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Striking Back on Empire Zones

by Timothy P. Noonan and Christopher L. Doyle

Imagine that you own a fledging company in upstate New York. You employ lots of people and always pay your taxes on time. Lured by the promise of tax benefits, you moved your company into a depressed area a few years ago and took steps to invest in new employees, technology, and real estate. And those tax benefits — as promised by New York state in its 2000 empire zone legislation — were supposed to last 14 years.

Or so you thought. In April the State Legislature decided to revise the empire zone program by increasing the obligations of those companies already in the program and entirely stripping the benefits of others. The promise of 14 years of tax benefits was broken for many companies in one fell swoop. And now some companies face the prospect of having to relinquish any tax benefits retroactively to January 1, 2008, under the newly enacted legislation.

This about-face by the Legislature on empire zone issues has created quite a mess, both politically and economically. But faced with the prospect of losing previously promised tax benefits, what's a company to do? In this article, we'll describe the history of the program, talk about the changes, and review some options that practitioners and their clients should consider when faced with problems like this.

Basics of the Empire Zone Program

As a result of legislation adopted as part of the fiscal 2001 New York state budget, areas previously known as Economic Development Zones were renamed "empire zones," and businesses located within those areas became entitled to three major new tax benefits:

- a sales and use tax exemption;
- a real property tax credit; and
- a tax reduction credit.

To obtain benefits, a business needed to be "certified" and "qualified." If it was located in an empire zone, a business would be certified if it had been a good corporate citizen (no run-ins with the Department of Labor) and projected an increase in zone employment or zone capital investment in the three-year period following certification. A certified business was a qualified business as long as it passed an annual employment test. Although the test has changed over the years, the essence is that a certified business will not be a qualified business unless its New York state and zone employment numbers increase, or at least don't decrease. Certified and qualified businesses are referred to as QEZEs (qualified empire zone enterprises).

The sales and use tax exemption applies to most goods and services used or consumed by the business within the zone for which it is certified. The sales tax exemption lasts 10 years and applies only to the statewide 4 percent tariff unless the local jurisdiction opts into the exemption.

The real property tax credit is a refundable credit that is applied against the New York state income tax liability of the QEZE, or its owners in the case of a look-through entity such as an LLC, partnership, or S corporation. The credit is based on (or for businesses certified after March 31, 2005, limited by) the eligible real property taxes paid by the QEZE on property located in the empire zone. The credit was originally the product of a benefit period factor (100 percent for the first several years following certification), the taxes paid on the zone real estate, and the employment increase factor

that increases the benefit owned to reflect new-employee hiring or extraordinary capital investment. In 2005 the credit calculation was changed. But it is sufficient for purposes of this analysis to recognize that even under the revised computation, it was possible for a taxpayer to earn a refundable credit equal to the real property taxes paid on zone real estate.

The third tax benefit available as part of New York's empire zone program is the tax reduction credit (TRC). The TRC is a nonrefundable credit that is applied against the New York state income tax liability of a QEZE or its individual owner or owners (in the case of a flow-through entity). The TRC is a function of the QEZE's New York state income tax liability on New York source income, the increase in the QEZE's number of zone employees, the QEZE's relative presence in the zones for which it is certified, and the benefit period factor. The computation of this credit has remained unchanged since 2001.

2009 Changes

Legislation enacted as Chapter 57 of the Laws of 2009 (the 2009 law) altered the eligibility requirements for New York's empire zone program.[1] Here are some of the highlights.

Sales Tax Exemption Replaced by Credit

The 2009 law amends the tax law by repealing the sales tax exemption applicable to purchases by a zone business and replacing it with a credit or refund. While this represents a cash flow issue for many zone businesses, the most pressing concern appears to be that the changes, when read in conjunction with the change in the sunset date to June 30, 2010, could be viewed as repealing the sales tax benefit effective June 30, 2010. Although the authors have been told this was not the Legislature's intention, it is unclear at this time how the new law will be construed.
New Requirements and Recertification

The 2009 law amends section 959(a) of the general municipal law to include additional grounds for the decertification of a business enterprise previously certified and receiving empire zone benefits.[2] Moreover, the budget requires the commissioner of economic development to conduct a review of all certified business enterprises in 2009 to determine whether they satisfy two of the new grounds for decertification.[3] If a business enterprise does not run afoul of the new grounds for decertification, the commissioner is to issue the business an EZ retention certificate.

Shirt Changers

For business enterprises first certified before August 1, 2002, the 2009 law creates a new ground for decertification based on the transfer of employees or real estate. According to the 2009 law, the commissioner can decertify a business entity if it "caused individuals to transfer from existing employment with another business enterprise with similar ownership and located in New York state to similar employment with the certified business enterprise or if the enterprise acquired, purchased, leased, or had transferred to it real property previously owned by an entity with similar ownership."[4] This provision could result in the decertification of many businesses that are not "shirt changers" and merely did an intercompany employment shift for nontax business reasons or received a transfer of real property from an affiliate.[5]

One-to-One Test

The 2009 law creates a new ground for decertification applicable to all certified business enterprises regardless of when they were certified. The new test that compares the amount of the tax benefits received by a certified business entity with the sum of the annual wages paid to all zone employees plus the entity's investments in the zone facility. If the amount of the business entity's tax benefits received from the state exceed its economic returns to the state (that is, wages and facility investments), the entity is subject to decertification.[6] According to the 2009 law, the comparison detailed above shall not occur unless the business has filed at least three business annual reports.[7]

Change in Ownership

The budget legislation created a final ground for decertification — based on a change in ownership. According to the legislation, a certified business entity is subject to decertification if it "has changed ownership or moved its operation out of the empire zone."[8] This language is vague. A change in ownership could mean the sale of 0.1 percent of the stock of the business, or it could mean the sale of all of the assets of the business.

Retroactivity

Though retroactive decertification is not expressly stated in the budget, we have been told that if a business enterprise is decertified as a result of the commissioner's review, that decertification will be retroactive to January 1, 2008. There is nothing explicit in the legislation, however, that provides for the 2008 effective date.[9]

The apparent retroactivity in particular puts the Department of Taxation and Finance and taxpayers in a bind. As noted above, the changes enacted by the Legislature were announced in early April 2009, when most taxpayers had either already filed their 2008 returns or were in the process of filing. Because the Legislature apparently believed it was making changes that could be applied to tax years beginning January 1, 2008, the tax department was forced to scramble to provide guidance and advice to taxpayers in the process of filing their 2008 returns. Ultimately, that led to the issuance of a TSB-M at 3:45 p.m. on April 15, 2009, giving taxpayers guidance as to how they should file their 2008 tax returns. As taxpayers who had just filed their tax returns that morning and were the recipients of 2008 empire zone benefits, we found that announcement amusing. The tax department was giving us guidance on how to file our 2008 tax returns a couple hours after we filed them and a couple hours before the due date! Of course, the tax department took some heat for that from taxpayers and practitioners. But it wasn't the department's fault. We blame the Legislature for the circumstances that created the need for quick guidance. Lawmakers are the ones who tried to enact retroactive changes dating back to 2008 one week before the 2008 filing deadline.

How Taxpayers Can Strike Back

Taxpayers facing decertification have at their disposal several potential causes of action. Indeed, there is something that immediately seems problematic about a government's attempt to take away tax benefits previously promised. Put yourself in the position of the hypothetical business owner discussed at the beginning of this article. If you moved into a depressed area and invested in jobs and technology based on promises by the government, you expect the government to own up to its side of the deal. That the Legislature underestimated the overall benefits from the economic development program it created isn't your fault.

There are many different possible claims taxpayers might consider bringing to strike back against changes to the empire zone program.

The first thing that comes to mind is basic due process. Whenever legislators seek to make retroactive changes, due process concerns arise.[10] Here, there are two aspects of retroactivity in play. Most obvious is the Legislature's apparent intention to make the empire zone changes retroactive to January 1, 2008. That raises obvious retroactivity concerns. But more subtly, the whole nature of the changes has a taint of retroactivity. Again, if your company made the decision in 2000 to relocate your business based on the promise of 14 years of tax benefits, you expected 14 years of tax benefits. If the Legislature wanted to make changes following the 14-year period or changes to the program for businesses not yet certified, no one should complain. But cutting off the benefits halfway through the 14-year period, or changing the tests for qualifying for benefits for businesses already certified and qualified, seems unfair and improper. The due process clause of the U.S. Constitution often comes into play when retroactive changes like this are made by governments. Courts have set forth a balancing test looking at a variety of different factors, including the forewarning of the retroactive legislation, the taxpayer's reliance on the old law, the length of the retroactive period, the public purpose of the retroactive legislation, and so forth.[11] Many of those factors would weigh in favor of a taxpayer in making such a claim against the recent law changes. Again, it just doesn't seem the government should be able to break its promises. The due process clause might be one way to hold it to a promise.

The contracts clause of the U.S. Constitution also might come into play. The contract clause of the U.S. Constitution provides that "no state shall . . . make any . . . law impairing the obligation of contracts."[12] The clause can be applied to invalidate state legislation, and it "limits the power of the states to modify their own contracts as well as to regulate those between private parties."[13] Although New York does not have a contract clause in its state constitution, the New York Court of Appeals applies the federal contract clause to state legislation.[14] So maybe there's an angle here that an aggrieved company could use. As a threshold matter, however, a business would have to demonstrate that the statutory benefits had been promised to it in some form of agreement.

Even an estoppel claim might have some legs in an action against New York for breaking promises under the empire zone program. Estoppel is, of course, rarely used against government entities. That's clear from the case law.[15] Still, some taxpayers (particularly those with really good lawyers) have been successful in making estoppel claims. In one recent New York state ALJ determination, a taxpayer was successful in making an estoppel claim when he took actions in reliance on a New York state regulation that ultimately was invalidated by the Tax Appeals Tribunal and later changed by the tax department.[16] As noted by the ALJ in *In re Reiner*, a three-part test is employed to determine whether to invoke estoppel:

- whether there was a right to rely on a representation made by the government;
- whether the reliance was reasonable; and
- whether the reliance resulted in a detriment to the taxpayer.

In *Reiner* the judge held it was reasonable for Reiner to rely on the tax department's regulation, that he did indeed rely on that regulation in planning his move to Florida, and that his reliance ultimately proved to his detriment because the delay in his move to Florida caused significant additional New York taxes under the application of the newly changed rules.

A company facing the loss of empire zone benefits might similarly have a great estoppel claim. Clearly it's reasonable for a company to rely on existing state tax laws in making decisions about when and where to move. Clearly many companies can claim that in making decisions such as this they relied on the existence of the empire zone program and the promise of 14 years of benefits. And those decisions — such as adding employees, moving to depressed areas, investing in real estate, and so forth — could clearly now be to the detriment of these companies, especially with the loss of the tax benefits. So while estoppel claims against the government are rare, this empire zone issue might present one of those rare opportunities.

These are just a few of the theories taxpayers could raise in fighting back against New York state. There are other issues, including the question discussed briefly above, of whether the retroactive nature of the legislation is even appropriately set forth in the enabling language. But whatever the arguments, you can be sure that this will be an issue of great importance in the very near future. Companies are already getting their decertification letters and trying to make decisions about where they go from here.

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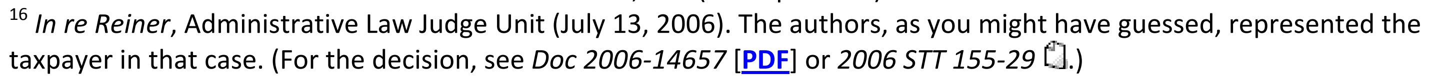
Noonan's Notes on Tax Practice is a column by Timothy P. Noonan, a partner with Hodgson Russ LLP, Buffalo, N.Y. This column was cowritten by Christopher L. Doyle, also a partner.

FOOTNOTES

[1] N.Y. Gen. Mun. Law section 959 (McKinney 2009).
[2] *See* N.Y. Gen. Mun. Law sections 959(a)(v)(5), (a)(v)(6), (a)(v)(7).
[3] *See* N.Y. Gen. Mun. Law section 959(w).
[4] *See* N.Y. Gen. Mun. Law section 959(a)(v)(5).
[5] *See* N.Y. Gen. Mun. Law section 959(a)(v)(5).
[6] *See* N.Y. Gen. Mun. Law section 959(a)(v)(6).

[7] *See* N.Y. Gen. Mun. Law section 959(w). Empire State Development, which exercises administrative oversight for the empire zones program, has promulgated regulations, permitting wages and investment from "any year" to be compared with the zone benefits from "any year."
[8] *See* N.Y. Gen. Mun. Law section 959(a)(v)(7).
[9] *Compare* sections 11 through 22 of part S-1 of the budget bill; subsection (a) of section 44 of part S-1 of the budget bill; TSB-M-09(5)C, TSB-M-09(4)I (Apr. 15, 2009), and NYCRR section 11.9(c)(2).
[10] *See, Replan Dev. Inc. v. Dep't of Hous. and Pres.,* 70 N.Y.2d 451, 456 (1987).
[11] *Id*.
[12] U.S. Constitution, Article I, section 10, cl. 1.
[13] *See U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 17 (1977).
[14] *See, e.g., Farrel v. Drew,* 19. N.Y.2d 486 (1967).
[15] *Turner Constr. Co. v. State Tax Com.* 57 A.D.2d 201, 203 (3d Dep't 1977).

[16] *In re Reiner*, Administrative Law Judge Unit (July 13, 2006). The authors, as you might have guessed, represented the taxpayer in that case. (For the decision, see *Doc 2006-14657* [**PDF**] or *2006 STT 155-29* .)

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