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Tax Regulations: Why They Matter, and What's New

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If tax regulations can be said to come in flurries, there are some early signs of winter in New York. This is welcome.

Governor Pataki took office twelve years ago and almost immediately imposed a 90-day "moratorium" on regulations. Issuing an Executive Order,[1] the Governor said that "the state bureaucracy has a reputation and record of imposing rules and regulations that go far beyond what the Legislature intended," and he vowed to "reinvent regulation."[2]

At the time, the Tax Section of the New York State Bar Association urged that tax regulations be exempted from the moratorium. Noting that tax regulations had been carved out of a federal regulatory moratorium, the Bar explained that "it is the absence of tax regulations that frequently is burdensome, as taxpayers are required to fulfill their tax reporting obligations with an incomplete understanding of the State's interpretation of the tax statute."[3] Tax regulations were not exempted, however, and as 90 days turned into 12 years tax regulations became a low priority in Albany, and were promulgated infrequently.

This was unfortunate. Tax regulations can, of course, be overly complex, burdensome and obtuse. Good tax regulations, however, can be extremely useful.[4] Tax statutes apply in some form or other to virtually every person and every commercial endeavor, yet tax statutes by nature tend to lack the details that are needed to apply the law to a wide variety of fact patterns and taxpayers. Well written, thoughtful and practical tax regulations fill gaps, address common issues and problems, offer examples, and frequently help taxpayers by providing the guidance they need to plan and comply, as they must, with the law. Well drafted regulations further serve to inform tax enforcers of the scope of taxpayers' rights and obligations, and provide stability and equality in the application of the law. When tax regulations are lacking, therefore, both taxpayers and the tax system can suffer.

Why Regulations Matter

New York's recent saga involving the taxation of nonresidents' stock option income[5] provides an excellent example of why regulations matter. In 1986, the Court of Appeals addressed a case in which qualified stock options were granted to a nonresident in 1968, exercised in 1972 and 1973, and the acquired shares then sold in 1973. [6] The stock sale produced federal taxable income in 1973; the nonresident claimed the gain was income from intangibles and not taxable in New York. The Court of Appeals held, however, that the taxpayer had New York source compensation income in 1973, equal to the difference between the exercise price and the value of the stock at the time of exercise.

The allocation of option income between New York and other states was not addressed by the Court in 1986. Indeed, the question of how various types of deferred compensation, earned over multi-year periods, is allocated between states is not a question well suited to litigation; a court can do no more than address the question before it, accepting the parties' stipulations. By contrast, this allocation question is precisely the kind of question that regulations should address. In 1995, however, regulations were not forthcoming.

To its credit, the State Tax Department attempted to fill the interpretative gap with a 1995 Technical Services Bureau Memorandum ("TSB-M").[7] This eleven-page document prescribed a variety of rules for apportioning different types of deferred compensation. The 1995 TSB-M did not, however, have the stature of a regulation. Eventually, this proved its undoing.

The 'Stuckless' Cases

Specifically, E. Randall Stuckless, another nonresident, was audited by New York, and was assessed tax on income he realized in nonresident years (1997 and 1998) with respect to options granted to and held by him while he worked in New York. He protested.

An Administrative Law Judge upheld the deficiency, and imposed penalties on Mr. Stuckless for failing to follow the 1995 TSB-M.[8] In 2005, however, the State Tax Appeals Tribunal reversed,[9] adopting an entirely new allocation approach. Stung by this loss, the

Department immediately asked for a rehearing. The Governor, meanwhile, asked the New York Legislature to direct his Tax Commissioner to issue regulations addressing the allocation of stock option income.[10] The Legislature obliged, ordering that regulations be proposed within 180 days.[11] While the Tribunal reconsidered its 2005 decision, the Department drafted new regulations.

On August 17, 2006, the Tribunal handed the Department an even more thorough loss in the case. This time, the Tribunal criticized the 1995 TSB-M as "a highly articulated set of rules of general application" [12] that was not the "ad hoc" type of adjustment that was authorized under the existing regulations.[13] Moreover, finding the TSB-M to be lacking the "precision of determinations generated through more formal Department action," the Tribunal concluded the TSB-M was entitled to no deference.[14] The detailed allocation methodologies set forth in the 1995 TSB-M were ignored, and Mr. Stuckless won his case.

Shortly thereafter, and as mandated, the Department issued new proposed regulations.[15] It also issued a new TSB-M, explaining the consequences of *Stuckless II*.[16] The proposed regulations apply to 2006 and later years; they generally allocate option income based on the portion of days worked in New York between grant and vesting. By contrast, the 2006 TSB-M applies to 2005 and earlier open years, and states that affected taxpayers can either apply the rule of *Stuckless II* (day count in year of exercise), or follow the 1995 TSB-M (day count from grant to exercise).

Taken together, this new guidance provides a practical approach that should quickly end the *Stuckless* confusion. It is however noteworthy that, because the 1995 TSB-M was not a regulation and was effectively invalidated in *Stuckless II*, the State now finds itself (a) allowing taxpayers to choose their preferred method of allocation for 2005 and earlier, and (b) allowing taxpayers who are under audit more flexibility in allocating option income than those whose earlier tax years are closed.

Stuckless is a real world illustration of why it is useful, to taxpayers and taxing authorities alike, to have in place tax regulations that provide clear guidance for common situations that the general statutory language does not, and cannot be expected to, address. On that score, the good news is that in recent weeks several other regulations projects have borne fruit, at both the State and City levels.

Just prior to announcing his resignation last month[17] Commissioner Eristoff finalized an important set of regulations that addresses the application of the State's corporate franchise tax to corporations that are partners in partnerships and members of LLCs.[18] Generally adopting an "aggregate" theory of partnership taxation, these regulations address a variety of common and technical questions that corporations must resolve in importing pass-through partnership items into their corporate tax returns. The Department invested several years in drafting these corporate partner regulations, working extensively with the private sector to identify issues and solutions. While the regulations do not resolve all problems, and likely will entail more extensive compliance efforts by taxpayers, they do provide welcome guidance on a number of important fronts.

'Tax Avoidance'

The State has also recently proposed guidance under the tax shelter-type disclosure rules that apply to New York taxpayers in 2005-2007.[19] The State guidance follows regulations under analogous federal disclosure requirements,[20] but also offers an interesting insight into what the Department considers to be "tax avoidance." Under the proposed regulation, "the determination that a type of transaction is a tax avoidance transaction shall be based upon a finding by the commissioner that (1) the transaction is not done for a valid business purpose, that is, one or more business purposes, other than obtaining tax benefits, that alone or in combination constitute the primary motivation for the transaction; (2) the transaction does not have economic substance apart from its tax benefits; or (3) the tax treatment of the transaction is based upon an elevation of form over substance." [21] Defining the concept of "tax avoidance" is a difficult problem, and it is unclear whether, if finalized, the definition proposed in these disclosure regulations might take on a broader significance. Plainly, however, it is useful to know what the Department is thinking in this important area, especially given that the standard as proposed appears very difficult to satisfy.

On the City front there are several other developments. First, the City has proposed a new definition of "partner." This definition is relevant under the unincorporated business tax ("UBT") in determining whether compensation paid to "contract partners" (and the like) is or is not deductible in calculating UBT taxable income.[22] The regulation responds to a series of cases,[23] and appears designed to quell the repeating controversies by adopting four more or less "bright line" tests of partner status. A related proposal clarifies that, if an amount paid to a third person is, in fact, paid as consideration for capital or services provided by a partner, the payment is nondeductible.[24]

The City also has proposed UBT regulations that address the manner in which taxpayers are to identify the portion of their "payroll" that is attributable to New York City,[25] a question relevant in apportioning the total income between the City and other jurisdictions.[26] This new UBT regulation is intended to conform the UBT rule to the existing general corporation tax ("GCT") rule.

Finally, the City has proposed an expanded definition of "manufacturing," under which "pre-production activities" can qualify a GCT or UBT taxpayer for the favorable City apportionment rules that allow for double-weighting of the receipts factor.[27] This proposed regulation responds to private sector concerns, particularly in the apparel industry, that their activities in connection with contract manufacturing were not, on audit, being respected as "manufacturing."

Conclusion

All of the proposed State and City regulations are currently open for comment, and careful readers may well identify areas in need of improvement. Now is the time to communicate those observations to the draftsmen, and to encourage the promulgation of further regulatory guidance.

Taxpayers by no means uniformly agree with tax regulations, and we are particularly mindful of the adage to be careful what one asks for. That said, knowing where one stands, and knowing that the playing field is level, can be profoundly important to taxpayers and their advisors. Good regulations are essential to good tax administration. It will be exciting if, with a new administration heading to Albany, there is a reinvigoration of government/private sector dialog that produces sound guidance for New York taxpayers.

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1 Executive Order No. 2, January 5, 1995.
2 Press Release of January 5, 1995, www.ny.gov/governor/press/older_years/regmor.htm.
3 NYSBA Tax Section Report #825, Feb. 6, 1995.
4 See, *e.g.*, Temp. Treas. Reg. §1.469-4T, promulgated T.D. 8253, May 11, 1989 (38 pages defining "activity"); replaced by Treas. Reg. §1.469-4, promulgated T.D. 8565, October 3, 1994 (3-1/2 pages on the same subject).
5 While an oversimplification, this article from time to time groups the varieties of deferred compensation for which allocation may be necessary under the phrase "option income."
6 *Matter of Michaelson v. N.Y.S. Tax Comm.*, 67 NY2d 579 (1986).
7 TSB-M-95(3)I, issued November 21, 1995.
8 *E. Randall Stuckless and Jennifer Olson*, DTA No. 819319, July 8, 2004 (ALJ).
9 *Stuckless*, May 12, 2005 (Tax Appeals Tribunal) ("*Stuckless I*").
10 New York State Budget Bill for 2006-07 state fiscal year, Part QQ.
11 L. 2006, Ch. 62, adding Tax Law §§631(g) and 638(c).
12 *Stuckless*, Aug. 17, 2006, withdrawing Stuckless I ("*Stuckless II*").
13 NYCRR §132.24.
14 *Stuckless II*.
15 Prop. NYCRR §§132.24, 132.25 and 154.6, proposed October 10, 2006.
16 TSB-M-06(7)I.
17 See NYS Dept. of Tax'n and Fin. Press Release of October 20, 2006, announcing Commissioner Eristoff's resignation effective November 3, 2006. (Commissioner Eristoff also served as New York City Finance Commissioner from 1999-2002.) Barbara G. Billet has been named Acting New York State Commissioner.
18 Amendments to NYCRR §§1-2.6 and Parts 3 and 4, adopted October 17, 2006, and providing guidance under New York State's Article 9-A.
19 Prop. NYCRR Part 2500, §§2500.1 *et seq*, promulgated under N.Y. Tax Law §25, enacted L. 2005, ch. 61, to expire and be deemed repealed July 1, 2007.
20 Treas. Reg. §1.6011-4.
21 Prop. NYCRR §2500.3(b).
22 Prop. Rule §28-06(d)(1)(iv).
23 *Buchbinder Tunick & Co. v. Tax App. Tribunal of NYC*, 292 AD2d 217 (1st Dept. March 12, 2002); *Ladas & Parry*, TAT(E) 98-19(UB) (Jan. 2003); *Proskauer Rose LLP*, TAT(H) 01-19(UB) (July 11, 2006); and *Citron Cooperman & Co. LLP*, TAT(H) 01-17(UB) (July 21, 2006).
24 Prop. Rule §28-06(d)(1)(i)(B). The example given (Example f) is a payment to the former spouse of partner A of an amount to which A is otherwise entitled.
25 Prop. Rule §28-07(d)(1)(ii)(C).
26 See NYC Admin. Code §11-508(c).
27 Prop. Rule §§28-07(d)(2)(ii)(A)(8) and (d)(2)(iv), Example 14 (under the UBT); Prop. Rule §§11-63(c)(4)(ii)(A)(8) and (c)(4)(v), Example 14 (under the GCT). To qualify, pre-production activities must be "extensive and constitute an integral part of the manufacturing process." *Id*.