier is the region where your local store is located because the store manager and regional representative wouldn’t overrule an ill-founded (albeit rational) interpretation of Jay the sales clerk. This is why the “only reasonable construction” standard is problematic: It takes the interpretation of sales directives out of the hands of the managers and puts it in the hands of the clerks.

### Gorsuch’s *BNSF Railway* Dissent

The Gorsuch dissent was issued in *BNSF Railway Co. v. Loos*.<sup>3</sup> The facts: Michael Loos injured his knee on the job after falling into a hidden drainage grate. He continued to miss work sporadically after his injury, and eventually his employment was terminated for violating the company’s attendance policy. After the company fired him, Loos filed a negligence claim against the railroad and a wrongful termination suit, claiming that BNSF wrongly retaliated against him for his absences. Loos was granted an award based on the railway’s negligence under the Federal Employers Liability Act, which comprised \$85,000 for pain and suffering, \$30,000 for lost wages, and \$11,212.78 for medical expenses. A federal appeal eventually ensued in the Eighth Circuit because BNSF offset the lost wages portion of the damages payment it made to Loos by the amount of tax BNSF argued the Railroad Retirement Tax Act (RRTA) required it to withhold for that portion of his award. The Eighth Circuit disagreed, holding that Loos’s award of lost wages wasn’t subject to RRTA taxes.<sup>4</sup>

BNSF appealed to the Supreme Court. In reversing the Eighth Circuit, the majority of the Court held that lost wages awarded to a railroad employee for work-related injuries are

<sup>3</sup>*BNSF Railway Co. v. Loos*, 139 S. Ct. 893 (2019).

<sup>4</sup>*Loos v. BNSF Railway Co.*, 865 F.3d 1106 (2017), *rev’d and remanded sub nom. BNSF Railway Co. v. Loos*, 139 S. Ct. 893 (2019).

compensation for tax purposes under the RRTA and that the tax offset was therefore appropriate. While it noted various IRS interpretations of the terms “wages” and “compensation,” the Court’s analysis was more focused on its own past interpretation of wages under the Social Security Act, which it said was analogous to the concept of compensation under the RRTA. Further, the Court refused to find that RRTA compensation excluded lost wages because such a determination would be inconsistent with the Social Security Act’s definition of wages and introduce an unwarranted disparity between terms Congress appeared to regard as rough equivalents.

Gorsuch disagreed, explaining in his dissent:

BNSF Railway’s negligence caused one of its employees a serious injury. After a trial, a court ordered the company to pay damages. But instead of sending the full amount to the employee, BNSF asserted that it had to divert a portion to the Internal Revenue Service. Why? BNSF said the money represented taxable “compensation” for “services rendered as an employee.” 26 U.S.C. [section] 3231(e)(1). Today, the Court agrees with the company. Respectfully, I do not. When an employee suffers a physical injury due to his employer’s negligence and has to sue in court to recover damages, it seems more natural to me to describe the final judgment as compensation for his injury than for services (never) rendered.

Gorsuch then analyzed the history of the RRTA, noting that it once had language explicitly treating amounts for time lost as compensation, but that this language was excised by Congress in 1975. This suggested to Gorsuch that Congress intended to exclude amounts paid for lost wages from compensation.

But we digress; let’s not get dragged too far down the rabbit hole of what is and is not compensation. From our perspective, the most important part of Gorsuch’s dissent is that while it disagreed with the majority’s result, it respected the majority’s process, which did not give any deference to the IRS’s interpretation of the statute:

Instead of throwing up our hands and letting an interested party — the federal

government’s executive branch, no less — dictate an inferior interpretation of the law that may be more the product of politics than a scrupulous reading of the statute, the Court today buckles down to its job of saying what the law is in light of its text, its context, and our precedent. Though I may disagree with the result the Court reaches, my colleagues rightly afford the parties before us an independent judicial interpretation of the law. They deserve no less.<sup>5</sup>

So from the highest court in the land, Gorsuch repeatedly underscores the notion that a court should not give any deference to a “government entity’s inferior interpretation of the law.”

### Back to New York

How would such an analysis play out in the DTA, where the tax department’s interpretations on issues of pure statutory construction are given deference in credit cases?

Let’s look at a recent case as an example. In *Matter of Purcell*,<sup>6</sup> the issue centered on the calculation of the taxpayers’ Empire Zone tax reduction credit (TRC), and the disagreement was whether the phrase “allocated within the state” requires that the income tax attributable to a New York S corporation’s out-of-state income be excluded when calculating a resident shareholder’s TRC.

The TRC is designed to reduce or eliminate taxes paid by a corporation or owners of a flow-through business operating in an Empire Zone. For example, for S corporations, the law provides that the shareholder’s credit is based on the amount of tax paid by the shareholder on income attributable to the S corporation.<sup>7</sup> 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*

<sup>5</sup> *BNSF Railway Co.*, 139 S. Ct. at 908-09.

<sup>6</sup> *Matter of Purcell*, DTA No. 825436 (N.Y.S. Tax App. Trib., Nov. 14, 2016), *confirmed sub nom. Matter of Purcell v. New York State Tax Appeals Tribunal*, 167 A.D.3d 1101, 1103 (3d Dept. 2018).

<sup>7</sup> N.Y. Tax Law section 16(f)(1).

York adjusted gross income.”<sup>8</sup> Distilled to its essence, the idea is that a shareholder’s credit is based in part on the amount of tax the shareholder paid on income from the S corporation that is allocated within New York State.

So how do we compute the amount of the shareholder’s income that is “allocated within New York state”? For years, this wasn’t a question. If the taxpayer was a state resident, calculating the credit was seemingly easy: Since all of a resident’s income gets allocated to New York State, resident shareholders of qualified Empire Zone enterprises (QEZE) treated all of their tax on income from the S corporation as attributable to the Empire Zone business.<sup>9</sup> But in *Purcell* (and several other cases), the department’s position was that it was required to use the corporate apportionment rules to determine how much of the shareholders’ income gets allocated within New York. The question in *Purcell* and other cases revolved around which interpretation was correct.

In its decision, the New York State Tax Appeals Tribunal noted that the definition of the phrase presented a question of pure statutory interpretation, requiring that it consider the statutory language and legislative history without deference to the department’s interpretation:

We note that we do not defer to the [department’s] proposed interpretation of [the tax credit statute] as the agency responsible for the administration of the QEZE tax reduction credit, as the [department] suggests. As we find that the resolution of the present dispute is a matter of pure statutory construction, such deference is inappropriate.

That sounds good to us, since the department’s interpretations may be tainted by the political considerations referred to in Gorsuch’s dissent. But here is the Tribunal’s description of the analysis it used:

Petitioners have the burden to establish “unambiguous entitlement” to the claimed statutory benefit. Indeed, petitioners must prove that the [department’s] interpretation is irrational and that their interpretation of the statute is the only reasonable construction.<sup>10</sup>

But isn’t this doing exactly what the Tribunal said it would not do — giving deference to the department’s interpretation? Leaving aside the “unambiguous entitlement” requirement, the second part of the test requires the Tribunal to accept the department’s interpretation if it is rational or if the taxpayer’s interpretation is just one of several reasonable interpretations. But a statute may (and usually does) have several rational interpretations and several reasonable interpretations. Under the standard articulated by the Tribunal, there’s basically a “least common denominator” approach; it will uphold any department interpretation, even if it’s the least rational and least reasonable of several competing interpretations.

This sounds like, well, deference!

Following the *Purcell*’s loss at the DTA, they appealed to New York’s appellate division.<sup>11</sup> And one of the more important issues, at least from our perspective, was the propriety of the “only reasonable construction” standard applied by the Tribunal. The standard, which the appellate division first articulated in 1984,<sup>12</sup> is premised on the doctrine of judicial deference to executive interpretations of tax statutes authorizing credits and exemptions. But it sanctions neither executive deference to executive interpretations nor — more particularly — an agency’s adjudicatory function deferring to interpretations of the agency’s operations function. In fact, Gorsuch’s dissent suggests that even the courts shouldn’t be deferring to agency interpretations.

The idea here goes to the nature of the tax appeals process. The Tribunal is within the agency itself, so it is questionable whether it should defer to other instrumentalities of the agency under the

<sup>8</sup> N.Y. Tax Law section 16(f)(2)(C) (emphasis added).

<sup>9</sup> See *Matter of Batty and Pennefeather*, DTA Nos. 824061 and 824063 (N.Y.S. Div. of Tax App., Apr. 4, 2013); see also Timothy P. Noonan and Ariel Doolittle, “Empire Zone Litigation: Taking the ‘Reduction’ Out of the Tax Reduction Credit,” *State Tax Notes*, Dec. 16, 2013, p. 665.

<sup>10</sup> *Matter of Purcell*, DTA No. 825436 (N.Y.S. Tax App. Trib., Nov. 14, 2016), at 16 (internal citations omitted).

<sup>11</sup> Our firm submitted an amicus brief to the appellate division for the New York State Society of CPAs and in support of the *Purcell*s.

<sup>12</sup> *Matter of Blue Spruce Farms v. New York State Tax Commission*, 99 A.D.2d 867 (3d Dept. 1984), *aff’d* 64 N.Y.2d 682 (1984).

guise of undertaking judicial deference or otherwise.<sup>13</sup> Doing so undermines fundamental due process and impairs the Tribunal's statutory objective. By way of background, the Tribunal oversees the DTA, which was created within the department to provide 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."<sup>14</sup> This quasi-judicial body was deliberately established as a separate and independent division of the tax department.<sup>15</sup> To ensure its separate and independent status, the DTA is governed by the Tribunal rather than by the commissioner of taxation and finance.<sup>16</sup> Consequently, the powers, functions, duties, and obligations of the DTA and the Tribunal are separate from and independent of the authority of the rest of the department.<sup>17</sup> Clearly, the State Legislature intended that the DTA cast an independent eye unhindered by interpretational blinders.

The Tribunal, which sits atop the DTA, is a creature of statute, namely Article 40 of the New York Tax Law.<sup>18</sup> The regulations implementing the Tribunal's statutory authority specifically address the nature of its review procedures. In particular, the regulations say that the Tribunal will "review the record and shall, to the extent necessary or desirable, exercise all the powers which it could have exercised if it had made the determination."<sup>19</sup>

This is a far cry from the limited review afforded to an appellate division court in an Article 78 proceeding. In a case involving a Tribunal decision, appellate review is confined to

the analysis enumerated under N.Y. C.P.L.R. section 7803.<sup>20</sup> Appellate review is limited to determining whether the Tribunal's decision is supported by substantial evidence and will be upheld unless it was erroneous, arbitrary, or capricious. Notably, the deferential standard applicable to appellate review presupposes that the Tribunal did not prejudice taxpayers by applying unreasonably stringent or deferential interpretive rules at the administrative level. In other words, the rules of appellate review assume that the Tribunal applied its wisdom and experience to independently interpret the statutes governing tax matters. The rules applicable to appellate review simply won't work as intended if the Tribunal and DTA judges also apply a deferential approach to the department's interpretations.

Thus, the Legislature endowed the DTA and the Tribunal with a role requiring a different analytical approach than that of a reviewing court. Administrative review is not intended to be an idle exercise nor a rubber-stamping of the department's decisions.<sup>21</sup> Rather, it is a fundamental and necessary part of the process of challenging agency missteps and misapplications of the tax law.<sup>22</sup> As such, a full and complete administrative review is important and worthy of encouragement and protection. If the DTA does not exercise its authority to enforce the most reasonable interpretation of a statute without deference to the department, it cannot provide meaningful independent consideration of tax disputes.

## Epilogue

Even the IRS seems to be getting on board here. Coincidentally, on March 5, the day after Gorsuch's dissent was issued, Treasury and the IRS announced clarifications of — and changes to — their policies regarding the issuance of tax

<sup>13</sup> See N.Y. Tax Law sections 2000, 2002.

<sup>14</sup> N.Y. Tax Law section 2000.

<sup>15</sup> See N.Y. Tax Law sections 170(1), 2000, and 2002; 20 N.Y.C.R.R. section 3000.1(d).

<sup>16</sup> N.Y. Tax Law section 2002.

<sup>17</sup> N.Y. Tax Law section 2000.

<sup>18</sup> *Matter of Flynn v. State Ethics Commission, Department of State, State of New York*, 87 N.Y.2d 199, 202 (1995) (administrative agencies are a "creature of the legislature").

<sup>19</sup> 20 N.Y.C.R.R. section 3000.17(e)(1); see *Matter of Upstate Farms Coop. v. Tax Appeals Tribunal of State of New York*, 290 A.D.2d 896, 901 (3d Dept. 2002).

<sup>20</sup> See *Featherstone v. Franco*, 95 N.Y.2d 550, 554 (2000) ("Judicial review of the acts of an administrative agency under article 78 is limited to questions expressly identified by statute"); N.Y. Tax Law section 2016; Mark S. Klein and Noonan, *Contesting New York Tax Assessments* 106-10 (2015).

<sup>21</sup> *Matter of Sterling Estates v. Board of Assessors of County of Nassau*, 66 N.Y.2d 122, 125 (1985), *rearg. denied* 66 N.Y.2d 1036 (1985).

<sup>22</sup> See *Matter of Grossman v. Board of Trustees of Village of Geneseo*, 44 A.D.2d 259, 265 (4th Dept. 1974).

guidance including temporary regulations and notices in the “Policy Statement on the Tax Regulatory Process.” In Section III of the statement, “Proper Scope of Subregulatory Guidance Documents,” the IRS addresses judicial deference to administrative agencies, noting that “when proper limits are observed, subregulatory guidance can provide taxpayers the certainty required to make informed decisions about their tax obligations. *Such guidance cannot and should not, however, be used to modify existing legislative rules or create new legislative rules.* The Treasury Department and the IRS will adhere to these limits and will not argue that subregulatory guidance has the force and effect of law. *In litigation before the U.S. Tax Court, as a matter of policy, the IRS will not seek judicial deference under Auer v. Robbins, 519 U.S. 452 (1997) or Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984), to interpretations set forth only in subregulatory guidance.*” (Emphasis added.)

So even the IRS wants the Tax Court to exercise an independent check and balance on its interpretations that are not regulations. The bulletin cites *Auer v. Robbins*, just as Gorsuch did in his dissent. That’s probably a coincidence, but what’s important here is that the Supreme Court, Treasury, and the IRS are evolving in a direction that prohibits adjudicators from applying deference to a tax agency’s nonregulatory interpretation of statutes.

As cases move through the DTA in the coming years, we hope to see a push in the same direction, and the abandonment of the “only reasonable construction” doctrine when considering exclusions and credits. ■

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