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Cleaning Up the Act: October Amendments Clarify May Tax Law

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In its haste to cure the state's financial woes, the New York Legislature passed a tax bill—over Governor George E. Pataki's veto—containing a number of inequities and ambiguities, including many affecting real estate. On October 21, Mr. Pataki signed legislation making important technical changes to some of the state and New York City tax laws enacted in May thereby ameliorating a number of the problems. While the October legislation cleaned up the May act, the primary provisions adopted this spring remain in effect and are important to understand in order to plan appropriately.

The May legislation imposed new obligations on partnerships, S corporations and other pass-through entities to make quarterly payments of estimated taxes in respect of their nonresident individual partners and shareholders and their C corporation partners or shareholders. The effect of these rules was to require payments that in many cases bore no relationship to the affected shareholders' and partners' actual tax liabilities.

Since partnerships and limited liability companies are the entities of choice for most real estate, this legislation has a far reaching effect on the real estate community. Many real estate partnerships are set up such that after inception the limited partners have no further obligation to contribute funds to the partnership. When these entities face the all too familiar situation of taxable income without matching amounts of cash flow (for example, when cash flow is used to pay debt amortization), the May legislation may put them in an impossible situation.

Moreover, the provisions clearly discriminated against nonresident owners (i.e., shareholders and partners), requiring estimated payments to be computed at the highest rates possible without any deductions, and to be paid by the entity in which the nonresident owns an interest. This prompted Roberts & Holland to file a lawsuit challenging the statute on constitutional grounds.

New Waiver System

The October legislation introduces a new waiver system that will alleviate several constitutional and practical problems with the May legislation. Under this system, entity payments of quarterly estimated taxes are not required if the Commissioner has issued a "waiver of withholding." The statute provides:

> The Commissioner may issue such waivers in respect of partners, members or shareholders who are not subject to New York income tax, or who establish that they are filing New York income tax returns and paying estimated taxes when due, and in other circumstances in which the Commissioner determines that withholding is not necessary to ensure collection of income tax on New York source income allocable to the nonresident or C corporation.

The New York Department of Taxation recently issued a notice implementing the waiver system enacted by the October legislation. As explained in the notice, the department has promulgated certification forms, which shareholders and partners will deliver to their entities to attest that the owner is in compliance with its New York filing responsibilities.

Entities are entitled to rely on such owner certifications for the last payment due for year 2003 and the payments due for tax years 2004 and 2005 and will not have to pay estimated tax in respect of certifying owners. Corporate partners should provide the entity with exemption Form CT-2658-E and nonresident individual partners and shareholders should provide the entity with exemption Form IT-2658-E. Both forms are available at www.tax.state.ny.us/default.htm.

The notice also details the procedure owners must follow to ensure credit of any estimated taxes paid on their behalf by a pass-through entity for the Sept. 15, 2003, payment. Partners or shareholders must claim those credits when they file their New York income tax returns; no refunds will be issued prior to that time.

Under the new law, publicly traded partnerships (as defined in the Internal Revenue Code) are now exempt from

making any estimated tax payment on behalf of their partners who are C corporations or nonresident individuals.

The new waiver system is a considerable improvement over the May legislation, for several reasons. The many corporate and nonresident owners who have been in compliance with their New York tax obligations are now exempt from the entity estimated tax regime. In allowing owners to preempt the entity's estimated tax obligations through their own compliance with New York's tax laws, the new legislation returns nonresidents to an even footing with residents. By paying estimated taxes directly, as they have always been required to do, nonresidents can continue to pay on the same basis as residents. Their only additional burden is to advise their entities that they are in compliance—a minimal burden that should prompt no real objections.

Because the October amendments, as implemented through the Department's waiver system, now appear to provide a simple mechanism for nonresidents to achieve parity with residents in their payments of estimated taxes, Roberts & Holland has withdrawn its constitutional challenge to the May legislation. Fortunately, the legislature corrected the situation promptly, eliminating the unpleasant prospect of unscrambling years of unconstitutional collections.

Under the new system, there will certainly remain circumstances in which nonresident or C corporation owners will fail to certify their compliance, or will fail to comply with their New York tax responsibilities, preferring instead that their entities pay their New York taxes for them. Where the entity would otherwise be making cash distributions at least as great as the New York estimated taxes, these noncompliant owners will not impose a true financial burden on the entity. However, in cases where the obligation to pay owners' taxes requires the entity to pay out funds it otherwise would not, then the estimated tax obligation will continue to represent a real cost, and a new financial burden, for New York businesses. Clearly, this burden is greatly reduced by the new certification process, but ultimately pass-through entities doing business in New York will need to recognize that nonresident and C corporation owners represent a potential financial cost to the business (which may not have the funds to make the required payments), and will need to plan accordingly.

Interest Deductions

In an attempt to curtail businesses' increasing creativity in reducing state taxes by transferring taxable income to low-tax jurisdictions, the May legislation disallowed deductions for royalties and interest paid to affiliates. "Affiliates" were defined as persons 30 percent or more commonly owned. Limited exceptions were provided for transactions that had a "valid business purpose" other than the reduction or avoidance of tax.

However, the May legislation also included a "rebuttable presumption" that any transaction would be treated as entered into for tax avoidance purposes if it involved payments by a New York taxpayer that were not reportable as income to New York state by the recipient.

It was soon recognized that the May legislation potentially affected far more business transactions than was intended. For example, under this rule, if an out-of-state corporation were to form a subsidiary to own its New York headquarters and were to capitalize that subsidiary with a combination of debt and equity, the new provision would disallow the interest deductions of the New York subsidiary.

With the October legislation, the disallowance of deductions for intercompany royalty expenses remains with some modifications, but the disallowance of interest has now been confined to interest incurred in connection with licenses, trademarks, copyrights, and other intangible assets. Interest unconnected to transactions involving royalty-producing intangibles is no longer subject to the disallowance regime. As a result, this disallowance should not generally affect real estate ownership.

Nonresidents' Sales

The May legislation imposed new estimated taxes on sales of fee simple interests of New York real property by nonresident individual taxpayers (as well as nonresident estates and trusts).

As originally enacted, the statute provided 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 would 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.

This gave rise to a very cumbersome system under which nonresident sellers had to pay estimated tax at or prior to the closing. Alternatively, the person recording the deed (the buyer) had to stop at the offices of the Department of Taxation and Finance and tender payment of the (seller's) estimated taxes, in order to properly record the deed.

The new legislation replaces this burdensome procedure with a new rule that (as implemented by newly issued regulations) empowers the state recording officers to collect these estimated taxes (in the form of a payment payable to the Department of Taxation and Finance). Payment of nonresidents' estimated income taxes can thus now be made at the recording office in a manner similar to the payment of transfer taxes on the sale of a fee interest.

The statute continues to exempt nonresident sellers from this procedure where (i) the real property transferred is a principal residence (for example, if a New Yorker moves out of state and sells his home shortly thereafter); (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.

While the October legislation clearly provides a much simpler and more workable mechanism for paying nonresidents' estimated taxes on real

property sales, there remain questions about the constitutionality of the manner in which nonresidents are required to calculate the estimated taxes due.

By applying the highest rate of tax to the gain from one particular sale, without regard to either the lower brackets applicable to smaller amounts of gain or the deductions nonresidents are entitled to claim, and by requiring nonresidents to pay their income taxes months earlier than residents do, there remains a discriminatory element in this new law.

Time will tell whether these burdens are sufficient to generate any real threat to the constitutional validity of the new provisions. At least the rules no longer operate in a manner that imposes highly unusual practical burdens on nonresidents' property sales.

Conclusion

Although there remains much to be worked out with respect to the May legislation, the October amendments and the department's implementation thereof have addressed the most important issues and displayed a practical spirit boding well for the future.

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