Noonan's Notes on Tax Practice
State Tax Notes, Aug. 10, 2009, p. 401
53 State Tax Notes 401 (Aug. 10, 2009)

Tough Measures for Tough Times — New York's Budget Bill

by Timothy P. Noonan and Mark S. Klein

In April -- when the New York State Legislature was actually able to get things done -- the 2009-2010 budget bill was passed. Gov. David Paterson (D) signed it shortly thereafter. Many of the initial provisions contained in Paterson's original budget proposal in January 2009, and covered in this column in February,[1] were not put into law, but still some interesting provisions made it through. After public outcry against far-reaching attempts in the governor's proposed budget to tax sugary soft drinks, iTunes, and a whole range of personal services, the new budget eliminated many of those sales tax measures. But the new provisions still increased tax rates for higher-income earners and made other interesting changes. And to be sure, the recent changes will affect the lives of everyday New York tax practitioners. We'll examine a few of the more noteworthy ones.

Personal Income Tax Changes

Higher Rates

There has been a lot of talk in Congress about raising rates for higher-income taxpayers. In New York, however, there has been *action*. The controversial measure in the new law adds two new tax rates for the 2009-2011 tax years. For joint return filers earning more than $300,000 but less than $500,000, the highest tax rate is 7.85 percent. But more interestingly, for all filers who have income in excess of $500,000, the rate of tax is now 8.97 percent, one of the highest individual tax rates in the nation. And when you consider that many of those high-income taxpayers are living and working in New York City and subject to the city resident tax, rates for some New Yorkers could be close to 13 percent. And like many of the other changes made in April 2009, changes in those rates were made retroactive to January 1, 2009. Those changes, of course, won't have an immediate effect on ongoing or soon-to-be initiated personal income tax audits. But you can bet this will cause more New Yorkers to change -- or try to change -- their residency status, which should keep the flow of residency audits and issues constant over the next few years.

Itemized Deductions

New York has historically limited the use of itemized deductions by high-income taxpayers, limiting them to 50 percent of itemized deductions when income reaches a specific level. Now, however, the rules are even more difficult. For those taxpayers earning more than $1 million, itemized deductions completely go away. All that remains is that taxpayers will be permitted to deduct 50 percent of their charitable contributions. So now taxpayers earning more than $1 million will be forced to choose between deducting 50 percent of their charitable contributions and simply taking the standard deduction.

548-Day Rule

Under current law, a domiciliary of New York is not taxed as a resident if in any period of 548 consecutive days the taxpayer is in a foreign country for at least 450 days and the taxpayer, the taxpayer's spouse, and the taxpayer's minor child are not present in the state for more than 90 days within that 548-day period.[2] Under previous law, the taxpayer's spouse and minor children could not be present for more than 90 days *at the taxpayer's permanent place of abode*. The new law requires that, for the taxpayer to meet the 548-day test, they must not be present *anywhere* in New York state. That is somewhat of an obscure change and affects only a limited class of cases. Interestingly enough, we are involved in one of those cases in which a taxpayer's spouse fell over the 90-day requirement but nonetheless still should qualify

under the 548-day rule because she did not spend all of her time in New York at her permanent place of abode. Under the new law, that exception is no longer available.

Gains From the Sale of New York Property

This is a good one. Normally income, gain, loss, and so forth are not taxable to a nonresident if they result from the sale of an intangible, from the sale of a partnership interest, from the sale of stock, and so forth. That is basic personal income tax 101, and is underscored by constitutional principles setting forth the limits of nonresident state taxation.[3] Under those principles, a New York nonresident selling an interest in a partnership, limited liability company, or S corporation would not be subject to personal income tax even if the assets of the entity were located in New York. A nonresident of New York could therefore avoid personal income tax on the sale of New York real property by putting the property in the entity and selling the interest instead of selling the real property itself.

The new provision, set forth in Tax Law section 631(b)(1)(A)(1), amends the personal income tax to redefine the phrase "real property located in the state" to include an interest in a partnership, LLC, S corporation, or closely held C corporation owning real property in New York if the value of the real property exceeds 50 percent of the value of all assets in the entity. In other words, if a nonresident taxpayer is selling an LLC interest and the majority of the assets in the LLC consists of real property located in New York, the taxpayer would be unable to avoid personal income tax on the sale of the interest. There are special rules for allocating that gain,[4] but the more interesting question concerns whether this provision is itself constitutional. As noted above, generally under constitutional principles, states are prohibited from taxing nonresidents on income from intangibles. This provision toes the line and could be subject to constitutional attack. Also, this could raise double taxation concerns, since not many states would allow a resident credit for the taxes New York will now be getting on sales of intangibles like this.

New MTA Mobility Tax

Rather than further increasing the personal income tax or corporate taxes, new legislation imposes a payroll tax on employers who employ people located within the Metropolitan Commuter Transit District (MCTD), that is, in New York City and its surrounding areas. This is a tax of 0.34 percent on an employer's MCTD payroll expense, and cannot be passed through to employees -- it's a tax on the employer. Moreover, it will also apply to owners of flow-through entities to the extent of their self-employment income if it exceeds $10,000. Here again there is an allocation to the extent the earnings from self-employment are earned in the MCTD. But it essentially amounts to an additional income-based tax on self-employed individuals or members of flow-through entities. More details are available in a recent publication of the Department of Finance and Taxation.[5] Many practitioners will be affected by this provision, and not only because their clients may have the issue. This will be a direct tax on many practitioners who are partners or members of flow-through entities doing business in New York City. What a bummer.

Sales Tax Changes

Commercial Aircraft Exemption

For years, taxpayers acquiring airplanes were allowed to purchase the planes using a tax department-approved structure to avoid the payment of sales or use tax on the acquisition. That involved applying New York's "commercial aircraft" exemption, and it allowed a person or operating company to set up an LLC to acquire the plane and thereafter have that entity provide air transportation services to the operating company or person who initially set up the entity. That structure was approved in numerous advisory opinions.[6] Effective June 1, 2009, that exemption is no longer available. The budget legislation removes the exemption if the commercial aircraft is being used to transport agents or employees of affiliated entities.

Nonresident Use Tax Exemption

This is another provision designed to close a perceived loophole in the sales and use tax. Under current law, use tax can apply only to residents. For businesses, a resident is defined as any company that is doing business in New York. And

under existing case law, taxpayers could acquire high-value assets (boats, vehicles, and so on) through entities that were not doing business in New York and avoid application of New York's use tax.[7] Recent changes legislate that loophole out of existence, restricting availability of the nonresident use tax exemption for some businesses if the owner of the business or anyone affiliated with the business was a New York state resident when the asset was acquired. That provision also took effect on June 1, 2009.[8]

New Compliance Measures

Finally, a new spate of compliance measures were added to the tax law as part of the tax department's overall efforts to increase enforcement and give its enforcement people more tools and powers to properly enforce the tax law. Here are some highlights:

- Issues involving maintenance of adequate records have long been an issue in sales tax audits. New provisions enacted in 2009 permit the imposition of a penalty of $1,000 for the first quarter and $5,000 for each additional quarter against any person required to make or maintain sales tax records who fails to do so. That will be a severe penalty in future sales tax audits and will definitely rear its head in audit negotiations.
- Regarding sales tax refunds and credits, the amended law changes the "start date" for the application of interest. Under previous law, and consistent with personal income tax law, interest accrued from the date of overpayment even if the refund claim was filed later. Effective for claims filed on or after June 1, 2009, interest will run from the *date of claim*. And no interest is payable if the payment of the refund is made by the tax department within 90 days of the filing of the claim.
- Efforts to increase information sharing also have begun. Under the new law, motor vehicle insurance sellers, franchisers, and alcohol beverage wholesalers must submit informational reports to the tax department regarding the sales they make to, or transactions they have with, New York customers or persons. That may be only the beginning of the tax department's efforts to require different industries to share information about their transactions with New Yorkers. Big Brother, it seems, is still out there.
- With the advent of the tax department's special investigations unit, imposition of civil fraud penalties and fraud investigations has gone through the roof.[9] The new legislation makes that an even bigger issue, by increasing the fraud penalty from 50 percent of the deficiency to 200 percent of the deficiency that's the result of fraud. That's right, 200 percent! Keep in mind, of course, that in fraud cases, the tax department has the burden of proof. But still, the consequences to the taxpayer, if that burden is met, will be severe.
- Responsible officers under the withholding tax are now liable for interest on the penalty from the date the penalty is first imposed to the date the penalty is paid. This provision applies to tax years beginning on and after January 1, 2009.
- The commissioner can now share with the IRS tax returns and reports filed under the Voluntary Disclosure and Compliance Program. The actual disclosure will remain confidential.[10]
- The personal, corporate, and sales tax administrative provisions now carry new penalties for submission of a false or fraudulent document. There does not appear to be any requirement that the submission be one that is knowing or willful before the penalty may be imposed. Finally, any person aiding or assisting in the giving of fraudulent sales tax returns or other documents with the intent to evade tax will now be subject to a civil penalty not to exceed $5,000, under new Tax Law section 1145(i).

Conclusion

Although taxpayers were saved from a variety of ground-shifting sales tax changes, lots of good stuff still made it through the budget process. These changes will affect the day-to-day practice of practitioners as they advise taxpayers and work through audits. And if New York state's budgetary problems increase, we can expect more measures to come in the future. There's certainly never a dull day for the New York tax practitioner.

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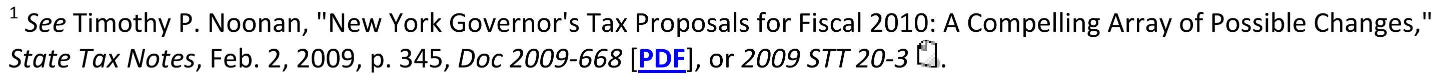
FOOTNOTES

[1] *See* Timothy P. Noonan, "New York Governor's Tax Proposals for Fiscal 2010: A Compelling Array of Possible Changes," *State Tax Notes*, Feb. 2, 2009, p. 345, *Doc 2009-668* [**PDF**], or *2009 STT 20-3* .

[2] Tax Law section 605(b).

[3] N.Y. Const., Art. XVI, section 3; *see Matter of Epstein*, 456 N.Y.S.2d 454 (3d. Dep't 1982); *Matter of Karayannides*, Tax App. Trib. (Mar. 13, 1997).

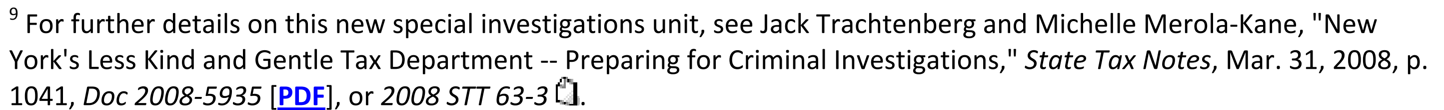
[4] *See* TSB-M-09(5)I.

[5] *See* TSB-M-09(1)MCTMT.

[6] *See Cleveland Browns Transportation LLC*, TSB-A-06(8)S; and *Standard & Poor's Securities Evaluations, Inc.*, TSB-A-05(15)S; *NYLIFE LLC*, TSB-A-05(38)S; and *Ernst & Young*, TSB-A-05(13)S and TSB-A-04(2)S.

[7] *Matter of Sunshine Developers*, Tax Appeals Tribunal (May 2, 1991); *Matter of Rochester Amphibian Airways*, Administrative Law Judge Unit (Apr. 17, 2008).

[8] *See* TSB-M-09(4)S.

[9] For further details on this new special investigations unit, see Jack Trachtenberg and Michelle Merola-Kane, "New York's Less Kind and Gentle Tax Department -- Preparing for Criminal Investigations," *State Tax Notes*, Mar. 31, 2008, p. 1041, *Doc 2008-5935* [**PDF**], or *2008 STT 63-3* .

[10] *See* TSB-M-09(6)I.

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