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Governor's Proposed Executive Budget for 2009-2010

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Governor David A. Paterson recently introduced the Executive Budget for New York State for 2009-10 (the "Budget Bill")[1]. Facing "the greatest economic and fiscal challenge" since the Great Depression, the Budget Bill proposes several important amendments to the tax law that primarily affect individual taxpayers.[2] Many of the proposals extend New York's sales and use taxes to essential items, such as clothing, beverages, transportation and personal services, as well as to entertainment products (including movies and downloadable music), cable and satellite television and other luxury goods. Similar to the last two budget cycles, the Budget Bill also contains certain "loophole closers" that alter or eliminate certain planning and structures that businesses and individuals have used to reduce New York taxes.[3] Other proposed amendments would eliminate the State's STAR property tax rebate program,[4] reform the Empire Zones Program to benefit businesses creating jobs in the State,[5] and expand the low income housing tax credit.[6]

New Sales and Use Taxes

*1. Non-Dietetic B*everages

Much is being written about the proposal to add an 18% tax on sales of non-dietetic soft drinks, such as soda, and other beverages containing less than 70% natural fruit juice.[7] In practice, this proposal will be difficult to administer, inasmuch as the law requires vendors to separately calculate the tax due when the taxable beverage is sold in a package with other items or as a mixed drink with non-taxable beverages based on a 500% markup on a cost basis.

2. Entertainment Events, Cable & Satellite Television & Digital Products

State sales tax would also apply for the first time to certain entertainment related expenses that were previously expressly exempt from tax.[8] For example, charges for admission to movie theaters, golf courses, beaches, live dramatic and musical arts performances, and other places where individuals will participate in a sport, such as swimming, bowling, and tennis. For those taxpayers who prefer to stay at home, the Budget Bill imposes sales and use tax on cable and satellite television and radio services,[9] as well as charges for digital products,[10] such as movies and music that one downloads to an Ipod.

The imposition of sales and use taxes on digital products extends well beyond individual personal use to businesses and commercial transactions. Historically, such sales were considered exempt sales of intangible property because the products were delivered in an electronic format versus a tangible format. Since sales tax applied solely to sales of tangible property (and certain services) the method of delivery chosen dictated the incidence of the tax (with the exception of sales of pre-written computer software that were statutorily categorized as tangible personal property). The Budget Bill eliminates the ability of taxpayers to avoid tax by obtaining delivery of the product electronically.[11] "Digital product" is defined broadly as "any property or service of whatever nature, delivered to the purchaser through the use of wire, cable, fiber optic, laser, microwave, radio wave, satellite or similar or successor media" and includes, but is not limited to, audio works, audiovisual works, visual works, books, graphic works, games, information and entertainment services, and the storage of digital products and computer software in a non-tangible form. Although the purchase and resale of a digital product will not be subject to tax, as well as the purchase and resale of property of which the digital product becomes a component part, purchases by businesses of digital products that are used in the performance of services in New York will now be subject to tax. Retailers that sell digital products will need to perform a nexus analysis to determine whether they have sufficient contacts with New York that would require them to register as a vendor and to collect and remit sales and use taxes on their sales of such products. In addition, companies that distribute promotional items in New York by electronic means may have use tax exposure, if the legislation is enacted.

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3. Clothing & Luxury Products

The Budget Bill would eliminate the current exemption from State sales and use taxes for clothing and footwear costing less than $110 and provide for two one-week exemption periods for clothing and footwear costing less than $500.[12] Furthermore, purchases of the following luxury items will be subject to a new additional tax at the rate of 5% (to the extent the cost exceeds the amount listed): motor vehicles ($60,000), boats ($200,000), aircraft ($500,000), and jewelry, fur clothing and footwear ($20,000).[13]

The Budget Bill also targets certain "sales tax avoidance schemes," namely the use of two exemptions often used by companies and individuals to purchase airplanes, motor vehicles, and boats, without payment of tax.[14] Part AA of the Budget Bill would amend the definition of commercial aircraft found in the commercial aircraft exemption to exclude aircraft that is used primarily to transport the purchaser's personnel or those of an affiliated company. This will prevent "business entities . . . [from] taking advantage of the commercial aircraft exemption to avoid sales tax on their purchase of aircraft used primarily to transport corporate executives by having the airplane purchased by a non-resident affiliate, which then charges resident affiliates for use of the aircraft."[15] A related use tax exemption, the exemption for property purchased while a nonresident of New York and subsequently brought into New York, is also substantially narrowed under the Budget Bill to exclude property purchased primarily to carry individuals who are agents, employees, officers, shareholders, members, managers, partners or directors of the purchaser, where any of those individuals was a resident of New York at the time of purchase, or an affiliate of the purchaser when such affiliate was a resident of New York at the time of the purchase. Historically, residents would form a nonresident business entity to purchase the vessel and subsequently use such product in New York.

4. Personal and Transportation Services

Similar to New York City, sales and use tax would apply to certain personal services, such as haircuts, manicures, pedicures, massages, and services sold by weight control salons, health salons, gymnasiums, and baths.[16] The sales tax would also be extended to certain transportation services: (i) taxicab, limousine, commuter van or other vehicle service (ii) horse-drawn cab and pedicab services (iii) intra-state charter bus, vessel, train and plane service (iv) charter fishing, and (v) and sightseeing services.[17]

5. *Capital Improvements*

Part PP of the Budget Bill will significantly impact the real estate industry, as well as individual tenants and homeowners, by limiting the type of improvements to real property that will qualify for the State's capital improvement exemption. In the case of buildings and other structures, the addition to or alteration to real property must "constitute[] new construction or a new addition to or total reconstruction of existing construction" to qualify as a capital improvement. Thus, the exemption will be limited to three general situations - new construction, gut renovation of an entire building, or the addition of a whole new addition to a building. This is a marked change from prior law, which will detrimentally discourage improvements to New York real estate and in effect be an indirect tax (and cost of living) on commercial and individual residents who will bear the cost of such improvements.

Individual Taxpayer Changes

Instead of including a personal income tax rate increase targeted at wealthy New York individuals, which was floated last budget cycle, the legislation would limit the use of itemized deductions by individuals whose adjusted gross income is over $1,000,000.[18] If enacted, such individuals would only be able to claim standardized deductions, with the exception of charitable contributions.[19] This amendment applies equally to the City personal income tax and is estimated to bring in $140 million for the 2009-'10 fiscal year.

For individuals living overseas, another proposal merits attention. Under current law, an individual domiciled in New York is not taxed as a resident (on worldwide income) if, within any 548 day consecutive period: (1) the taxpayer is present in a foreign country or countries for at least 450 days; (2) the taxpayer is not present in the state for more than 90 days; and (3) the taxpayer's spouse and minor children do not reside *at the taxpayer's permanent place of abode* in New York for more than 90 days. The Department of Taxation and Finance has lost cases on this issue based on the plain language of the statute.[20] In these cases, the taxpayer was determined to be a nonresident, even though the taxpayer's spouse and minor children were present in New York for more than 90 days because they were staying at a hotel or with relatives, rather than *at the taxpayer's permanent place of abode*. The Budget Bill would amend the law to provide that presence in New York for more than 90 days by the taxpayer's spouse or children creates residency, regardless of where they stay while in New York.[21] This "loophole closer" would apply to tax years on or after January 1, 2009.

Partners and Partnerships

Nonresident hedge fund managers and other partners of investment partnerships doing business in New York may face an increased New York tax bill if Part N of the Budget Bill is enacted. The legislation would impose New York personal income tax on income (capital gain income) attributable to "investment management services"[22] provided to a partnership or other entity doing business in New York.[23] Simply stated, this legislation would extend New York's personal income tax to carried interests received in exchange for services, which the State views as a form of taxable compensation income.[24]

Nonresidents that are partners of partnerships, members of limited liability companies, or S corporation shareholders, may also be subject to tax on a portion of the gain attributable to the sale of their ownership interest in the entity, if more than fifty percent of the fair market value of the entity's assets consist of New York real property at the time of sale.[25] Similar to the provision proposed last cycle this provision contains an anti-stuffing rule (i.e. only those assets that the entity owned for at least two years prior to the date of sale are used to determine fair market value of all the assets held by the entity on the date of sale). It remains to be seen whether this proposal will die as it did last year in the Assembly or will be enacted to close the "loophole" that currently exists, namely the ability of nonresident taxpayers to "escape taxation by placing New York real estate in an entity and then selling his or her interest in the entity."[26] Under current law, the sale of an interest in an entity by a nonresident is not subject to tax; whereas, the direct sale of real estate by a nonresident is subject to tax.

The Budget Bill would also extend the State's annual filing fee on partnerships to general partnerships with New York source income greater than $1 million.[27]

Corporate Provisions

In contrast to the last budge cycle, there are relatively few proposals involving New York's corporate franchise tax. The primary amendment would effectuate a change in timing of a payment, rather than an increase in the total amount due. The amendment would require taxpayers whose tax for the preceding year was in excess of $100,000 to remit 40%, rather than 30%, of such amount, as their mandatory first installment of estimated franchise tax (and MCTD surcharge) due for the current tax year.[28]

Significant reforms are proposed for the taxation of insurance companies.[29]

The Budget Process

Taxpayers, businesses and practitioners will have to wait and see which provisions are accepted and rejected by the legislative bodies. In addition to the provisions discussed above, several other fees (e.g. $100 fee for tax return preparers and $10 paper return filing fee) and taxes, as well as the rate of interest that applies to underpayments and overpayments, are under consideration to bridge the budget deficit, together with new tax compliance and criminal enforcement provisions (including a controversial provision that would allow New York State Tax Department attorneys to be appointed as special assistant district attorneys in state tax cases for the purpose of bringing tax prosecution cases).[30] How stormy will the legislative process be? Unfortunately, given the amount of the deficit at issue, many of the proposed changes may become law.

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1 S.60, A160 (hereinafter the "Budget Bill").

2 Governor's Letter, 2009-2010 Executive Budget Briefing Book, available at http://publications.budget.state.ny.us/ebudget0910/fy0910littlebook/governorsletter.html.

3 *See* 2009-10 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support (hereinafter *Memorandum in Support)*, available at http://publications.budget.state.ny.us/eBudget 0910/fy0910artVIIbills/REVENUEConsBMwtoc.htm.

4 Budget Bill, Part Q.

5 Budget Bill, Part K.

6 Budget Bill, Part L.

7 Budget Bill, Part HH.

8 Budget Bill, Part OO.

9 Budget Bill, Part Q.

10 Budget Bill, Part CC.

11 Currently, certain information (non-custom reports) and entertainment services delivered in electronic form are subject to tax. N.Y. Tax Law §§1105(c)(1) & 1105(c)(9). The statement in the text relates primarily to music, books, and other property that was not subject to tax under these provisions.

12 Budget Bill, Part U. New York City's year-round exemption for clothing and footwear costing less than $100 remains, but the City (and other localities) is authorized under the Bill to eliminate such exemption.

13 Budget Bill, Part RR.

14 *Memorandum in Support, supra note 3,* Part AA.

15 *Id.*

16 Budget Bill, Part V.

17 Budget Bill, Part NN. Public transportation services (i.e. subway), ferry service, transportation of certain children to and from school, funeral and emergency transportation services would be exempt from tax.

18 Budget Bill, Part M.

19 Currently, individual taxpayers with New York adjusted gross income over $525,000 are limited to 50% of otherwise allowable itemized deductions. N.Y. Tax Law §615(f)(1)&(2).

20 *See e.g.* Matter of Gass, N.Y. Div. of Tax Appeals, DTA No. 819722, Small Claims Determination, May 27, 2004; *see also Memorandum in Support, supra note 3,* Part A, (stating "some taxpayers have exploited the plain language of the law by having their spouses and minor children avoid using their permanent place of abode in New York, and instead either staying with relatives or in a hotel in New York").

21 Budget Bill, Part A.

22 Part N of the Budget Bill amends section 631(b)(1)(B) to provide that New York source income includes income from a "business, trade, profession or occupation carried on in this state, including investment management services to a partnership or other entity as defined in subsection (h) of this section." Subsection (h) defines "investment management services to a partnership or other entity" as providing a substantial quantity of the following services: (1) advising the partnership as to the value of any specified asset (2) advising the partnership as to the advisability of investing in, purchasing, or selling any specified asset (3) managing, acquiring, or disposing of any specified asset (4) arranging financing with respect to acquiring specified assets (5) any activity in support of any service described in subparagraphs (1)-(4).

[23] Budget Bill, Part N.

[24] Currently, under the Tax Law, nonresidents are not subject to tax on investment income (capital gain income) including investment income earned as a partnership carried interest received for providing services in New York.

[25] Budget Bill, Part H.

[26] *Memorandum in Support, supra note 3,* Part H.

[27] Budget Bill, Part J. This fee is currently imposed on limited liability companies and limited partnerships and is likely to be enacted to level the playing field among these different types of partnerships.

[28] Budget Bill, Part I.

[29] Budget Bill, Parts D & F.

[30] Budget Bill, Part SS, Subpart K; *See also Memorandum in Support*, supra note 3, Part SS, Subpart K.