*R & H Letter to Clients & Friends* *November 10, 2003*

# Recent Developments in State and Local Taxation

There have been a variety of important developments in state and local taxation recently, and we want to take this opportunity to provide you with an update and overview.

## 1. New York Technical Corrections Legislation

On October 21, 2003, Governor Pataki signed legislation making important technical changes to certain State and City tax laws enacted in May of 2003.[1] Although technical changes to tax statutes are not common in New York, let alone so promptly enacted, in this case considerable pressure from the private sector and a welcome openness on the part of the Legislature combined to ameliorate a number of problems that arose as a consequence of last May's tax legislation.

### *A. Relief from Payment of Estimated Tax by Pass-Through Entities*

As we explained in earlier letters describing the May legislation and our lawsuit challenging the constitutionality of these new provisions, last spring's amendments to New York's tax law imposed new obligations on partnerships, S corporations and other pass-through entities (collectively "entities") to make quarterly payments of estimated income taxes in respect of their nonresident individual and C corporation partners or shareholders (collectively "owners").[2] The effect of these new rules was to require payments that in many cases bore no relationship to the affected owners' actual New York State tax liabilities. The estimated tax rules imposed real and significant burdens on New York businesses, which were required to use their own funds -- or even to borrow if they did not have funds -- in order to pay income taxes for nonresidents and C corporations. Moreover, in the case of nonresident owners, the new law imposed a clearly discriminatory tax regime. It was the unconstitutional discrimination against nonresidents that prompted Roberts & Holland LLP to file a lawsuit challenging the new statute on constitutional grounds.

The October legislation introduces a new waiver system that will alleviate many of these problems.[3] Under this system, entity payments of quarterly estimated taxes are not

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[1] Chapter 686, Laws of 2003 (S.5725), which amends Chapters 62 and 63 of the Laws of 2003 (S.1406-B/A.2106-B, and S.4968/A.8388, respectively).

[2] Tax Law §658(c)(4).

[3] Ch. 686, Part DD, amending Tax Law §658(c)(4).

required if the Commissioner has issued a "waiver of withholding." "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 [i.e., the payment of estimated tax] is not necessary to ensure collection of income tax on New York source income allocable to the nonresident or C corporation."[4]

We met with representatives of the Department of Taxation and Finance while the technical corrections legislation was pending, to discuss how the Department will implement this new waiver authority. The Department is now in the process of promulgating certification forms, which owners will deliver to their entities to attest that the owner is in compliance with his, her or its New York filing responsibilities (or, in the case of corporations, that the owner is a tax-exempt entity). See CT-2658-E and IT-2658-E, and the Department's Important Notice explaining the October amendments. Entities will be entitled to rely on such owner certifications, for a multi-year period, and will not have to pay estimated tax in respect of certifying owners.

The Department has stated that the new waiver system will be available for payments otherwise due on January 15, 2004 (or which otherwise would be made for corporate owners on December 15, 2003). However, since the waiver system did not exist when the first estimated tax payments came due on September 15, 2003, it appears that payments made by entities on that date cannot be recouped by the entity, but instead will be applied to the tax obligations of, and in many cases refunded to, the owners on whose behalf the September estimated taxes were paid.

The new waiver system is a considerable improvement over the May legislation, for several reasons. It eliminates from the entity estimated tax regime the many corporate and nonresident owners who have been in compliance with their New York tax obligations, and for whom the May legislation effectively imposed new tax burdens. In allowing owners to trump the entity's estimated tax obligations through their own compliance with New York's tax laws, the new legislation also 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, we have decided to withdraw our constitutional challenge to the May legislation. We are pleased that this situation was corrected so promptly; the prospect of unscrambling several years of unconstitutional collections of estimated taxes threatened considerable confusion.

The new law also gives the Commissioner discretion to waive entity estimated tax obligations in circumstances where the entity's payment is not considered necessary to the collection of New York taxes. It remains to be seen how this discretion will be exercised. This

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4 Ch. 686, amending Tax Law §658(c)(4)(D)(ii).

authority does, however, offer a potential path for resolving cases in which it is not appropriate to penalize the entity for the noncompliance of its owners.

In the end, there will certainly remain circumstances in which nonresident or C corporation owners will fail to certify their compliance, and 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 should 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 Tax Law §658(c)(4) 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, and will need to plan accordingly.

The October amendment also clarifies that "publicly traded partnerships," as defined in Internal Revenue Code §7704 ("PTPs"), are not subject to the estimated tax payment obligations at all. Definitionally, this carves all PTPs out of the estimated tax rules, whether or not the PTP is in fact taxable as a corporation under federal income tax law.[5] The exclusion of all PTPs seems appropriate, given the difficulty such entities would encounter in identifying nonresidents and C corporations on a sufficiently timely basis to allow them to comply with New York's quarterly estimated tax payment requirements. This amendment is retroactive to the enactment of the original May legislation.

### *B. May's Anti-Abuse Measures Have Been Partially Repealed*

In an attempt to curtail business' 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% 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 other taxpayers."[6]

It was soon recognized that the May legislation potentially affected far more business transactions than was intended. Ordinary intercompany financing among multi-state affiliates suddenly became burdened with the risk that New York would disallow legitimate business expenses, or at the very least subject each such transaction to the heavy burden of proving a lack of a tax avoidance motive. The adverse effects on New York's financial services sector were immediately apparent, although in fact the broad scope of the May legislation had

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[5] Certain PTPs are not taxed as corporations, notwithstanding their publicly traded status, if they satisfy a 90% passive income test. See IRC §7704(c).

[6] See, e.g., Tax Law §208(9)(o), as enacted by S.1406-B, and amended by Ch. 686, Part M. See also Tax Law §§612(r), 1453(r), 1503(b)(14), 292(a)(6) and NYC Admin. Code §§11-506, 11-602, 11-641, 11-1712.

the potential to increase New York taxes on a very wide variety of multi-state businesses operating in numerous sectors of the economy.

With the October legislation, the disallowance of deductions for intercompany royalty expenses remains, and in a sense has been strengthened, but the disallowance of interest has now been confined to interest incurred in connection with the acquisition, use, etc. of licenses, trademarks, copyrights, and other intangible assets. Interest unconnected to transactions involving royalty-producing intangibles is no longer subject to the disallowance regime.

In addition, the definition of "valid business purpose" has been revised to eliminate the rebuttable presumption previously attached to payments to non-New Yorkers. Instead, exceptions to the disallowance of deductions for royalties and related interest paid to affiliates are now provided for two types of situations: (1) arm's-length transactions with a valid business purpose that ultimately involve payments to third-party licensors; and (2) royalties paid to foreign affiliates subject to a comprehensive tax treaty with the U.S. and subject to home-country taxation at rates not less than New York State's.

In addition, the affiliation test has been refined to refer to ownership or control (an interesting notion) of 30% or more of the voting stock (or of the capital, profits or beneficial interest in voting stock) of corporations, or of 30% or more of the capital, profits or beneficial interest in a partnership, association, trust or other entity.

### *C. There are New Procedures for Nonresidents' Real Property Sales*

The May legislation inaugurated a new requirement that nonresidents pay estimated taxes at the time they sell any fee interest in real property. This rule applied, with certain limited exceptions, to sales after September 1, 2003, made by nonresident individuals, estates and trusts.

As originally enacted, the new estimated tax provision prohibited a recording officer from accepting any deed for recording without either a certification from the transferor that the estimated tax rule was inapplicable, or a certification from the Commissioner that the tax had been paid.[7] This gave rise to a very cumbersome system under which nonresident sellers had to pay estimated tax at or prior to the closing, or else the person recording the deed had to first stop at the offices of the Department of Taxation and Finance and tender payment of the estimated taxes, in order to receive the certification that the recorder's office would need to record the deed.

The new legislation[8] replaces this burdensome procedure with a new rule that permits the county (or City) recorder to record a deed where accompanied by the prescribed estimated tax form and payment of the estimated taxes reported as due, or where the transferor certifies that the estimated tax rules are inapplicable. Payment of nonresidents' estimated income

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[7] Tax Law §663.

[8] Ch. 686, Part P.

taxes can thus now be made in a manner similar to the payment of transfer taxes on the sale of a fee interest. This change was made retroactive to the original enactment of the estimated tax rule, although obviously recorders' offices were not following this procedure prior to the October legislation.

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.

*D.* *Use Tax Reporting on Income Tax Returns*

The May legislation directed that New York's Personal Income Tax returns and other forms be amended to insert a line for reporting unpaid "compensating use tax." The idea was to provide individual taxpayers with both a reminder and an easy means of reporting use tax due on items purchased outside New York, or purchased from mail order or internet vendors who did not collect and remit sales taxes.

In implementing this directive the Department reportedly found it awkward to address only the use tax, particularly as many people have no idea the use tax exists, or how it applies. Apparently in response to that concern, the October legislation now expands the directive to require the addition of new lines on PIT and other forms "to report unpaid sales and compensating use tax . . . ."[9]

This change arguably adds a new dimension to the new reporting requirement, potentially requiring not only that consumers report unpaid use tax, but also that vendors report unpaid sales taxes, as part of their income tax returns. What that really means for New York filers remains to be seen, but clearly tax return preparers must now solicit information necessary to complete the new line item, and taxpayers must think more thoroughly about the sales and use taxes they owe to New York, but have failed to pay.

*E.* *Technical Changes to Depreciation "Decoupling"*

In decoupling New York's depreciation from the federal "bonus" depreciation rules, the May amendments to the personal income tax inadvertently were reversed, with the result that the prescribed subtractions and additions made no sense. As now corrected, Tax Law §612(b)(8) requires individuals to add back to their federal taxable income the amount of federal depreciation allowed for property outside the "Liberty" and "Resurgence" Zones placed in

[9] Ch. 686, Part V.

service on or after June 1, 2003. Tax Law §612(c)(16) then provides for a depreciation deduction calculated under the standard depreciation rules in Internal Revenue Code §167(k).[10] Tax Law §612(l) was also amended to clarify that taxable gain or loss on a disposition of affected property is computed by making modifications to the gain or loss included in federal adjusted income, not to that included in New York's entire net income.

## 2. Changes in State Taxation of S Corporations

When New York State extended pass-through status to electing S corporations in 1990 it did so under a regime that preserved the higher corporate rate of tax on S corporation income by imposing a "sliver" or "pick-up" tax on S corporations' entire net income allocable to New York. Initially this tax was essentially imposed at a rate equal to the excess of (i) the rate of corporate tax on allocated entire net income ("ENI"), over (ii) the highest rate of Personal Income Tax (this component being referred to as the "Article 22 tax equivalent").[11] As the highest PIT rate was reduced during the late 1990's, however, the Article 22 tax equivalent was pegged at earlier, higher PIT tax rates, allowing S corporation shareholders to enjoy the diminishing PIT rates rather than lose the PIT rate reductions to a higher S corporation sliver tax.[12] Ultimately, the Tax Law specified a variety of different Article 22 tax equivalent amounts, with the rate set to take effect June 30, 2003, being 7.1425%, as compared to the then-highest PIT rate of 6.85%.[13]

In the May, 2003 legislation, the PIT rate was reset, effective for tax years beginning in 2003, at 7.7%. The corporate tax rate on ENI was unchanged, remaining at a maximum 7.5%. With this inversion of the rate structures the premise of the sliver tax became moot -- PIT taxpayers paid tax at a higher rate than corporations, so there was no slippage in revenues caused by elections of S corporations status, and no need for the additional S corporation tax based on the rate differential.

A Technical Services Bureau Memorandum dated October 20, 2003 has helped to clarify an interesting aspect of the May legislation.[14] The May legislation did not simply moot the S corporation sliver tax by raising PIT rates above corporate rates -- it actually repealed the sliver tax for tax years beginning in 2003, 2004 and 2005, leaving only the payroll-based minimum tax for such years.[15] Barring further legislation, the S corporation sliver tax on allocated ENI will be reimposed for corporate tax years beginning after 2005; but of course further amendments to both the PIT and the corporate tax rates remain a distinct possibility.

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10 Ch. 686, Part L.

11 Tax Law §210(1)(g), enacted as part of Ch. 190, Laws of 1990. A minimum tax also applied, based on payroll.

12 See Tax Law §210(1)(g)(2), enacted in 1996.

13 Tax Law §210(1)(g)(2), as amended in 1998 and 2000.

14 TSB-M-03(5)C.

15 Ch. 62, Laws 2003, part Y3, §5, amending Tax Law §210(1)(g)(1).

## 3. New York City Amnesty is Underway

The May legislation authorized a New York City amnesty for a variety of business taxes. The amnesty program took effect on October 20, 2003, and will run through January 23, 2004. Amnesty is available for a wide variety of New York City taxes, but is not available for the real property tax, the City resident income tax, or sales and use tax (the PIT and sales/use taxes having been included in the State amnesty implemented a year ago). Amnesty is available for tax years or periods ending on or before December 31, 2001 (May 31, 2001, in the case of commercial rent or occupancy tax).

Qualification for the City amnesty entitles taxpayers to relief from penalties, and to forgiveness of interest accruing for periods more than three years ago. Various aspects of the amnesty program are discussed in Department of Finance proposed regulations, and in Question and Answer bulletins, most recently updated on October 20, 2003.

One peculiar feature of the City's amnesty program is that it is not available to taxpayers who had audits pending on March 10, 2003. The City's published guidance details the conditions for determining whether a City audit was pending on that date. If an audit had not yet commenced, or had already been concluded (for example by the issuance of a Notice of Determination), then amnesty will be available. For cases pending in the City Tax Appeals Tribunal, all proceedings for the tax(es) or periods for which amnesty is requested must be withdrawn or discontinued in order to be eligible for amnesty.

These rather onerous conditions to amnesty qualification will prove to be considerable barriers to the prompt resolution of pending City tax matters, and work at cross-purposes to the City's stated goal of monetizing its receivables backlog to concentrate fresh efforts on current enforcement. As the three-month amnesty period unfolds it will be interesting to see whether informal resolutions of pending audits on a basis comparable to amnesty's penalty and interest relief are attainable. At this point, however, all indications are that the City is interpreting these amnesty restrictions rather narrowly.

## 4. IRS and States Announce Tax Shelter Audit Initiatives

In September, the Commissioner of the Internal Revenue Service announced[16] an IRS agreement with forty states[17] and the District of Columbia to forge a "new nationwide partnership to combat abusive tax avoidance." Specifically, the IRS has executed a "Memorandum of Understanding" with these jurisdictions which is targeted specifically at the cooperative identification and auditing of "abusive tax avoidance transactions." The participating governmental agencies have said they anticipate "greater cooperation in sharing leads in the area of abusive tax transactions," as well as "joint outreach activities to the public to more effectively counter the claims of those marketing tax schemes and scams."

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[16] IR-2003-111, September 16, 2003.

[17] The participating states include New York, New Jersey, Connecticut, Pennsylvania, Massachusetts, California and Florida.

In addition to this new federal/state effort, California recently struck out on its own against tax shelters, enacting legislation imposing significant new disclosure rules, fines and penalties in respect of tax shelter activity engaged in by California taxpayers. These changes[18] are modeled after recently proposed federal legislation, but have been implemented in advance of federal action.

These new initiatives serve to reinforce the message that transactions perceived as "tax shelters" are clearly in the crosshairs, throughout the country. Dwindling state revenues, federal deficits, and the perception that illegitimate tax planning is rampant at every level will no doubt continue to drive federal, state *and* local audit and enforcement activity in the direction of finding and challenging tax-motivated transactions.

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If you have any questions or comments on the subjects addressed in this memorandum, or state and local tax issues generally, please feel free to contact Carolyn Joy Lee (212-903-8719) or Joseph Lipari (212-903-8765).

[18] CA AB 1601 and SB 614.