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# Federal, State and City Tax Amendments: Effects on N.Y. Law Firms

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Recent weeks have seen the enactment of important tax legislation at the federal, New York State and New York City levels. As widely publicized, federal rates have gone down, while State and City rates have gone up. The full picture is, however, considerably more complex. Particularly for partners in law firms in New York, the new State tax legislation requiring estimated tax payments by partnerships inaugurates significant new compliance burdens, and necessitates some immediate decisions about how to pay June 15 estimated taxes in New York.

One common feature of all three tax bills is rate changes. The federal income tax now provides that, through 2008, dividend income is taxed at 15%, as are most capital gains.[1] For other types of income, including interest, the maximum marginal federal income tax rate for noncorporate taxpayers has been reduced, through 2010, to 35.0%, with corresponding reductions in lower rate brackets. The new federal rates should prompt individuals to review their current portfolios, and rethink investment decisions and strategies. For example, it may be preferable to hold interest-bearing investments in IRA or pension accounts, where taxation of the income can be deferred until distribution, while investments generating capital gain or dividend income might be held directly, and "profit taking" on appreciated assets may make sense if the capital gains tax rate threatens to increase again in a few years.

It should be noted that no reduction has been made to the federal alternative minimum tax ("AMT") rate, which is generally 28%. In light of the increases in New York's already significant personal income tax rates, the federal AMT's disallowance of deductions for State and local income taxes, becomes increasingly important to New York taxpayers.

And increase the State and local taxes have.[2] The New York State personal income tax rates have risen to a maximum of 7.7%, for the full years 2003 through 2005. For residents of New York City, income tax rates have increased to a maximum of 4.45%, also for 2003-05. There is no rate differential for capital gains or dividends in New York State or City. The total combined income tax rate for a New York City resident therefore is 12.15%. Moreover, under both the State and the City income taxes, the benefit of the lower rate brackets has been eliminated for high-income taxpayers – at the highest income brackets, every dollar of income is taxed at the maximum rate.

New York's rate increases were not limited to personal income taxes, however. The State sales tax rate has been raised from 4% to 4.25% for transactions occurring between June 1, 2003 and May 31, 2005; and the City sales tax rate has been increased from 4% to 4.125% through May 31, 2005. Taking into account the MTA surcharge on sales taxes, these increases bring the total New York City sales tax rate to 8.625%. Moreover, the sales tax on clothing has been restored, for the period June 1, 2003 to May 31, 2004, with the exception of two one-week holidays for items under $110.

New York has also moved to enhance collections of the use taxes its citizens have been ignoring on "sales-tax-free" purchases made by catalog or over the Internet. It has long been the law that, even if an out-of-state vendor does not collect sales tax on a purchase, use tax is nevertheless required to be paid by the purchaser directly to the State. Now, a new line is being added to the New York State personal income tax returns for reporting use taxes due, and the Commissioner has been instructed to implement an education program explaining individuals' use tax responsibilities. Clearly the legislature is seeking to enhance sales/use tax collections without imposing new taxes or further raising rates, and while it may be difficult for individuals to estimate with precision the dollar amount of the unpaid use taxes on purchases made from remote sellers, it will be difficult for most taxpayers to claim zero use tax due. In any event, the State is now making the attempt to staunch this loss of sales tax revenues, and to defuse the competitive advantage remote sellers have had over local sellers, who must of course collect and remit sales tax. [3]

While New York's rate changes are painful they are at least easy to understand. Much more complex, and potentially much more unreasonable, are the new rules[4] requiring partnerships, LLC's and S corporations ("entities") to make estimated tax payments in respect of certain of their partners/members/shareholders ("owners"). Specifically, pass-through entities will be required to make quarterly estimated tax payments to New York State, based on the portion of entity income that is allocable to owners who are either nonresidents of New York, or C corporations. (The new estimated tax procedures do not apply to entities that file New York composite returns for, and pay income tax annually in respect of, nonresident partners. However, because New York's rules for such filings are rather strict, many entities do not qualify for this exemption.)

Under the new legislation, law firms and other partnerships, LLCs and S corporations which include nonresidents or C corporations are now required to make quarterly payments to New York State based on the highest rate of tax applied to such owners' allocable shares of New York source income. The new estimated tax is a direct obligation of the entity. Tax must be paid quarterly, whether or not the entity has the funds to pay the tax , whether such payments violate obligations under other agreements (such as loan covenants[5]), and whether or not payments made on behalf of (and credited to) certain owners accord with the distribution agreements applicable to the entity. This means that the entity's New York tax responsibilities will often conflict with the owners' economic arrangements, and interfere with the entity's business operations.

Apart from the business issues that result from mandating that entities pay some partners' taxes, the practical and technical issues presented by this new estimated tax are legion. For example, pass-through entities must now systematically identify every owner who is a "nonresident" of New York, and every owner who is a C corporation. Because the residence of an individual is not always clear, and can vary from time to time, procedures will be needed to ascertain which owners trigger the quarterly estimated tax obligations.

The new provision requires taxes to be paid in the manner and at the time specified in the statute[6] for individuals' estimates. These rules include safe harbors based either on the current year's income or on the previous year's income. Where the interests of owners vary from year to year, it is unclear how the entity is to calculate its estimated tax obligation.

Significantly, the income on which entity payments are based is the entity's income, not the owner's taxable income. An owner may have personal deductions, or losses from other sources, and C corporations may have differing allocation percentages or combined group reporting, but there appears to be no mechanism for reducing the base of the entity's estimated tax payments so that it more closely corresponds to the owner's actual New York taxable income. As a result, estimated tax payments made by an entity will often far exceed the owner's actual New York tax liability, and the payments required to be made in respect of nonresident partners will exceed the estimated tax payments required of a similarly situated New York resident partner. Obviously this raises constitutional issues.

For more complex structures the application of the new rules is unclear. For example, rules are needed to clarify the treatment of tiered pass-through entities—presumably the estimated tax obligation should fall on the entity that directly has nonresident or C corporation owners. Where an entity's tax year differs from the owner's, it is unclear how the entity's estimated tax payments are to be coordinated with, and credited to, the owners.

Entities with C corporation partners face particularly confusing rules. The amount of estimated tax is determined by applying the highest corporate rate to the portion of the entity's "New York source" income allocable to the C corporation owner. However, New York corporate tax is based on allocated worldwide income, not on concepts of "source." Consequently, there is a fundamental mismatch between the entity's tax base and its C corporation owners'. The source of income is often a meaningless term when applied to intangible investment income of a partnership or corporation. And, oddly, because the term "C corporation" technically may include corporations which are not taxable (*e.g.*, charities), the estimated tax obligation of the entity could bear no relationship whatsoever to tax owed by the owner, but instead simply be an interest-free loan made to New York each quarter. That result seems unduly harsh but also appears to have been specifically intended by the state legislature.

Of most immediate concern are the effective dates and transitional effects of the new rules. The estimated tax provisions became effective immediately upon enactment, and apply to all entity years ending after 2002. As a result, a partnership with a fiscal year that ended January 31, 2003, is apparently required to make four quarterly estimated tax payments for the year already ended, plus estimated taxes for the current year—an absurd result.

Moreover, while the statute affords a grace period through September 15, 2003, during which no penalties will be incurred for the entity's late payment of estimated taxes, there is a potential danger in having owners make their June 15, 2003 estimated tax payments, while the entity waits until September 15, 2003 in the hopes of further guidance. There is no mechanism in the current law for crediting against an entity's estimated tax obligations a payment already made by an owner. New York tax officials have informally advised that the statute therefore appears to require a doubling-up of estimated tax payments in 2003 – owners will have made estimated tax payments on April 15 and possibly also June 15; on September 15 the entity will be required to pay tax for those two quarters again.

The statute does however give credit in the other direction—the owner is credited for estimated tax payments made by an entity. For that reason, it may make sense for the entity to pay the June estimates, even though the base amount on which estimated tax will be paid may be greater than the individual's estimated tax base. What is certain is that law firms subject to the new estimated tax regime have about a week to decide what to do in respect of their nonresident partners' June 15 estimated taxes.

Another new estimated tax provision that takes effect on September 1, 2003, will raise additional compliance burdens for taxpayers and lawyers alike. New York's personal income tax has been amended to impose new estimated taxes on sales of New York real property made by nonresident individual taxpayers. These new rules provide that a nonresident must estimate his or her personal income tax liability on the gain from such sale or transfer; prepare a form reporting tax on the gain, at the highest rate of tax; and file the form and pay taxes to the State. No deed will be recorded without either a certification by the Commissioner of the receipt of the taxpayer's filing and payment, or a certification by the transferor that the estimated tax rules are inapplicable.

The only cases specified in the statute for which nonresidents are not subject to these FIRPTA-like provisions are (i) where the real property transferred is a principal residence; (ii) where the seller is a mortgagor conveying to a mortgagee in foreclosure or in lieu of foreclosure; or (iii) where the transferor or transferee is one of several specified governmental agencies.

Clearly, this new rule introduces considerable transactional burdens for real estate sales. Third-party buyers generally will not close without knowing the deed is in recordable form. This, then, raises questions as to how a buyer is to know whether a seller is a nonresident individual, or that the seller's certification is accurate. Further questions arise when the seller is a partnership or an LLC, when the interest purchased is 100% of a partnership or LLC, or when the seller expects to defer gain through a §1031 like-kind exchange completed up to 180 days after the buyer's purchase. A pre-transfer certification program like that used under the repealed "Cuomo" tax could be put in place to address the practical consequences of this new estimated tax, but if that process devolves into a pre-transfer income tax audit of every seller, checking for and measuring the nonresident's gain, rather than simply a process for registering nonresidents to ensure that they file and pay income tax, then the conveyancing process in New York will be slowed considerably. Needless to say, developments in this area must be closely watched as the September 1, 2003, effective date approaches.

In the arena of economic stimulus legislation, we now have directly contradictory signals from Washington and Albany. As a response to sluggish economic conditions, the federal Job Creation and Worker Assistance Act of 2002 (the "2002 Act") provided that 30% of the cost of certain depreciable property placed in service after September 10, 2001, and before January 1, 2005 (or, in some cases, before January 1, 2006), could be deducted as a "bonus" in the year the property was placed in service. Regular depreciation allowances, computed on the remaining 70% of the cost, would also be allowed in the year the property was placed in service and subsequent years. New York State initially conformed to this 2002 federal bonus depreciation legislation. The City, on a tighter budget, conformed only in respect of property in the "Resurgence Zone" (south of Houston Street).

The 2003 federal tax legislation increases the bonus to 50% for certain property acquired after May 5, 2003, and liberalizes some of the requirements for property eligible for the 30% bonus under the 2002 Act. By contrast, the 2003 State legislation decouples from federal "bonus" depreciation, except for Resurgence Zone property.

On the federal front, to qualify as "50-percent bonus depreciation property," four requirements must be met: (i) the property must be depreciable property to which Code section 168 applies which has a recovery period of 20 years or less or certain computer software or "water utility property" or "qualified leasehold improvement property"; (ii) the original use of the property must commence with the taxpayer after May 5, 2003; (iii) the property must be acquired by the taxpayer after May 5, 2003, and before January 1, 2005, and no written binding contract for its acquisition may have been in effect before May 6, 2003[7]; and (iv) the property must be placed in service before January 1, 2005 (or, in the case of certain property having a long production period, January 1, 2006). Property acquired as replacement property in a like-kind exchange under Code section 1031 or following an involuntary conversion under Code section 1033 may qualify for the bonus. A taxpayer may however elect to waive the 50% bonus.[8]

New York State has now "decoupled" from all Federal bonus depreciation, joining the dozens of states that could not afford the stimulus package. For taxable years beginning after 2002, in the case of property placed in service on or after June 1, 2003, New York State depreciation will generally be based on the original Federal MACRS cost recovery schedules, with no "bonus" depreciation. Gain and loss on sale will be adjusted for New York purposes as well. The decoupled depreciation applies for New York corporate tax under Article 9-A, the bank tax, the section 1503 computation of insurance corporation income, and the personal income tax.

Exceptions from State decoupling are provided for "Qualified Resurgence Zone Property" and "Qualified Liberty Zone Property." "Qualified Liberty Zone Property" is defined in accordance with the federal Internal Revenue Code. "Qualified Resurgence Zone Property" follows the New York City definition—essentially property all of the use of which is in Manhattan, south of the center line of Houston Street. There are also constitutional issues in providing more favorable depreciation rules for in-state properties than out-of-state properties which may lead to litigation over this issue.

Interestingly, the effective date rules of the 2002 and 2003 federal and State stimulus legislation produce some unusual results. The federal 50% bonus is available for qualified property acquired after May 5, 2003. New York's decoupling from the federal depreciation deduction applies for property placed in service on or after June 1, 2003, for taxable years beginning after 2002. Calendar year taxpayers who placed property in service between May 6 and May 31, 2003, thus appear to qualify for 50% bonus depreciation for federal and New York purposes. Similarly, fiscal year taxpayers placing property in service after May 5 and prior to the end of a taxable year that began in 2002 apparently also can place qualified property in service through the end of that fiscal year, and qualify for 50% bonus depreciation for both federal and state purposes.[9]

New York's 2003 legislative season was punctuated by some highly controversial television commercials that showed shuttered emergency rooms, and demanded that the State budget legislation close "corporate loopholes." One such attempt found its way into the State and City corporate, unincorporated business, and personal income taxes as an anti-"passive investment company" (or "PIC") disallowance of deductions for certain related party payments of interest and royalties. Business taxpayers around the country have increasingly found ways for entities in high-tax jurisdictions to make deductible payments to affiliates in low-tax jurisdictions, in the expectation of lowering the overall tax burden on the multi-state business. New York State and City have now joined in legislative attacks on PIC's, although in a rather muted and somewhat confusing fashion.

For taxable years beginning on or after January 1, 2003, payors of certain interest and royalties to related persons must add back those expenses in computing taxable income for New York purposes. "Related person" is defined to include a variety of entities and arrangements that are at least 30% commonly owned. The payments subject to add-back include interest expense deductible under Code section 163, and royalties and copyrights directly connected to the use of licenses, trademarks, copyrights, trade names, and similar intangible assets.

The add-back of otherwise covered expenses is not required, however, if certain conditions are met. Royalty payments are not disallowed if the transaction has a valid business purpose (as defined in the new law) and (i) the related member accrued "the amount" to an unrelated person, or (ii) the payments are made pursuant to a contract reflecting an arm's length charge. Add-back of interest expense is not required if there is a valid business purpose (again, as defined) for the transaction, and either the intercompany indebtedness is financed or funded with third-party debt and at arm's length interest; or the intercompany debt is "part of a regular systematic funds management or portfolio investment activity." This summary vastly oversimplifies the new expense add-backs, and the companion income exclusions for the payees, which are quite complex and controversial. Taxpayers with intercompany expenses are cautioned to look carefully at related party transactions that generate deductions for New York taxpayers, to ensure that the intended deductions are still available under the new regime.

A few other changes in the New York tax laws merit note. The New York State annual fee payable by limited liability companies and limited liability partnerships with New York source income has been increased for 2003 and 2004 from $50 to $100 per member; and the minimum and maximum fees have been increased to $500 and $25,000, respectively. The fee also is now imposed on single-member LLC's, although the minimum fee for such entities is $100, not $500. The new fee is due within thirty days of the close of the LLC's taxable year, and applies for tax years beginning in 2003 and 2004.

Certain expiring bank tax provisions have been extended again. The general bank tax provisions are extended to January 1, 2005; Gramm-Leach-Bliley transitional rules are extended to January 1, 2004. For insurance companies, non-life companies move to a premiums based tax effective 2003. The new rates are 1.75% of gross premiums for accident and health insurance contracts relating to risks located or resident in New York, and 2% for other non-life premiums.

The new tax legislation also provides authorization for New York City to conduct a tax amnesty program, to run for three months in the fiscal year beginning July 1, 2003. The amnesty applies to the Unincorporated Business Tax, General Corporation Tax, Commercial Rent Tax, Utility Tax, Real Property Transfer Tax, and certain other City taxes. Amnesty is available for taxes attributable to periods ending, or transactions occurring, on or before December 31, 2001. Under the amnesty the City will waive penalties, and will waive the portion of the total interest that relates to periods more than three years prior to the inception of the amnesty. In various specified circumstances, however, a taxpayer may be ineligible for the amnesty.

Two changes were made to the City real property transfer tax. The RPT has long provided for "formula allocation" in determining the consideration subject to tax on certain entity transfers, and under this formula the transfer tax on certain entity transfers can be less than a tax on the fair market value of the entity's realty. Labeling this a "loophole," the RPT has been amended to provide that transfer tax on entity transfers will be measured by the value of the real estate owned by the transferred company, apportioned to the percentage interest transferred. In addition, the transfer tax now treats an entity that owns City real property as an additional "grantor." As a result, even if the grantor(s) and grantee(s) of a controlling interest themselves have no nexus to the City, the transferred entity can be required to pay the RPT.

Finally, the State legislation authorizes the City to increase the property tax imposed on owners of Class I properties (1-, 2- or 3- family homes and residential condominium units) who do not live in such property, and to make that surcharge a personal obligation of the owner. The authorized increase is a 25% tax surcharge, to take effect July 1, 2003, and a 50% surcharge for the following fiscal year.

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[1] The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "2003 Act").

[2] The 2003 New York legislation is set forth in A. 2106-B and A. 8388-B, both enacted by the State legislature last month over the Governor’s veto. City legislation raising rates as authorized by the State changes was passed last week.

[3] The Legislature further authorized New York State to enter into a "Streamlined Sales and Use Tax Agreement," a compact that is increasingly being adopted throughout the country in an effort to simplify state and local sales taxes, and thus support a Federal initiative to require sales/use tax collection by remote sellers.

[4] A.2106-B, Part L3, amending N.Y. Tax Law section 658.

[5] Often in sale leaseback transactions, all revenues are devoted to debt repayment until the loan is fully amortized.

[6] N.Y. Tax Law section 685(c).

[7] Special rules are provided where some of the components of a larger item of property are acquired pursuant to a pre-May 6, 2003, contract.

[8] The 2003 Act also extended to December 31, 2004, from September 10, 2004, the date by which property eligible for 30% bonus depreciation under the 2002 Act must be acquired, and made conforming changes to the rules under the 2002 Act relating to property having a long production period.

[9] New York also has decoupled from the special Federal deduction allowed under for large sport utility vehicles used by businesses, except in the case of "eligible farmers". The Federal allowance of an immediate income tax deduction for the cost of purchasing an SUV is, therefore, unavailable for New York corporate and personal income tax purposes; the cost of such vehicles is instead recovered under the rules generally applicable to vehicles under Code section 168.

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