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Give and Take—New Federal, State and City Tax Legislation

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Whether or not it results in jobs and economic growth, the avalanche of recent legislation at the federal, state and city levels has created a stir in the tax community. Many of the changes will materially impact – or at least annoy – the New York real estate industry.

The most important change for real estate owners contained in the federal Jobs And Growth Tax Relief Reconciliation Act Of 2003 (2003 Act) is the reduction of the capital gains rate.

In the case of noncorporate taxpayers, the maximum federal income tax rate applicable to capital gains for regular and alternative minimum tax purposes has been reduced to 15 percent (or lower, in the case of certain taxpayers who are not in the maximum brackets for regular tax purposes). However, the 25 percent tax rate applicable to "unrecaptured section 1250 gain" remains in effect. In the case of the sale of depreciable real property, "unrecaptured section 1250 gain" generally represents the depreciation previously claimed by the seller with respect to the property.

The maximum federal tax rate for capital gains of corporations remains 35 percent – yet another reason never to own real estate through a C corporation.

Although the Act puts dividends and capital gains on the same footing by reducing the tax rate on dividends to 15 percent, the reduction of the capital gains rate to 15 percent creates a larger gulf between so-called "dealer property" (property that gives rise to ordinary income if sold at a profit), now taxed at a maximum rate of 35 percent, and property eligible for capital gains treatment.

Moreover, the capital gains rate reduction makes the 25 percent tax on unrecaptured section 1250 gain more significant. Now, there is a 10 percent rate differential between the capital gains attributable to appreciation of the property and those capital gains which result from depreciation deductions previously taken. It is yet to be seen whether the reduction of the capital gains rate to 15 percent will result in throngs of real estate owners foregoing tax-deferred transactions, (e.g., like-kind exchanges) and electing instead to sell their property in taxable transactions, pay their tax and go home – a dramatic break from the traditional approach of real estate owners.

The other federal change that significantly impacts real estate is the increase to bonus depreciation. The Job Creation and Worker Assistance Act of 2002 (2002 Act) provided that 30 percent of the cost of certain depreciable property, including certain leasehold improvements, placed in service after Sept. 10, 2001, and before Jan. 1, 2005 (or, in some cases, before Jan. 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 percent of the cost, would also be allowed in the year the property was placed in service and subsequent years.

The 2003 Act increases the bonus to 50 percent for qualifying property acquired after May 5, 2003.

State and City Changes

When the dust cleared after a series of legislative votes and gubernatorial vetoes, the following changes were made to the New York state and city tax systems:

Income Tax Rate Increases: While the 2003 Act decreased federal tax rates, the state and city personal income tax rates have been increased. Among the reasons for New York's fiscal woes is a curtailment of federal funding that can be linked to federal tax cuts. Ironically, the resulting rate hike in New York may put many New Yorkers in a higher combined tax bracket than they were before the federal tax cuts. This development has the ancillary effect of making New York taxes a bigger part of the overall tax picture and in future years more time and effort will likely be spent on New York tax planning – and tax controversies.

Estimated Tax Payments Required from Pass-Through Entities: One of the most significant amendments included in the state legislation is a new rule requiring partnerships, limited liability companies and S corporations to make estimated tax payments in respect of certain partners/members/shareholders. Under the new legislation, these 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 nonresidents or C corporations.

This new estimated tax will affect many different types of pass-through entities, including real estate partnerships with nonresident or C corporation partners. The issues these entities and owners now face include:

- Where the interests of owners vary from year to year, it is unclear how the entity is to calculate its estimated tax obligation. (For federal income tax purposes partnership allocations may in some cases be set by amendment to the partnership agreement as late as the due date of the partnership return).
- An owner may have personal deductions, or losses from other sources, but there appears to be no mechanism for reducing the base of the entity's estimated tax payments to resemble the owner's actual New York taxable income. As a result, estimated tax payments made by an entity may far exceed the owner's actual New York tax liability.
- The term "C corporation" may include corporations which are not taxable (e.g., charities), in which case the estimated tax obligation of the entity is simply an interest-free loan made to New York each quarter.
- The new estimated tax is a direct obligation of the entity. It must be paid when there is New York income allocable to a nonresident or C corporation owner, whether or not the entity has the funds to pay the tax.

Case Illustration

The following case illustrates the difficulties created by this provision: ABC, a California partnership with California resident partners, was formed in 2001 and now owns properties in many states including a building located in New York which is net leased for 20 years.

Pursuant to the "credit-tenant financing" on the property, the net lessee pays all the rent directly to the lender. The financing amortizes over 20 years and, as a result, although partnership ABC has no cash flow for 20 years, it does have taxable income. The interest expense washes against the rent, but the amortization component of the debt service does not provide a deduction to offset the rental income used to pay it.

Under the new legislation, ABC is required to make estimated tax payments to New York with respect to its partners' shares of partnership income. Yet, ABC may not have the cash necessary to fund these payments and at the time ABC's partnership agreement was signed, the partners made no provision for this situation. What if a partner refuses to contribute the money necessary to make the estimated tax payment? Thus, in addition to dramatically complicating certain real estate transactions entered into from this point forward (e.g., partnerships that want to retain rather than distribute their profits), it also creates tremendous difficulties for entities with pre-existing agreements that do not contemplate this situation.

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 composite filings are rather strict, many entities will not qualify for this exemption.

Decoupling from Federal Depreciation Rules: As noted above, the 30% federal "bonus" depreciation deduction for certain property has now been increased to 50 percent. New York State initially conformed to the 2002 federal bonus depreciation legislation, while the city conformed only with respect to property in the "Resurgence Zone" (south of Houston Street).

New York State has now "decoupled" from all federal bonus depreciation (except as noted below), joining the dozens of states which could not afford to conform their income tax systems to the federal 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 be calculated without bonus depreciation.

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 Manhattan property south of the center line of Houston Street.

This decoupling may engender unexpected complications. Assume that a New York resident has an interest in a Michigan partnership that takes bonus depreciation with respect to tenant improvements located in Michigan in a given year. Michigan has not decoupled from the federal bonus depreciation. Nevertheless, for purposes of computing New York taxable income, the New York resident would be required to recompute his share of partnership income backing out the bonus depreciation. Obviously, the information necessary for these calculations would not be contained in the Schedule K-1 typically issued to a partner.

FIRPTA-Like Estimated Tax Provisions: New York's personal income tax law has been amended, effective Sept. 1, 2003, to impose new estimated taxes on sales of New York real property by nonresident individual taxpayers (analogous to the so called "FIRPTA" rules imposed on the federal level with respect to non-US residents).

These new rules provide that a New York nonresident must estimate his 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 provisions are (i) where the real property transferred is a principal residence; (ii) the seller is a mortgagor conveying to a mortgagee in foreclosure or in lieu of foreclosure; or (iii) the transferor or transferee is one of several specified governmental agencies.

Clearly, this new rule introduces considerable transactional burdens for New York real estate sales. Third-party buyers generally will not close without knowing the deed is in recordable form, but how is a buyer to know whether a seller is a nonresident individual, or that the seller's certification is accurate?

Disallowed Interest Deductions for Related Party Loans: The new legislation requires that 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 involve at least 30 percent common ownership.

Add-back of interest expense is not required if there is a valid business purpose 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."

Thus, under this rule, if a corporation located in Iowa forms a subsidiary to own its New York headquarters and capitalizes that subsidiary with a combination of debt and equity, the new provision would disallow interest deductions of the New York subsidiary.

Conclusion

As we saw last year with respect to the estate tax repeal, the federal tax cut seems to be more than offset by an increased State (and in this case local) tax burden.

Moreover, the approach taken by New York which is manifestly focused on the bottom line rather than tax policy has left a morass in its wake.