

APPEALS SETTLEMENT GUIDELINES

ISSUE: New York State
Qualified Empire Zone
Enterprise Credit
Real Property Taxes

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The attached document has been approved as the Appeals Settlement Guidelines and is effective from the date shown below until withdrawn or superseded by subsequent Appeals Settlement Guidelines.

APPROVED:

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April 4, 2013

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April 4, 2013

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EFFECTIVE DATE: April 4, 2013

APPEALS SETTLEMENT GUIDELINES

New York State Qualified Empire Zone Enterprise Credit Real Property Taxes

STATEMENT OF ISSUES

Issue 1: Is the amount of a New York State income or franchise tax overpayment attributable to the refundable New York Qualified Empire Zone Enterprise credit for real property taxes (QEZE Real Property Tax Credit) includable in gross income for federal income tax purposes?

Issue 2: If the refundable portion of the credit is includable in gross income, what is the year a cash-basis taxpayer includes the amount into income for federal tax purposes?

COMPLIANCE POSITION

Issue 1: The receipt of the refundable portion of the QEZE Real Property Tax Credit should be treated as a recovery of real property tax and includable in federal gross income to the extent that the property tax was previously deducted and resulted in a tax benefit.¹ Compliance relies on the reasoning and authorities set forth in I.R.S. CCA 200842002.

Issue 2: Taxpayers can choose to receive the refundable portion of the credit in cash or apply the refundable portion to their future New York State income or franchise tax liability. Therefore, taxpayers on the cash method of accounting, actually or constructively, receive the refundable portion and include the amount in income for federal tax purposes in the year the amount is available.

Note: Three issues are not addressed in this ASG. (1) Accrual method of accounting taxpayers; (2) the treatment of Compliance's position on overpayments as a refund of income or franchise tax payment, to the extent of those payments where the excess refund is attributed to the refundable QEZE Real Property Tax Credit; and (3) Compliance's adjustments on other New York State refundable credits, such as the New York EZ Wage Credit and the New York EZ Investment Credit.

¹ The term "refundable" means that the credit can be paid to a taxpayer in the same manner as a tax refund to the extent it exceeds the tax liability; this amount is not an actual refund of income or franchise tax (or withholding) originally paid to the state. For purposes of this Appeals Settlement Guidelines (ASG), the term "refundable portion" is the amount of the credit that exceeds the taxpayer's income or franchise tax liability and is refundable in cash.

TAXPAYER POSITION

Issue 1: The receipt of the refundable portion of the QEZE Real Property Tax Credit is not a recovery of real property taxes previously deducted. Instead, the refundable portion is properly a recovery of New York State income or franchise taxes that did not result in a prior tax benefit. Taxpayers argue that New York State law is interpreted to treat the refundable portion of the QEZE Real Property Tax Credit as a refund of New York State income or franchise taxes, and as the taxpayers did not deduct the New York State income or franchise taxes in prior years, the refundable portion should not be included in income. Taxpayers further assert that Compliance has not provided any authority for its position.

Taxpayers take the position that including the refundable portion of the credit in federal taxable income is not fair or equitable.

Issue 2: Taxpayers do not believe that the refundable portion of the QEZE Real Property Tax Credit is includable in Federal taxable income. Therefore, they have not addressed the timing issue.

DISCUSSION

BACKGROUND

As part of the Empire Zones Program, New York State law provides special incentives to stimulate private investment, private business development and job creation in certain economically impoverished areas within the state of New York. As part of the Empire Zones Program, New York offers a corporate franchise tax credit² or a personal income tax credit for taxes paid on real property located in an Empire Zone, when a business qualifies as a QEZE under [New York Tax Law § 15](#).

To qualify as a QEZE, a business must be located within a designated geographic area and meet an annual “employment test” of maintaining or increasing the number of full-time employees. [New York Tax Law §§ 15\(a\) and 15\(b\)](#). The formula for computing the credit is based on the amount of real property taxes paid and depends on when the business first became a QEZE. The amount of the credit cannot exceed the amount of eligible real property taxes paid. [New York Tax Law §§ 15\(b\) and 15\(f\)](#).

While the credit is for “eligible real property taxes,” it is claimed against New York State income or franchise taxes. [New York Tax Law § 15\(a\)](#). A taxpayer who is a partner in a partnership that is a QEZE or a shareholder of a New York S corporation that is a QEZE can claim the credit. A partnership or New York S corporation computes the credit and provides its partners or shareholders with the amount of their pro rata share of the

² The New York State franchise tax on a corporation is generally based on a percentage of its net income plus a tax on its subsidiary capital base, if applicable. [New York Tax Law § 209](#).

credit. It is important to note that not all federal S corporations are New York S corporations. (New York State Department of Taxation and Finance, Publication 35 – New York Tax Treatment of S Corporations and Their Shareholders (3/00))

The amount of credit not used in a taxable year to reduce an income or franchise tax liability (that is, the refundable portion of the credit) is treated as an overpayment of New York income or franchise tax for state tax law purposes. Taxpayers may choose to have this amount refunded as a cash payment, or credited to the following tax year. [NY Tax Law § 210.27](#). New York does not tax the refunded portion of the credit; it treats the payment as a refund of state income tax or franchise tax. New York State Department of Taxation and Finance, [TSB-M-10\(9\)C, \(15\)](#) -- *New York State Tax Treatment of Refunds of the Qualified Empire Zone Enterprise (QEZE) Credit for Real Property Taxes* (Dec. 31, 2010).

Taxpayers are not required to have previously paid New York State income or franchise taxes in order to be eligible for the credit.

LEGAL ANALYSIS

ISSUE 1

I.R.C. § 61 provides that gross income includes all income from whatever source derived. Gross income is an all-inclusive term with broad scope, intended “by Congress to exert ...the full measure of its taxing power.” [Commissioner v. Glenshaw Glass Co.](#), 348 U.S. 426, 429 (1955) (quoting [Helvering v. Clifford](#), 309 U.S. 331, 334 (1940)). The United States Supreme Court has held that “instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion” are taxable income to the recipients. [Glenshaw Glass Co.](#), 348 U.S. at 431. Courts have emphasized the “sweeping scope” of I.R.C. § 61 and have recognized that exclusions from income must be narrowly construed. [Commissioner v. Schleier](#), 515 U.S. 323, 327-8 (1995); [Commissioner v. Kowalski](#), 434 U.S. 77, 82-3 (1977).

Although many state tax credits are only used to reduce a state tax liability, some may also be refundable, such as the QEZE Real Property Tax Credit. The amount of a state tax credit that reduces a potential tax liability as part of computing how much tax is due does not represent an accession to wealth. Therefore, this amount is not includable in gross income. [Tempel v. Commissioner](#), 136 T.C. 341 (2011), *sub nom.* [Esgar v. Commissioner](#), appeal docketed, No. 12-9009 (10th Cir. Sept. 6, 2012).

Where credits represent the right to reduce a taxpayer’s state tax liability, “[i]t is without question that a government’s decision to tax one taxpayer at a lower rate than another taxpayer is not income to the taxpayer who pays lower taxes. A lesser tax detriment to a taxpayer is not an accession to wealth and therefore does not give rise to income.” [Id.](#) at 351. Instead, the federal income tax consequence is generally a decrease in the deductible amount of state or local tax under I.R.C. § 164.

However, to the extent a state tax credit is refundable, the amount made available to the taxpayer in the form of a cash payment, actually or constructively received, is

not a "lesser tax detriment;" rather, it is an accession to the taxpayer's wealth. As such, it is includable in federal gross income under the broad reach of I.R.C. § 61, unless an exclusion applies.

Several authorities support the position that, absent exclusion, the refundable portion of a state tax credit is an "accession to wealth" under the broad principles of gross income.

1. The taxability of the refundable portion of a state tax credit is strongly implied by the holding in [Tempel v. Commissioner](#), 136 T.C. 341 (2011), appeal docketed, No. 12-9009 (10th Cir. Sept. 6, 2012). The court states, "[c]redits do not increase a donor's wealth, *as long as they are used to offset or reduce the donor's own State tax responsibility*. A reduced tax is not an accession to wealth. It is only, as occurred in the instant case, when the donor sells or exchanges a State tax credit to a third party for consideration that an accession to wealth has occurred." (Emphasis added). *Id.* at 351, n. 17. At issue in [Tempel](#) was the receipt of cash from the sale of a transferable state tax credit received with respect to a donation of a conservation easement to a charity. Receipt of a cash payment from the state for a refundable credit is analogous to the receipt of sale proceeds for a transferable credit. Both are accessions to wealth, not mere reductions in a potential tax liability.

2. [Rev. Rul. 78-194](#), 1978-1 C.B. 24, provides further support. The State of New Jersey granted homestead tax rebates to qualifying taxpayers intending a return of property tax with respect to a principal residence. The New Jersey homestead tax rebate that was paid in 1977 to a qualifying taxpayer was includable in gross income to the extent it exceeded the property tax that the taxpayer actually paid in 1977, whether or not the taxpayer itemized deductions. Taxpayers itemizing deductions were required to reduce their deduction for property tax paid by the amount of the rebate.

Under the tax benefit rule, the recovery of taxes deducted in an earlier taxable year is includable in gross income except to the extent that the deduction did not reduce tax imposed. The tax benefit rule includes two components, an inclusionary part and an exclusionary part. Generally, the inclusionary part of the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if an event occurs that is fundamentally inconsistent with the premise on which the deduction was initially based. [Hillsboro National Bank v. Commissioner](#), 460 U.S. 370, 383 (1983).³ The

³ An amount subject to the inclusionary part of the tax benefit rule is includable in income unless a non-recognition provision of the Internal Revenue Code prevents it. [Hillsboro National Bank v. Commissioner](#), 460 U.S. 370, 372 (1983). There are no non-recognition provisions of the Internal Revenue Code that prevent the QEZE Real Property Tax Credit from being included in taxable income.

exclusionary part of the tax benefit rule is codified in I.R.C. § 111 and allows a taxpayer to exclude an amount that did not previously provide a tax benefit when it was deducted. Under the inclusionary part of the tax benefit rule, the refundable portion of the QEZE Real Property Tax Credit would be included in federal gross income when a taxpayer benefitted from a prior federal deduction for real property tax.

A business that is a QEZE will deduct real property taxes. Similarly, a partnership or a New York S corporation that is a QEZE will deduct real property taxes on its tax return and will pass the benefit through to the partners or shareholders. As discussed further below, there is a clear nexus between the QEZE Real Property Tax Credit and the payment of real property tax. The amount of the QEZE Real Property Tax Credit that is applied to reduce a taxpayer's potential state income or franchise tax liability is not an accession to wealth and is not included in federal gross income under the tax benefit rule. Instead, it will generally be reflected in a reduced federal deduction for state tax under I.R.C. § 164. However, to the extent an overpayment of New York State income tax is attributable to the refundable QEZE Real Property Tax Credit, the refundable portion is a recovery of real property taxes and is included in income under tax benefit principles, unless the exclusion in I.R.C. § 111 applies.

I.R.C. § 111(a) provides that gross income does not include income attributable to the recovery during the tax year of any amount deducted in any prior tax year, to the extent that amount did not reduce the amount of tax imposed by chapter 1 of the Code. I.R.C. § 111(c) provides that an increase in a carryover that has not expired before the beginning of the taxable year in which the recovery takes place is treated as reducing the amount of tax imposed. Under I.R.C. §111, the refundable portion of the QEZE Real Property Tax Credit is excluded from gross income to the extent the prior deduction of New York State property tax did not reduce a taxpayer's federal income tax.

Taxpayers argue that since the QEZE Real Property Tax Credit is, in form, a credit against state income and franchise tax, the refundable portion of the credit is not includable in federal taxable income. It is a "recovery" of an item for which they received no tax benefit for federal tax purposes and is excluded from income under I.R.C. §111.

The taxpayer's reasoning is without merit for two basic reasons. First, the New York QEZE Real Property Tax Credit is based on how much real property tax has been paid, not on how much income or franchise tax has been paid; thus, it is a recovery of real property tax, not income or franchise tax. Second, the exclusion in I.R.C. § 111 is premised on a prior payment or accrual, the deduction of which did not result in an overall reduction in federal income tax. It is not applicable where New York State income or franchise taxes were never paid or accrued, such that a deduction was never previously claimed. There is no federal

exclusion from income based solely on the fact that an amount takes the form of a tax refund for state tax purposes.

With this analysis in mind, the first issue to address is the taxpayers' contention that the QEZE Real Property Tax Credit does not take the form of a direct payment to a taxpayer, but is instead provided through the mechanism of a state as an income or franchise tax credit under New York Tax Law § 15(a). To the extent, an overpayment is attributable to the QEZE Real Property Tax Credit; there is an obvious nexus between the credit and the payment of real property tax, and not between the credit and the payment of state income or franchise tax. As contemplated and described by the New York Legislature, both the name of the credit (New York State's Qualified Empire Zone Enterprise credit for real property taxes) and the plain language of the statute, reflect the fact that the QEZE Real Property Tax Credit is a recovery of real property taxes. New York Tax Law § 15(a) describes the refundable credit as a credit "**for eligible real property taxes.**" (Emphasis added). Most importantly, the method of computing the credit demonstrates that the QEZE Real Property Tax Credit is directly related to real property taxes paid in the past. Taxpayers are eligible to receive a refundable QEZE Real Property Tax Credit only when real property taxes are paid. The amount of the credit cannot exceed the amount of eligible real property taxes paid. A portion of the credit must be recaptured if the amount of the real property taxes on which the credit was calculated is subsequently reduced by a final order in any legal proceeding, to the extent the recalculated credit exceeds the credit originally taken. Taxpayers are not required to have previously paid New York State income or franchise taxes in order to be eligible for the credit. There is no transactional relationship between the receipt of the refundable portion of the QEZE Real Property Tax Credit and the payment of state income or franchise taxes in a prior year. Thus, the refundable portion of the QEZE Real Property Tax Credit is considered a recovery of real property taxes previously paid. As such, it is a subsequent event that is fundamentally inconsistent with an earlier deduction under I.R.C. § 164. See Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983).

The second issue to address is what is a proper interpretation of the tax benefit rule and I.R.C. § 111. The exclusion in I.R.C. § 111 applies to income attributable to recovery of amounts deducted in a prior tax year to the extent the amount did not reduce the amount of tax imposed. However, where there were no amounts paid or accrued and no deduction claimed in a prior year, I.R.C. § 111 does not apply. Specifically, the regulations under I.R.C. § 111 state: "Recoveries result from the receipt of amounts in respect of the *previously deducted or credited* section 111 items, such as from the ... refund or credit of taxes paid, or cancellation of taxes accrued." Treas. Reg. § 1.111-1(a)(2) (emphasis added). A taxpayer who pays \$100 in Year 1 and recovers \$100 in Year 2 is no better off overall. If the Year 1 deduction for that payment reduced federal tax, to that extent the recovery should be included in income on tax benefit principles; if the Year 1 deduction for that payment did not reduce federal tax, it is reasonable to exclude the Year 2 recovery under I.R.C. § 111. However, a taxpayer who pays *nothing* in Year 1 and receives a

\$100 "refund" in Year 2 is \$100 richer; this accession to wealth must be included in gross income under I.R.C. § 61, and the absence of a deduction in Year 1, for a payment that never existed, is irrelevant. As noted above, there is no federal exclusion from income based solely on the fact that an amount takes the form of a tax refund for state tax purposes. The taxpayers' argument amounts to an assertion that no refundable state income tax credit is ever includable in federal gross income under I.R.C. § 61. This is untenable. A state payment is not immune from federal income tax merely because it is provided in the form of a tax "refund." To ensure equitable tax treatment of similarly-situated taxpayers, the refundable portion of such a credit should be analyzed the same as any other payment from the state, includable in gross income unless a federal exclusion applies.

The third issue to address is the taxpayers' reliance on Tempel, 136 T.C. 341 (2011) and Buffalo Wire Works v. Commissioner, 74 T.C. 925 (1980), aff'd by unpublished opinion, 659 F.2d 1058 (2nd Cir. 1981), nonacq., AOD 1981-195.

Tempel addressed the tax treatment of the sale of transferable state tax credits. In that case, the court, as quoted earlier, noted that credits that simply reduce a tax liability are not includable in gross income. Taxpayers argue that this statement also applies to refundable credits. Taxpayers misinterpret the Tax Court's opinion by focusing solely on statements made to credits that reduce a potential tax liability and overlook the tax treatment of credits that result in a cash payment to the taxpayer. To the extent the Tax Court addressed the federal tax treatment of state tax credits that result in the receipt of cash by a taxpayer, rather than a mere reduction in state tax liability, the court's statements supports the government's position.

Buffalo Wire Works addressed whether the part of a condemnation award related to moving fixtures should be treated as a reimbursement of moving expenses or as compensation for a loss due to the condemnation of property, qualifying for I.R.C. § 1033 treatment. The Tax Court concluded that, under New York law, moving expenses were intended as a component of the value of the condemned property, not as a separate item to be reimbursed. Therefore, the award constituted compensation for the condemned property, not part compensation and part reimbursement of moving expenses. Since the award did not constitute a recovery of prior moving expenses, the tax benefit rule did not apply, and the award qualified in full for non-recognition treatment under I.R.C. § 1033. Buffalo Wire Works, 74 T.C. at 939.

Taxpayers cite Buffalo Wire Works to support the position that the treatment of the QEZE Real Property Tax Credit as an income or franchise tax recovery under New York Tax Law § 15(a) "controls" for purposes of determining whether the credit is excludable under I.R.C. § 111. This reliance is incorrect for several reasons.

First, the Commissioner did not acquiesce in Buffalo Wire Works. Applying the Golsen rule, the Court followed an older Second Circuit tax benefit rule analysis

that was different from the “fundamentally inconsistent event” test established several years later by the Supreme Court in Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983).

Additionally, the relationship between state law and federal tax law is well established: state law determines the underlying substantive legal interests, rights, and obligations of the parties; federal law determines the federal tax consequences of transactions involving those interests and relationships. See United States v. Irvine, 511 U.S. 224, 238-9 (1994); Morgan v. Commissioner, 309 U.S. 78 (1940). In order to ensure uniformity of federal tax treatment, the particular label given to a legal relationship or transaction under the law of a particular state is not necessarily controlling; rather, federal tax law looks to the substance of the legal interests and relationships established by state law. See Irvine, 511 U.S. at 238-9; Morgan, 309 U.S. at 81. The Tax Court in Buffalo Wire Works looked to New York State law to determine whether, in substance, a condemnation award was intended as compensation for property or as compensation for moving expenses. That conclusion cannot be broadened into the proposition that state law “controls” federal tax consequences.

Furthermore, as discussed above, the result of a proper analysis of New York State law is that the QEZE Real Property Tax Credit, consistent with its name, is intended as a recovery of real property tax.

Finally, in Buffalo Wire Works the result of the Tax Court's characterization was that the award was treated as an amount subject to non-recognition under I.R.C. § 1033. Regardless of how the refundable portion of the QEZE Real Property Tax Credit is characterized in the present situation, it is still includable in federal gross income and is not eligible for non-recognition under I.R.C. § 1033 or any other provision. As discussed above, the refundable portion of the QEZE Real Property Tax Credit is properly viewed as, in substance, a recovery of property tax. However, if instead it is treated as the payment of a refundable income or franchise tax credit (as opposed to an actual refund of prior estimated tax payments or withholding), the refundable portion would still be includable in gross income under I.R.C. § 61 as an accession to wealth. As discussed above, there is no federal exclusion from income based solely on the fact that a payment takes the form of a tax refund for state tax purposes. Also as discussed above, I.R.C. § 111 only excludes the recovery of amounts that were previously deducted or credited without tax benefit; it does not exclude a “recovery” of amounts that were never deducted because they were never paid. Unlike the situation addressed in Buffalo Wire Works, the refundable portion of the QEZE Real Property Tax Credit is currently includable in federal gross income even under the taxpayers' re-characterization.

With respect to the taxpayers' alternative position, they have argued that it is not fair or equitable to include the refunded portion of the QEZE Real Property Tax Credit in taxable income. First, case law holds that issues of fairness and equity of an enacted tax law are not within the jurisdiction of the courts. Although taxpayers may perceive the law to be unfair, the tax benefit rule and I.R.C. § 61 require the refundable portion of

the credit to be included in income, subject to the exclusion provided in I.R.C. § 111. See [Commissioner v. Gooch Co.](#), 320 U.S. 418, 422 (1943); [United States v. Brockamp](#), 519 U.S. 347, 352 (1997). In addition, to the extent the tax benefit rule and I.R.C. § 111 reflect equitable principles, such considerations fully support treatment of the QEZE Real Property Tax Credit as income, subject to possible exclusion under I.R.C. § 111. Taxpayers wish to retain the full tax benefit of an I.R.C. § 164 deduction for the payment of property tax, while excluding from income what is, in substance, a recovery of that same property tax. This inconsistent double benefit is what the tax benefit rule and I.R.C. § 111 generally were designed to prevent. Contrary to the taxpayers' assertion, allowing them to retain this double benefit would be unfair to other taxpayers.

Accordingly, a payment attributable to the refundable portion of the QEZE Real Property Tax Credit is income under the inclusionary part of the tax benefit rule, subject to the provisions of I.R.C. § 111 based on the presence or absence of a federal tax benefit from the prior deduction of state property tax (CCA 200842002). Even if the refundable portion of the QEZE Real Property Tax Credit is not treated as a recovery of previously paid property taxes, but instead as a refundable income or franchise tax credit, the refundable portion is still includable in gross income under I.R.C. § 61 as an accession to wealth.

With respect to partnerships and their partners as well as New York S corporations and their shareholders, the property tax on which the QEZE Real Property Tax Credit is owed and paid by the partnership or S Corporation – rightfully belongs to the partners or shareholders, not the entity. The credit passes to the partner/shareholder as an income or franchise tax credit. The refundable portion of the QEZE Real Property Tax Credit is treated as a nonpartnership item, and each partner's tax benefit income is determined based on the extent to which that partner receives the refundable portion, and the benefit the partner previously received through the partner's share of the partnership's property tax deduction. Generally, in situations involving QEZEs, the previous property tax deduction is not separately stated on the partners' Schedules K-1, but only included in the computation of "bottom-line" gain or loss.⁴

⁴ If the partnership is subject to the unified partnership audit and litigation procedures of I.R.C. §§ 6221-6234 (TEFRA partnership procedures), the QEZE Real Property Tax Credit tax benefit is not a partnership item (§ 6231(a)(3) and Treas. Reg. § 301.6231(a)(3)-1) and cannot be determined in a TEFRA partnership proceeding. [Nusdorf v. Commissioner](#), 129 T.C. 30, 41 (2007); [Roberts v. Commissioner](#), 94 T.C. 853, 863 n. 6 (1990). However, the tax benefit to the partner is an affected item as it is affected by the partnership's claimed expense of property taxes and each partner's share of that item, both of which are partnership items. (§ 6231(a)(5)). If the Service initiated a TEFRA partnership proceeding, the Service cannot issue an affected item notice of deficiency before the conclusion of the partnership-level proceeding. [GAF v. Commissioner](#), 114 T.C. 519, 524-528 (2000). The Service may, however, issue an affected item notice of deficiency without opening and closing a TEFRA partnership proceeding. In such circumstance, the Service is bound by the partnership items as reflected on the partnership return and records for purposes of the partner-level deficiency proceeding. [Roberts](#), 94 T.C. at 862.

ISSUE 2

To the extent, the amount of the QEZE Real Property Tax Credit exceeds taxpayers' New York State income or franchise tax liability, taxpayers can receive the refund in cash or apply it to the following year's New York State income or franchise tax liability. Treas. Reg. § 1.451- 2(a) provides that income is constructively received by taxpayers in the taxable year during which it is credited to their account, set apart for them, or otherwise made available. Cash method taxpayers should therefore include the refundable portion of the QEZE Real Property Tax Credit in income subject to I.R.C. § 111 in the year the credit would have been refunded, even if taxpayers chose to use it as a credit against state taxes in a future year.

APPEALS ANALYSIS

ISSUE 1

Compliance's position is that the receipt of the refundable portion of the QEZE Real Property Tax Credit is income under the tax benefit rule, subject to the exclusion provided under I.R.C. § 111. Even if the refundable portion of the QEZE Real Property Tax Credit is not treated as a recovery of previously paid property taxes, but instead as a refundable income or franchise tax credit, the refundable portion is still includable in gross income under I.R.C. § 61 as an accession to wealth.

Taxpayers' reliance on Tempel is misplaced. Taxpayers seek to extend the Tax Court's statements in Tempel regarding nonrefundable credits to include refundable credits. To the extent the Tax Court addressed the federal tax treatment of state tax credits that result in the receipt of cash by a taxpayer, rather than a mere reduction in state tax liability, the court's statements supports the Government's position. In addition, the references in New York State Law as to the nature of the QEZE Real Property Tax Credit indicate that the credit is for real property taxes and not income taxes. Taxpayers' interpretation of the New York State Law to support their position that the refundable portion of the QEZE Real Property Tax Credit is a refund of New York State income or franchise taxes that were never paid is at odds with the plain language of the New York statute. The references to New York State income or franchise taxes only provide the manner in which the credit for real property taxes can be claimed. They do not alter the federal tax treatment of the refunds.

Taxpayers also are misinterpreting the tax benefit rule and I.R.C. § 111. Even if the state tax overpayment is considered a "refund" of New York State income or franchise taxes, not property tax, unless, the taxpayers could show that they actually paid income or franchise taxes the deduction of which did not reduce the federal tax liability in the prior year, I.R.C. § 111 does not apply. The amount of the overpayment is still includable in income.

As the relevant tax law, rulings and court cases do not support taxpayers' position, it is Appeals' position that the refundable portion of the QEZE Real Property Tax Credit is a recovery of real property taxes and included in income, subject to the I.R.C. § 111 exclusion.

In addition, Appeals is not persuaded by taxpayers' alternative arguments based upon "fairness" or "equity". Any conclusion regarding proper tax treatment is based on the tax law as enacted by Congress and interpreted by case law. See Commissioner v. Gooch Co., 320 U.S. 418, 422 (1943); United States v. Brockamp, 519 U.S. 347, 352 (1997).

ISSUE 2

Compliances' position is based on Treas. Reg. § 1.451-2(a), which supports the tax principle that when taxpayers are given the option to receive an item in cash or defer an item of income, taxpayers have constructively received the item and must include it in taxable income. Compliance's position is fully supported by the tax law.

SETTLEMENT GUIDELINES

ISSUE 1

Based upon evaluation of the relevant and judicial precedents as described above, the government's hazards are de minimis and the hazards of litigation for taxpayers are substantial. It is Appeals' position that the refundable portion of the QEZE Real Property Tax Credit is a recovery of real property taxes and must be included in income, subject to the I.R.C. § 111 exclusion. In addition, after a review of relevant case law, Appeals is not persuaded by taxpayers' alternative arguments based upon "fairness" or "equity". Taxpayer's full concession of the issue is the appropriate resolution.

ISSUE 2

Treas. Reg. § 1.451-2(a) supports Compliance's position that when taxpayers are given the option to receive an item in cash or defer an item of income, taxpayers have constructively received the item and must include it in taxable income. Therefore, the Government's hazards of litigation are de minimis. Taxpayer's full concession of the issue is the appropriate resolution.