NY Tax Minutes: July

By **Timothy Noonan and K. Craig Reilly** (July 31, 2018, 2:13 PM EDT)

Life moves fast in New York. So do taxes. New York state (and City) tax a lot of people, places and things. The state and city's audit divisions and administrative appeal tribunals are both among the most active in the country. So how, you're asking yourself, do I possibly keep up with all the headlines, rulings, opinions and law changes happening across the Empire State? Well, you've come to the right place.

Timothy Noonan

Once a month, your authors, two practicing tax ~~attorneys~~ nerds with ties all over the state (Tim was born and raised in Buffalo; Craig grew up on the shores of the St. Lawrence River, before moving to New York City) will give you a full update on everything New York tax. But we'll also deliver the news in a way that's made for life in New York: fast.

Craig Reilly

So, without further fanfare, we give you the first installment of "New York Tax Minutes." This month, we cover New York state's deafening silence on the Wayfair ruling and the state's pending lawsuit against the federal government over the recently enacted state and local tax deduction cap. We also highlight two recent New York state and city publications addressing some complicated apportionment issues surrounding hedge fund manager compensation.

The Headlines

New York Remains Silent on Impact of Wayfair Ruling

On June 21, 2018, the U.S. Supreme Court sent shockwaves through the internet — and the state and local tax community — by issuing its long~~-awaited~~ overdue decision in South Dakota v. Wayfair Inc.[1] and resoundingly overturning the Quill Corp. v. North Dakota[2] physical-presence nexus standard that had been the law of the land for sales tax purposes over the past several decades.

This. Was. Huge. News. And not just with the state and local tax community. Unless you're a Luddite who refuses to buy or sell anything online, this decision is going to affect you.

In a 5-4 decision written by Justice Anthony Kennedy, the court ruled that the "physical presence rule [has] become further removed from economic reality" with every passing year. In the view of a majority the court, the growth of e-commerce and internet sales has made Quill unworkable and unreliable as precedent; so the court took the somewhat unusual step of overturning not one but two of its prior decisions on the issue of constitutional nexus (Quill and a 1967 case called Bellas Hess). And once it disposed of Quill, the court remanded the case back to the lower courts for a final determination on whether South Dakota's new nexus standard discriminates against or unduly burdens interstate commerce in violation of the dormant commerce clause.

And what does South Dakota's new law provide? The law requires a seller to collect and remit the South Dakota sales tax if it: (i) delivers more than $100,000 of goods and services into South Dakota, or (ii) engages in 200 or more transactions for the delivery of goods and services into South Dakota. The Supreme Court held that these limitations — along with prospective-only applicability and South Dakota's participation in the multistate Streamlined Sales and Use Tax Agreement — appears to have been "designed to prevent discrimination against or undue burdens upon interstate commerce." So, even though the case was remanded to the lower courts, a majority of the Supreme Court is sending signals that South Dakota's new law seems A-OK.

We expect state tax department officials and legislators across the country to be copying and pasting South Dakota's laws onto their books as fast as they can hit "Ctrl+C" and "Ctrl+V." In fact, many states have already jumped on the bandwagon and proposed or passed similar provisions. As of now, however, New York remains silent, as the New York State Department of Taxation and Finance has declined to comment on the Wayfair decision, saying only it is under review.

It's worth noting that New York already has a law on its books that could possibly give the department the right to impose tax collection and payment requirements on out-of-state vendors without a physical presence in the state. New York tax law Section 1101(b)(8)(i)(E) treats any person who "regularly or systematically solicits business in this state" as a vendor required to collect tax, so long as "such solicitation satisfies the nexus requirement of the United States constitution."[3] After Wayfair, it's possible that certain solicitation would qualify as constitutional even without an in-state physical presence. Despite this general provision in the law, we expect to hear more from New York on this issue soon. We'll keep you posted.

New York Joins Suit Against Federal Government Regarding SALT Cap Deduction

On July 17, 2018, four states — New York, Connecticut, New Jersey and Maryland — banded together and filed a complaint in the U.S. District Court for the Southern District of New York against the federal government arguing that the state and local tax, or SALT, deduction cap that was passed as part of the federal Tax Cuts and Jobs Act is unconstitutional and should be blocked from enforcement.

The lawsuit argues the SALT cap was enacted to target New York and similarly situated states, that it interferes with states' rights to make their own fiscal decisions and that it disproportionately harms taxpayers in those states. New York state Gov. Andrew Cuomo said in a press call that the cap violates the 10th Amendment (which reserves general powers to the states), the 16th Amendment (which empowers Congress to levy an income tax) and Article 1, Section 8 of the U.S. Constitution (which describes the powers of Congress). He further noted, "the federal government is hell-bent on using New York as a piggy bank to pay for corporate tax cuts."

Taxpayers had before this year enjoyed an unlimited federal deduction for state and local taxes (limited only by the alternative minimum tax, or AMT). But under the new SALT cap, individuals and married taxpayers filing jointly who itemize deductions may deduct only up to $10,000 annually for state and local income, property and sales taxes.

Dollar-wise, the loss of the SALT deduction is no small matter. With less deductions, taxpayers pay more taxes. The SALT cap is estimated to increase New Yorkers' federal taxes by $14.3 billion in 2018 alone and an additional $121 billion between 2019 and 2025.

Skeptics are already questioning the validity of the constitutional claims in the states' suit and doubting whether courts will accept the challenge. Tax Foundation Executive Vice President Joseph Bishop-Henchman, for example, found the lawsuit's three constitutional claims unconvincing and has noted, "high-tax states likely wanted to reassure high-income residents that they are attempting to prevent higher tax bills under the SALT deduction cap." We, too, are all for state-level officials fighting for their residents but aren't expecting to be able to deduct our full state taxes any time soon. Have the states considered lowering their own rates to offset the additional federal taxes?

Other Guidance: Hedge Fund Compensation

Although nonbinding in nature, both the New York State Department of Taxation and Finance and the New York City Department of Finance issue technical memoranda to assist taxpayers and tax practitioners in completing tax returns and preparing for audits. This month, the New York City Department of Finance issued a long-awaited overdue memorandum explaining the recognition and allocation of deferred income from nonqualified deferred compensation plans.[4]

Just to recap the issue: In 2008, Congress eliminated a common mechanism used by cash basis hedge fund managers to defer the receipt and recognition of certain incentive or management fees. Under Internal Revenue Code Section 457A,[5] which was effective for fees earned for services rendered on or after Jan. 1, 2009, hedge fund managers were limited in their ability to defer those fees. Before Section 457A, the management company was able to defer the receipt and recognition of the incentive or management fees (per the deferral agreements) that were charged to offshore funds. Those fees were able to appreciate, tax-deferred, for up to 10 years. Because the management companies taking advantage of the benefit were cash-basis taxpayers, the management companies, and therefore their owners, did not have to recognize the deferred fees until they were received. But under the new rules, the ability to defer fees earned after Jan. 1, 2009, was limited; and any fees earned and deferred before Jan. 1, 2009, would have to be recognized for tax purposes by the end of 2017. As 2017 approached, many wondered what states (and cities) would do.

In April 2018, the New York State Tax Department issued a Technical Memorandum addressing the issue[6] and on June 28, 2018, the New York City Department of Finance followed suit, issuing a Finance Memorandum, entitled "Recognition and Allocation of Deferred Income from a Non-Qualified Deferred Compensation Plan."

Here are some highlights of what the state tax department memorandum asks of taxpayers:

- Nonresident employees are to allocate the deferrals (including appreciation on the deferrals) based on New York work days/total work days for each year services were performed. 20 NYCRR § 132.18 is cited. These allocations have to be done year-by-year for each year in which deferred fees were earned and then separately flowed up to the 2017 return. And here's a funny quote from the memo: "Taxpayers must maintain documentation to substantiate the allocation." This would have been really helpful information to have FIFTEEN YEARS AGO! Or at least maybe sometime last year when taxpayers were preparing estimated taxes?

- Proprietorships and partnerships with nonresident owners also use a year of performance approach but use a books and records method or the three-factor business allocation percentage from the year of performance to determine the source and then flow it up to the 2017 return.

- Part-year residents use a “time of receipt” approach to determine whether they are paying tax on everything as a resident or on New York source income as a nonresident.

- C corporations and nonresident shareholders of S corporations do NOT use the year of performance, but instead, use a year of receipt (i.e., 2017) apportionment percentage to source income to New York. All of the deferred income (including the appreciation) is included in the tax base as business income. We interpret a particularly confusing passage to require that nonresident S-corp owners who are also employees use the employee approach for employee compensation and the apportionment percentage for flow-through deferred comp.

The city’s guidance explains how taxpayers should report this deferred income under the city’s entity-level tax regimes (primarily under New York City’s unincorporated business tax, or UBT, but also under the city’s business corporation tax and general corporation tax). The main takeaways (from a very detailed memo) are:

- Taxpayers must recognize the full amount of their deferred income as compensation for services in the same tax year that they recognize the income for federal income tax purposes;

- Taxpayers must use the law and rules that apply in the year of recognition to compute their business allocation percentage, or BAP; and

- Taxpayers’ activities that generated the right to its deferred income determine their connection to the city and place of performance for purposes of the payroll and gross income factors attributable to that income in their BAP.

In plain English, this means taxpayers have been instructed to treat deferred compensation as taxable business income and to use the allocation factors and rules that apply in the year of recognition (for tax year 2017, the UBT allocation factors include 93 percent sales, 3.5 percent property and 3.5 percent payroll) but use the facts and places of performance that existed in the year(s) the income was earned — i.e., current apportionment rules with historic apportionment factors.

The Department of Finance also notes at several points in its memo that it may need to use its “discretion” in certain cases to compute an equitable BAP and includes three helpful examples of actual UBT calculations to assist taxpayers in understanding the city’s position.

Both the state and city publications, however, should be taken with a grain of salt. Because legislation and regulation remain absent, many taxpayers may take the position that this memorandum is nonbinding and merely advisory in nature. We’ll save that argument for another day.

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firm. Noonan and Reilly are regular contributors to Tax Authority Law360.

[1] South Dakota v. Wayfair Inc., 138 S. Ct. 2080 (2018).

[2] Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

[3] N.Y. Tax Law § 1101 (b)(8)(i)(E).

[4] NYC Department of Finance, Finance Memorandum 18-6, "Recognition and Allocation of Deferred Income from a Non-Qualified Deferred Compensation Plan," June 29, 2018.

[5] 26 U.S.C.S. § 457A.

[6] TSB-M-18(2)C(3)I, "New York State Tax Treatment of Nonqualified Deferred Compensation," April 6, 2018.