New York State Bar Association

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NYSBA

Tax Section

Comments on 2015-2016 New York State Executive Budget

Tax #1 March 6, 2015

2015-2016 NEW YORK STATE EXECUTIVE BUDGET[1]

Introduction

This report on selected tax provisions of the 2015-2016 New York State Executive Budget (the "Budget Bill") was prepared by the Tax Section of the New York State Bar Association. Senate Bill No. S2009, Assembly Bill No. A3009. It focuses on certain technical, administrative and conceptual issues raised by selected provisions of the Budget Bill with reference to the New York Tax Law ("Tax Law") and identifies aspects we think should be clarified or reconsidered prior to adoption by the Legislature.

This report offers comments and recommendations on the following parts of the Budget Bill:

Part T: Amend the Corporate Tax Reform Statute for Technical Changes.

Part X: Expand Sales Tax Collection Requirements for Marketplace Providers.

Part Y: Close Certain Sales and Use Tax Avoidance Strategies.

Part DD: Make Warrantless Wage Garnishment Permanent.

Part EE: Lower the Outstanding Tax Debt Threshold Required to Suspend Delinquent Taxpayers' Driver's Licenses.

Part JJ: Authorize a Professional and Business License Tax Clearance.

Part QQ: Implement New York City Corporate Tax Reform.

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I. Part T: Technical Changes to the 2014 Corporate Tax Reform Statute

Last year's 2014-2015 budget legislation (the "2014 Budget Legislation") contained comprehensive revisions to New York State's corporation franchise tax. The revisions went into effect for tax years beginning on or after January 1, 2015. Part T of the Budget Bill includes what are referred to in the Memorandum in Support as "technical changes," which clarify and change some elements of last year's legislation. This report focuses on the more significant proposed changes to the mechanics of the 2014 Budget Legislation, some of which may actually reduce clarity or create ambiguities.

A. ***Corporations Subject to Tax – Nexus***

1. Current Law

The 2014 Budget Legislation expanded the list of activities that cause a corporation to be subject to franchise tax by adding the activity of "deriving receipts from activity in this state."[2] This economic nexus standard requires the filing of an Article 9-A return if a taxpayer has at least $1 million in receipts sourced to New York State based on the market-based apportionment provisions included in Tax Law § 210-A. Alternatively, if a taxpayer has at least $10,000 in receipts sourced to New York and the total New York receipts of related corporations that are a part of the taxpayer's "combined reporting group" are at least $1 million, the taxpayer will be considered to be "deriving receipts from activity in" New York State and must file an Article 9-A return.

2. Proposed Changes

Part T, § 8 of the Budget Bill would clarify that for purposes of aggregating multiple corporations' receipts, only receipts of corporations engaged in a unitary business with the taxpayer and that meet the ownership requirements contained in the mandatory combined filing provisions in Tax Law § 210-C.2 are aggregated for purposes of the $1 million "economic nexus" threshold. Similar changes would be made with respect to the nexus provisions for credit card issuers and acquirers under

[2] Tax Law § 209.1(a).

Tax Law § 209.1(c). Part T, § 9 makes similar changes with respect to the nexus requirements for the metropolitan commuter transportation district tax under Tax Law § 209-B.1.

3. **Comments**

The Memorandum in Support states only that this proposal "ensure[s] proper application of the aggregate economic nexus test." The term being replaced under the proposal ("combined reporting group") is not a defined term, and the replacement language referencing the statutory requirements for filing an Article 9-A combined return may avoid any ambiguity. Under this interpretation, the proposal merely clarifies that aggregation of all members included in an Article 9-A combined return (other than non-unitary members included pursuant to a commonly owned group election) is required.

On the other hand, the proposal could be read to require not only the aggregation of receipts of corporations that are included in a combined return, but also the receipts of corporations that cannot be included in a combined return, but that are unitary and meet the ownership test, for purposes of the $1 million economic nexus threshold. For example, a subsidiary taxable under Article 9 (utilities) or Article 33 (insurance) that is engaged in a unitary business with an Article 9-A taxpayer and also meets the ownership requirements of Tax Law § 210-C.2, would nonetheless not be included in the Article 9-A combined return. However, under this interpretation, the non-Article 9-A corporation's receipts would be aggregated with the receipts of the Article 9-A corporation to determine whether the $1 million economic nexus threshold is met. This interpretation would thus expand the scope of the existing economic nexus provisions. For example, an affiliate of an insurance company taxable under Article 33 that meets the ownership and unitary business tests, and that has at least $10,000 of receipts sourced to New York, could have economic nexus under Article 9-A if the insurance company affiliate has $990,000 of New York receipts, even though the insurance company is not subject to Article 9-A. In that case, the affiliate would be required to file its own Article 9-A return. The affiliate would also be required to aggregate its receipts with affiliates of the insurance company that also meet the ownership and unitary business tests.

In the case of an affiliate that is an alien corporation that meets the ownership and unitary business requirements, and that has at least $10,000 of New York receipts, if the aggregate New York receipts of the alien corporation and its unitary affiliates is at least $1 million, the alien corporation would be subject to Article 9-A.[3] An alien corporation with less than $10,000 of New York receipts would not be subject to this aggregation rule.

We express no view on whether it is appropriate to expand the scope of the economic nexus provisions as discussed above. We recommend, however, that the intended scope of the proposal be clarified.

B. Definition of Investment Capital

1. Current Law

The 2014 Budget Legislation exempted from taxation under Article 9-A income from "investment capital," but significantly limited the types of assets that qualify as investment capital. As revised, investment capital is limited to certain investments in the stock of nonunitary, noncombined corporations, but only if the stock is held for at least six consecutive months. Stock that is "held for sale to customers in the regular course of business" does not qualify as investment capital.

2. Proposed Changes

Part T, § 1 of the Budget Bill would modify the definition of "investment capital " to require that to qualify as investment capital, the stock must "have *never* been used by the taxpayer in the regular course of business." (Emphasis added.) It would also eliminate the long-standing reference to stock "held for sale to customers in the regular course of business" -- which disqualifies such stock from investment capital treatment -- and replace it with the phrase "used by the taxpayer in the regular course of business."

[3] In any event, an alien corporation with effectively connected income may be included in an Article 9-A combined return, regardless of whether it meets the economic nexus threshold, where the ownership and unitary business requirements are met.

3. Comments

While this change is being proposed as a technical change, it is in fact a significant substantive change to the Tax Law. First, it would exclude from "investment capital" stock that at any prior time, regardless of how long it was held, was used by the taxpayer in the regular course of its business. This would require corporations to maintain records indefinitely regarding the historic uses of otherwise qualifying stock, and we believe many corporations will be unable to provide such information covering an indeterminate look-back period.

The Tax Section is mindful that absent a look-back period, taxpayers could convert otherwise non-qualifying stock to investment capital simply by changing its classification in the year that it is sold. We believe that the proposed unlimited look-back period, however, is harsh and largely unworkable. Instead, we recommend a reasonable look-back period regarding the use of otherwise qualifying stock of anywhere between one to five years prior to the tax year in issue. A reasonable look-back period would address the Department's concerns, while at the same time ease taxpayer compliance and make the limitation easier for the Department to administer on audit.

The Tax Section also believes that the proposed elimination of the phrase "held for sale to customers in the regular course of business" and substitution of the phrase "used by the taxpayer in the regular course of business" may be a technical error. The language that would be removed has long been recognized as properly requiring that a securities broker-dealer treat its designated inventory of stock as business capital, not as investment capital. The proposed exclusion of the reference to property "held for sale to customers in the regular course of business" appears to be based on the view that such property is "used" in the business. Under the federal tax rules, however, the term is used differently (in IRC §1231) in a way that does not include property held for sale to customers. As such, we believe that the deletion of the phrase "held for sale in the regular course of business" could have the unintended result of including inventory in investment capital.

Moreover, the proposed substitute phrase– "used by the taxpayer in the regular course of business"– is not defined in either the proposed or current Tax Law, or in the Article 9-A regulations.

While it is clear that the eliminated phrase "held for sale to customers in the regular course of business" referred to inventory, the meaning of the proposed language is far less clear. For example, it is unclear whether stock that otherwise would qualify as investment capital, but that was used as collateral in a lending transaction, would qualify as investment capital. Further ambiguity and administrative complications could arise based on the use of the loan proceeds from the lending transaction. Under the federal *Corn Products* doctrine,[4] whether the proceeds of a loan are used for investment purposes or used in the "regular course of business" would be relevant in determining whether the use of stock as collateral would be considered a use in the regular course of the taxpayer's business. We note that during the 1980s, the New York State Department of Taxation & Finance ("Department") considered adopting a *Corn Products* approach to the definition of investment capital, but rejected it as being subjective and very difficult to administer.

In light of the above-described concerns, we urge retention of the existing language. At a minimum, however, the scope of the proposed language excluding from investment capital stock "used by the taxpayer in the regular course of business" should be clarified.

C. Six-Month Holding Period Presumption for Investment Capital

1. Current Law

The 2014 Budget Legislation recognized that a taxpayer could acquire stock that would otherwise qualify as investment capital during the last six months of the taxable year and therefore not meet the six-month holding period during the taxable year itself. A presumption was created allowing a taxpayer to treat stock purchased during the last six months of the taxable year and still held on the last day of the taxable year as meeting the six-month holding period requirement. If a taxpayer ultimately held the stock for fewer than six consecutive months (taking into account the actual holding period that

[4] *Corn Products Refining Co. v. Comm'r*, 350 U.S. 46 (1955).

spanned two tax years), the taxpayer would be required to treat income from the stock in the first tax year as business income on its Article 9-A tax return filed for the year of disposition.

2. Proposed Changes

Part T, § 2 of the Budget Bill would alter the mechanics of the six-month holding period presumption. The presumption would only be available if a taxpayer "in fact owns the stock at the time it files its original report for the taxable year in which it acquires the stock."

3. Comments

The Budget Bill would limit the availability of the six-month holding period presumption to stock that is still owned by the taxpayer at the time it files its Article 9-A return. Presumably, this change was intended to prevent taxpayers from deferring tax on business income generated by stock purchased during the last six months of the year, but disposed of within six months and prior to the filing of the taxpayer's Article 9-A return for that year.

The Tax Section recognizes that it is difficult to justify allowing a taxpayer to file its return based on the six-month holding period presumption when the taxpayer knows at the time of filing that the stock was not in fact held for six months. On the other hand, requiring that the taxpayer file its Article 9-A return on the basis of facts that occur in close proximity to the actual filing of that return will present compliance difficulties for many taxpayers. It is usually not feasible for the individuals who prepare, review, and sign a large corporate taxpayer's return to make last minute adjustments and inquiries to positions taken in the return based on events occurring after the close of the tax immediately before the tax return is due. Under the proposed change, tax return preparers would need to take into account sales of stock that occur up to the actual day the tax return is signed and filed. As a practical matter, it may also have the effect of encouraging some taxpayers to delay filing their returns within two and one-half months of the close of the year to avoid this complication, since the delay will allow the taxpayer to know significantly in advance of the filing date whether the stock in question was held for the requisite six-month period.

In addition, the reference to the time a taxpayer "files" its Article 9-A return for determining whether the presumption applies is unclear. The time of "filing" referenced in the proposal appears to be the date the taxpayer actually submits its Article 9-A tax return. However, under the existing Article 9-A regulations, a return is "deemed filed" on the later of the return's due date or the actual filing date.[5] For example, a calendar-year taxpayer could mail its Article 9-A return on February 1, prior to its March 15 due date, at a time it still held a particular stock, but then dispose of the stock on March 14 – the day before the return would be "deemed" filed. As proposed, the presumption may not be available since the taxpayer did not hold the stock on the date the return was "deemed" filed. At a minimum, the proposal should make clear that it is the actual filing date, and not the "deemed" filing date, that is relevant for this purpose.

The Tax Section remains concerned with the potential compliance difficulties under this proposal. Indeed, the possibility of inadvertent deferral of business income by taxpayers that sell their stock after the close of the tax year, but before the return is filed, may be outweighed by the compliance and administrative burdens imposed by the proposal. If the Department anticipates substantial deferrals of tax resulting from the existing presumption, one alternative would be to require that a taxpayer file an amended Article 9-A return if it later determines that stock that it treated as investment capital under the presumption was not actually held for six consecutive months, or pay an interest charge on the deferred tax due with the following year's return.[6]

D. Qualified New York Manufacturer

1. Current Law

The 2014 Budget Legislation established a 0% business income tax rate and a capital base cap of $ 350,000 for a Qualified New York Manufacturer. Under both the business income base and the capital base, there are two ways to meet the definition of a Qualified New York Manufacturer: (i) the

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[5] 20 NYCRR § 8-1.2(a).

[6] A somewhat analogous interest charge rule is contained in IRC § 1291.

"Principally Engaged" test, which looks to the taxpayer's in-State receipts and property; and (ii) an alternative test which looks to in-State employment and property.

For purposes of the Principally Engaged test, both the business income base and the capital base provisions define qualifying property as property described in Tax Law § 210-B.1. For purposes of the alternative test, both the business income base and the capital base provisions define qualifying property as "property in the state used in manufacturing."

2. Proposed Changes

Part T, § 11 would restrict the type of property that would qualify for the Principally Engaged test contained in the business income base provisions to property described in Tax Law § 210-B.1(b)(i)(A) – that is to property "principally used by the taxpayer in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture or commercial fishing," a smaller subset of the broader list of property described in § 210-B.1. (This is the same reference used in the pre-2014 definition of a qualified New York manufacturer.) However, while Part T, § 18 would make a non-substantive change to the capital base reference to property, it retains the reference to the broader list of property described in § 210-B.1. There would be no changes to the description of property under the alternative test under either tax base.

3. Comments

The Budget Bill would result in different types of qualifying property for purposes of the Principally Engaged test in the business income base and in the capital base. The proposed changes retain the different definitions of property for the Principally Engaged test and the alternative test. It is unclear whether the latter was intentional or a drafting oversight.

The description in the 2014 Budget Legislation of receipts that satisfy the receipts test portion of the Principally Engaged test under both tax bases appears to contain a drafting error. The tests are satisfied when "more than fifty percent of the gross receipts of the taxpayer or combined group, respectively, are derived from receipts from the sale of goods produced by such activities." The second use of "from receipts" is unnecessary and should be removed.

II. Part X: Sales Tax Collection Requirements for Marketplace Providers

Part X of the Budget Bill proposes a major change to the way sales and use taxes would be collected for sales made through so-called "marketplace providers." The proposal would shift the burden of collecting sales tax from the retailer to a "marketplace provider" that "facilitates a sale, occupancy or admission." It also appears to have the effect of increasing the reach of New York's authority to require the collection of sales tax on online sales made by out-of-State sellers through marketplace providers with New York State nexus. It would also shift responsibility for the collection of sales tax for sales by an in-State seller to the marketplace provider.

A. Current Law

Under current law, the responsibility to collect and remit sales taxes on taxable in-State sales is limited to "vendors."[7] A vendor is defined as a person "making sales" that has a sufficient connection to New York State to require the vendor to collect and remit sales tax on sales to customers in the State.[8] In certain circumstances, an agent of the vendor can be treated as a "co-vendor," with joint responsibility for collecting and remitting the tax.[9] Use tax is generally acknowledged to be underreported.[10]

Because vendors are defined as the persons actually making sales, a party that merely facilitates a sale between a seller and a buyer through a physical or online marketplace forum having in-State nexus is not a vendor and does not have tax collection responsibilities. The responsibility for collecting sales tax lies with the seller itself. Critically, an out-of-State seller that does not otherwise have nexus

[7] Tax Law §§ 1131(1), 1132(a)(1).

[8] Tax Law § 1101(b)(8).

[9] Tax Law § 1101(b)(8)(ii)(A).

[10] Memorandum in Support, Part X (stating that the proposal will increase revenues by $59 million annually).

with New York does not create in-State nexus by selling goods through an online marketplace, and is not required to collect and remit sales tax on sales made through an online marketplace.[11] This does not relieve in-State purchasers from liability for use tax.[12]

B. Proposed Changes

Part X of the Budget Bill would alter this structure by placing the burden of collecting tax on sales facilitated through an online or physical marketplace on the "marketplace provider." Under the proposal, a "marketplace provider" is defined as any person who "facilitates a sale, occupancy or admission" ("facilitates sales") by a "marketplace seller" pursuant to an agreement with such marketplace seller. A marketplace provider facilitates sales when it, directly or through an affiliated person, collects the receipts, rents or charges paid by the customer, and either (i) "provides the forum" through which the sale takes place, or (ii) "arranges for the exchange of information or messages between the customer . . . and the marketplace seller." A "forum" includes an internet website, catalog or similar forum, or a physical forum, such as a "shop, store, or booth." A "marketplace seller" is defined as any person who contracts with a marketplace provider for such provider to facilitate sales, occupancies or admissions and that (i) sells tangible personal property or certain services, (ii) operates a restaurant, tavern or other establishment, or acts as a caterer, (iii) is an operator of a hotel, or (iv) collects, receives or is under a duty to collect an amusement charge. The proposal would take effect on March 1, 2016.

C. Comments

The proposed approach in the Budget Bill would significantly alter nationwide practices as to the party responsible for collecting sales tax on sales facilitated through third parties. The proposal would impose significant compliance obligations and potential tax liabilities on marketplace providers,

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[11] Tax Law §§ 1101(b)(8)(v)(A).

[12] Tax Law § 1110.

parties whose sole role in the transaction is to facilities sales between two unrelated parties, and who may not be in a position to make determinations as to taxability. Under the proposal, this designation of collection responsibility is mandatory -- if a marketplace provider facilitates sales, the marketplace provider will be responsible for sales tax compliance for those sales.[13] The Tax Section expresses no opinion on this provision as a policy matter, although we note that it would represent a substantial change.

The shifting of responsibility for collecting tax from the marketplace seller to the marketplace provider under the proposal appears to have two major effects. First, with respect to sellers that already have nexus in New York, it would appear to relieve them of the responsibility of collecting sales tax, and shift that responsibility to the marketplace provider.[14] Second, it appears to provide a mechanism for the collection of sales tax for sales by sellers that do not have any nexus with the State.[15] The marketplace provider would be responsible for collecting and remitting the tax on sales made by both in-State and out-of-State sellers.

1. Nexus

Although the Memorandum in Support states that only marketplace providers having a sufficient presence in the State would be affected by the proposal, the Budget Bill is silent on what type of presence would be sufficient. We have not identified any obvious constitutional infirmity in placing this responsibility on marketplace providers, so long as the marketplace provider meets the statutory and constitutional nexus requirements with the State. Indeed, it may be analogized to imposing a sales

[13] Budget Bill Part X § 2.

[14] We note that under the proposal, in order to be relieved of responsibility for collecting sales tax, the seller must obtain a "completed certificate of collection" from the marketplace provider which states that the marketplace provider will collect the sales tax. Budget Bill Part X § 3.

[15] The Memorandum in Support states that the marketplace provider provisions would "minimize the number of persons who have tax collection responsibilities." This may be interpreted to mean that the intent of the proposal is to impose a tax collection responsibility on marketplace providers only with respect to sales by sellers that already have a tax collection obligation – that is, sellers that already have nexus with the State.

tax collection responsibility on in-State co-vendors (discussed below).[16] We do, however, recommend that the Tax Law make clear that only marketplace providers with nexus to New York are required to collect sales tax. At a minimum, the law should provide that marketplace providers must have "a connection with the state which satisfies the nexus requirement of the United States constitution."[17,18]

In order to satisfy constitutional requirements, a marketplace provider would need to have a non-*de minimis* physical presence in New York, either directly or through *Scripto/Tyler Pipe*-type agency or representative nexus. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the U.S. Supreme Court reaffirmed its decision in *National Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753 (1967), which established a "bright-line" rule under the Commerce Clause which permits a state to compel out-of-state mail order sellers having a physical presence in the state to collect its use taxes but not those who do no more than communicate with customers in the state by mail or common carrier as part of an interstate business. Accordingly, a marketplace provider would have nexus with the State if personnel of the marketplace provider are physically present in the State on a regular or systematic basis. While in-state physical presence is a necessary predicate to nexus, such in-state presence need not be "substantial;" rather, it need only be demonstrably more than the slightest presence.[19] For example, it is unclear whether merely having a server in the State would meet this nexus standard.

Nexus can also be established through attribution from independent contractors or agents under the U.S. Supreme Court decisions in *Scripto* and *Tyler Pipe*. In *Scripto, Inc. v. Carson*, 362 U.S. 207

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[16] *See, e.g.*, TSB-A-86(13)S (N.Y.S. Dep't of Taxation & Fin., Mar. 26, 1986) (ruling that a household appliance telephone ordering service is responsible for collecting and remitting sales tax as a co-vendor on sales made on behalf of out-of-state suppliers).

[17] *See, e.g.*, Tax Law § 1101(b)(8). Inasmuch as the definition of "marketplace provider" does not fall under the definition of vendor, the references to nexus under the definition of vendor are not applicable.

[18] We note that under the Budget Bill, marketplace sellers that have nexus with New York must ascertain whether the marketplace provider has nexus in order to determine which party will bear tax collection responsibilities. If the marketplace provider has nexus with New York, the marketplace seller will be relieved of sales tax collection responsibilities. However, if the marketplace provider does not have nexus with New York, sales tax collection responsibilities will remain with the marketplace seller.

[19] *National Geographic Soc. v. California Bd. Of Equalization*, 430 US 551 (1977); *Orvis Co. v. Tax Appeal Tribunal*, 86 N.Y.2d 165 (1995).

(1960), the Supreme Court held that regular solicitation of sales by independent contractors (and not employees) was sufficient to establish a sales and use tax collection obligation by an out of state corporation with no physical presence in the state. Indeed, the Supreme Court has stated that "'the crucial factor governing nexus is whether the activities performed in [the] state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in [the] state for the sales.'"[20]

In view of the above precedent, and in the absence of direct precedent regarding marketplace providers, some members of the Tax Section are of the view that if the marketplace seller does not have a direct nexus with the State, then the marketplace provider should only be required to collect sales tax with respect to that seller if the provider's in-State activities are significantly associated with the seller's ability to establish and maintain a market in the State. Others have noted that since only the marketplace provider, not the out-of-State marketplace seller, would be subject to a tax collection obligation, only the marketplace provider must have nexus with the State. The Tax Section does not take a position on the required nexus where the marketplace seller does not itself have nexus with the State, but raises it as an issue that should be considered and addressed in the legislation, or else by regulation.

2. <u>Scope of Application</u>

While we are not familiar with the different ways that marketplace providers may provide their services, the definition of a "marketplace provider" in the proposal may be both under inclusive and over inclusive. Under the proposed definition, an entity is a "marketplace provider" only if it collects the "receipts, rent, or amusement charge[s]" paid by a customer. We understand that there are "peer-to-peer" online marketplaces online where the buyer has the ability to pay the seller directly, and therefore the marketplace provider does not handle the receipts. Thus, it seems likely that certain marketplace providers may be collecting receipts from some buyers, but not from others. We believe the proposal

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[20] *Tyler Pipe Indus., Inc. v. Washington State*, 483 U.S. 232 (1987) (quoting *Tyler Pipe Indus. v. Dep't of Revenue*, 105 Wash.2d 318, 323 (1986)).

should make clear that the marketplace providers should only be required to collect sales tax in those situations where it receives payment from the buyer and remits it to the marketplace seller.

We also understand that there are companies that create and manage websites that are branded in the name of the selling business, and may provide the types of services identified in the definition of a "marketplace provider." For example, in addition to creating a website for the seller, such companies may also collect the receipts from the seller's customers through the website and remit them to the seller. If the intent of the proposal is to treat as a "marketplace provider" an entity that facilitates sales through a website address that is specific to a single business, rather than a website address that identifies a marketplace, then we recommend that the proposal make that clear.

3. Physical Marketplaces

In identifying the "forum" through which a marketplace provider facilitates a sale, the proposal also refers to a "shop, store, or booth" in addition to online marketplaces. We have struggled to identify a situation where a physical marketplace such as a store, that does not already have tax collection responsibilities, would meet the criteria specified in the statute. It would be helpful to have clarification on when the proposal would apply to such physical marketplaces. If there are no instances where a marketplace provider would facilitate a sale in a "shop, store or booth," then we do not see the purpose for including the reference in the Tax Law.

4. Co-Vendor Approach

One alternative to the Budget Bill's approach that could achieve the Bill's apparent policy objectives would be to amend the law to permit a marketplace provider to be treated as a co-vendor under Tax Law § 1101(b)(8)(ii). Under existing law, the Department has the authority to treat any "salesman, representative, peddler or canvasser" as the seller's agent, and thus as jointly liable for collecting and remitting the sales tax.[21] By allowing the Commissioner to treat the marketplace provider as a co-vendor, the marketplace seller would remain the party primarily responsible for

[21] Tax Law § 1101(b)(8)(ii).

collecting and remitting the tax, but where the Commissioner determines it to would be efficient for administration of the tax, the marketplace provider could be held jointly responsible. Under this approach, whether or not a marketplace seller has New York nexus, the marketplace provider could be treated as responsible for collecting the sales tax upon reasonable notice by the Department.

III. Part Y: Close Certain Sales and Use Tax Avoidance Strategies.

Part Y of the Budget Bill proposes to eliminate a variety of perceived sales and use tax avoidance strategies. The proposals in the Budget Bill primarily affect transactions between related parties and would become effective immediately upon enactment of the legislation.

A. Proposed Changes

Section 1 of Part Y of the Budget Bill would add a new § 1118-A to the Tax Law. Entitled "limitations on tax avoidance strategies," this provision would implement several distinct changes to the Tax Law.

1. Limits to the Nonresident Use Tax Exemption

Proposed § 1118-A(a) would eliminate the existing exemption from use tax for property or services used in New York where such property or services were purchased outside of New York by a nonresident business.[22] Under the existing exemption, a business can avoid sales and use tax by forming a new out-of-State entity to purchase and bring property into New York for use within the State. The Budget Bill proposes to eliminate this perceived loophole by disallowing the use tax exemption in situations where the nonresident business was doing business outside of New York for less than six months before using the property or services within the State. The proposal does not apply to individuals.

[22] *See* Tax Law § 1118(2).

2. Elimination of the Separate Status of Single Member LLCs and Their Members

Proposed § 1118-A(b) would deem a single member limited liability company ("SMLLC") and its single member to be one person for sales tax purposes, regardless of whether the SMLLC is disregarded for income tax purposes. Consistent with historical norms of generally applying the sales and use tax in a "form over substance" manner, under current law SMLLCs and their members are considered separate persons for sales tax purposes. Accordingly, under existing law, an SMLLC may purchase property or services without paying sales tax in situations where it is purchasing the property or services for resale to its single member.[23] Similarly, current law allows the single member to purchase property or services for resale (*i.e.*, tax free) to the SMLLC. The Budget Bill would prohibit the LLC or its member from purchasing property or services for resale to the other because the purchase or sale by either would be deemed to be the purchase or sale by the other.

3. Acceleration of Tax Payments for Related-Party Leases

Proposed § 1118-A(c) would apply to leases of tangible personal property between related entities by requiring that sales tax be paid at the inception of the lease on all payments required under the lease where the lease term is for more than one year. Under current law, except in the cases of certain motor vehicles, vessels, and airplanes, sales tax is due each time a lease payment is made by the related-party lessee. The Budget Bill's proposal would also permit the Department to impose sales tax based on an estimate of the "true value or cost" of the property subject to a related-party lease where the Department determines that the sum of the payments due under the lease does not reflect the value or cost of the property.

4. Intercompany Transfers of Tangible Personal Property

Section 2 of Part Y of the Budget Bill would amend Tax Law § 1111(q) so as to impose sales and use tax on most intercompany transfers of tangible personal property between related parties. Under current law, with the exception of transfers of aircraft and vessels between affiliated persons,

[23] *See e.g.*, TSB-A-00(32)S (N.Y.S. Dep't of Taxation & Fin., Sept. 7, 2000).

New York excludes from sales and use tax most transfers or contributions of property to either a corporation or partnership solely in exchange for shares of stock or a partnership interest. The existing exclusion generally applies to distributions of tangible personal property by a corporation or partnership to a stockholder or partner upon liquidation and to transfers to a corporation in a merger in exchange for its stock. The Budget Bill proposes to expand the existing prohibitions on such tax-free transfers (*i.e.*, for aircraft and vessels) to apply to all tangible personal property. The only exception would be where property is transferred to an unaffiliated corporation in exchange for stock under a merger or consolidation plan. However, a credit would be permitted for any sales or use tax due as a result of the transfer, contribution or distribution for tax paid to New York or another state on the purchase or use of the property by the seller.

B. Comments

1. Limits to the Nonresident Use Exemption

The Budget Bill's proposal to restrict the nonresident use tax exemption means that a newly formed nonresident business would not be entitled to the exemption, regardless of whether it is a bona-fide business, yet an older nonresident business that has conducted business outside of New York for at least six months would benefit from the exemption, even if it is arguably not a bona-fide business under the facts of a particular case. In this regard, the proposal may prove to be both under and over inclusive. When a nonresident business is a bona fide business, the Department would be powerless to allow the nonresident use tax exemption solely because it was doing business outside the State for less than six months. Conversely, where the nonresident business is not a bona fide business, the Department's ability to disregard the transaction under a "sham" theory could be hindered because the legislative change could be viewed as specifically sanctioning the transaction.

The Memorandum in Support states that the purpose for this proposal is to combat situations in which "a business can avoid sales tax by creating an out-of-state entity to purchase and bring property into the State for use here."[24] The Tax Section believes there may be more targeted ways to address this perceived loophole. For instance, the Department might be better served by relying on its existing authority to challenge sham transactions where the facts warrant such a challenge. In the alternative, the Department could seek specific legislative authority to challenge a transaction for sales and use tax purposes where a valid business purpose is lacking and the transaction was entered into solely for the purpose of tax avoidance.

2. Elimination of the Separate Status of SMLLCs and Their Members and Acceleration of Tax Payments for Related Party Leases

Regarding the Budget Bill's proposal to eliminate the separate status of SMLLCs and their members, according to the Memorandum in Support, its stated purpose is to "eliminate an abusive sales tax avoidance scheme whereby a single-member LLC makes an otherwise taxable purchase but relies on the resale exemption from sales and use tax because it sells the item to its single member."[25] Similarly, the stated purpose of the Budget Bill's proposal regarding related-party leases of tangible personal property is to prohibit one entity from purchasing property for resale without paying sales tax, and then delaying or avoiding the payment of sales tax by entering into a lease with a related party for an extremely long term or low monthly lease payments, or both.[26]

Without commenting on the policy goals behind the SMLLC and related party lease provisions, the Tax Section is concerned that the sweeping nature of these proposals may be unwise given the difficulty in anticipating all of the circumstances where they may apply, including situations where legal or policy considerations may not warrant their application. For example, it is not uncommon for corporate groups to centralize their procurement functions in one legal entity that purchases goods or services for resale or re-lease to related members.

[24] Memorandum in Support, at 29.

[25] Memorandum in Support, at 29.

[26] *Id.* at 30.

Moreover, because the stated goals of the SMLLC and related-party lease proposals are to close certain specific perceived sales and use tax "loopholes" related to the resale exclusion, there are more targeted alternatives to combat taxpayer abuse. One approach would be for the Budget Bill to give the Department specific statutory authority to disregard a taxpayer's use of the resale exclusion under an anti-abuse standard, such as where the Department determines that the resale transaction between related entities lacked a valid business purpose and was undertaken for the principal purpose of avoiding the payment of tax.

Specifically with respect to the related-party lease provision, one alternative could be to include an exception that would exempt from sales tax acceleration those related-party leases that are entered into for a reasonable period of time and that comport with the true value or cost of the item. For example, the proposal could exempt leases that are for a term of no longer than the property's federal depreciation recovery period (which is typically shorter than the property's actual useful life) and with respect to which the rent payments at least equal the purchase price and are not back-loaded to unreasonably defer the sales tax on the rental payments. Another alternative would be to exempt from sales tax acceleration those related party leases that reflect a reasonable lease term and arm's-length rental payments. The Department could flesh this out by regulation, which could include a rebuttable presumption against sales tax acceleration where (as discussed above) the lease term is no longer than the depreciation recovery period, and the rent payments at least equal the purchase price and are not back-loaded. These alternatives would apply objective standards that would foster compliance and ease administration by the Department. Moreover, they would be consistent with the goal of minimizing tax avoidance in this area, but would avoid penalizing bona fide lease transactions between related parties.

The Tax Section also believes that the language of the related-party leases provision should be clarified. Under the proposal, it is not clear whether the accelerated sales tax collection requirements apply only to lease payments due under the initial lease, or to lease payments due under an option to renew as well as the initial lease. The proposal incorporates by reference Tax Law § 1111(i), which provides that an option to renew (or similar provision) must be accounted for in determining whether the lease is for the requisite period of one year or more, but which does not impose sales tax on the lease payments due under the option to renew unless and until the option is exercised. The language of the proposal, however, appears to modify the incorporation by reference of § 1111(i) as follows:

> Provided that any payments due under such a lease under this subdivision shall be due at the inception of the lease regardless of the length of the term of such lease, including any option to renew or similar provision, or combination of them . . . .[27]

It is unclear why this language is necessary if similar language from § 1111(i) is being incorporated by reference. Its inclusion may be significant however, since the above-quoted language does not appear to contain accompanying language similar to § 1111(i), language which makes clear that sales tax should not be due on the amounts due under an option to renew until the option to renew is exercised. This, and the ambiguous nature of the language itself, suggests that the proposal may be intended to treat all payments due under the lease as being due at the inception of the initial lease, including any payments due under an option to renew.

If this was not intended, the proposal should be clarified. If it was intended, the Tax Section questions whether it is appropriate to impose sales tax on lease payments that would not become due unless and until the option to renew was exercised. On the other hand, if the proposal is intended to tax the renewal lease payments at the inception of the base lease, we recommend amending the proposal to include a provision for a refund of sales tax paid on the renewal payments should the option to renew not be exercised.

3. Intercompany Transfers of Tangible Personal Property

Finally, with respect to the Budget Bill's proposal to tax most intercompany transfers of tangible personal property between related parties, unlike the other proposals in Part Y, the Memorandum in Support does not explain why this change is being pursued. Since the proposal is contained in Part Y of the Budget Bill, it is presumably designed to curb a perceived tax avoidance strategy. Nonetheless, the proposal would be inconsistent with the tax-free treatment of such related-

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[27] Budget Bill Part Y § 1.

party transfers, often involving transfers that are part of a corporate reorganization, in the vast majority of states including New York. This suggests that whatever perceived tax avoidance strategy is being addressed could perhaps be addressed through less drastic and far-reaching legislation. While the proposal contains an exception for tangible personal property transferred to an unaffiliated corporation in exchange for stock under a merger or consolidation plan, and a credit for certain taxes previously paid on the purchase or use of the property by the seller that is the subject of the transfer, the proposal would nonetheless create a significant sales tax cost to many taxpayers engaged in an otherwise tax-free restructuring transaction. This is precisely the result that most jurisdictions seek to avoid given the well-established and recognized policy justifications for not taxing certain types of business reorganizations.

One particular concern is with the credit that the Budget Bill would make available where sales or use tax was previously paid to New York State or another state on the property that will become subject to tax under the Budget Bill's related-party intercompany transaction provisions. The text of the Budget Bill makes the credit available "in the amount of any sales or use tax paid to [New York State] or any other state on *the seller's* purchase or use of the tangible personal property so transferred, distributed or contributed . . . " (Emphasis added).[28] Because existing law has long exempted otherwise tax-free transfers of tangible personal property between related parties for sales tax purposes, it is likely that situations will arise where items of tangible personal property, on which sales tax was previously paid by the original purchaser, have been transferred to another legal entity in a tax-free reorganizations without sales tax being paid on the tax-free transfer. In such cases, if subsequent intercompany transfers were to become subject to sales tax under the Budget Bill, the credit for the sales tax previously paid may not apply because the original purchaser may not be considered the "seller" in the subsequent intercompany transaction for purposes of determining the credit's availability. If one of the purposes of the proposal is to tax related-party intercompany transactions only to the extent tax was not

[28] Budget Bill Part Y § 2.

previously paid, the legislation should be clarified to ensure that the credit is available under the circumstances described.

Although the Memorandum in Support does not identify what tax avoidance strategy this proposal is intended to combat, one transaction that could be specifically addressed is where a corporation makes a tax-free transfer of tangible personal property to a newly-formed corporation ("Newco") in exchange for stock, and then sells the stock in Newco to a third party in a transaction to which sales and use tax do not apply. The Tax Law could be amended to impose sales tax on the initial transfer to Newco in those instances where (i) that initial transfer is part of a plan to sell the stock in Newco to a third party or (ii) where the stock in Newco is sold to a third party within a short period following the initial transfer, regardless of the existence of a plan.

If the proposed language is adopted, we are concerned that it could pick up the following types of commercial transaction that are not sales or use tax avoidance strategies:

Example 1 (Tax Free Spin Off). A corporation ("Distributing") has conducted two businesses, A and B, for more than five years. For substantial business reasons unrelated to tax, Distributing contributes all of the assets and liabilities of business A to a wholly owned subsidiary, Controlled, and distributes all of the stock of Controlled to its shareholders. The transaction qualifies for income tax purposes as a non-taxable spin off under IRC § 355

Example 2 (Joint Venture). Corporations A and B are unrelated and decide for non-tax reasons to enter into a joint venture ("JV") to which each will contribute one of its existing businesses for a 50% interest in JV. JV may be formed as a corporation, partnership or LLC. Neither Corporation A nor Corporation B has any plan to dispose of its interest in JV.

As these examples illustrate, the proposal to impose sales tax on most related party transfers of tangible personal property may have unintended tax consequences, and have the effect of taxing intercompany transfers made as part of bona fide commercial transactions having nothing to do with the avoidance of sales tax.

4. Effective Date

Part Y states that it "shall take effect immediately." Since these proposals represent substantive changes to the existing Tax Law, they should apply only to transactions that take place after enactment of the legislation, or a later date that affords taxpayers adequate notice of these changes.

IV. Part DD – Make warrantless wage garnishment permanent

Part EE – Lower the outstanding tax debt threshold required to suspend delinquent taxpayers' driver's licenses

Part JJ – Authorize a professional and business license tax clearance

Parts DD, EE, and JJ of the Budget Bill propose a number of changes affecting the ability of the Department to enforce compliance with the Tax Law. Specifically, the provisions provide the Department with new or modified tools to enforce the collection of past-due tax liabilities.

A. Proposed Changes

Tax Law § 174-c, which was enacted into law as part of the 2013-2014 Executive Budget, allows the Commissioner to serve income executions on individual tax debtors and their employers without having to docket a public tax warrant (*i.e.*, a lien) with the appropriate county clerk's office and the Department of State. This warrantless income execution provision is set to expire on April 1, 2015. Part DD of the Budget Bill would make the Commissioner's warrantless income execution authority permanent.

Part EE of the Budget Bill would reduce the threshold for driver's license suspensions for past-due tax liabilities. Under current law, the Commissioner is authorized, in cooperation with the Department of Motor Vehicles, to suspend the New York State driver's license of any taxpayer who owes $10,000 or more in past-due tax liabilities. Part EE of the Budget Bill would reduce the $10,000 threshold to $5,000.

Part JJ of the Budget Bill would create a new professional and business license tax clearance program. Under the program, applicants for a professional or business license would be required to pay their past-due tax liabilities (or enter into a payment agreement with the Department) before such a license is issued or renewed. This provision would apply to individuals or entities with past-due tax liabilities of $500 or more.

B. Comments

1. Making Warrantless Wage Garnishment Permanent

The Tax Section commends the Budget Bill's proposal to make the Commissioner's warrantless wage garnishment authority permanent. Without this authority, the Commissioner would be required to file a public tax warrant with the appropriate county clerk's office and the Department of State prior to undertaking a wage garnishment. Publicly filed tax warrants can impose additional harms and burdens on taxpayers that may not be necessary to effectively enforce the state's tax laws. These include negatively affecting the taxpayer's credit report, causing an increase to the taxpayer's insurance premium rates, and jeopardizing employment opportunities with employers that conduct credit checks as part of the hiring process. By making the Commissioner's warrantless wage garnishment authority permanent, the Department will be permitted to engage in a routine and productive tax collection technique without creating unnecessary burdens and hardships for taxpayers.

2. Lowering the Threshold for Suspending Driver's Licenses and Creating a New Professional and Business License Clearance Program

The Tax Section takes no position with respect to the policy goals of the Budget Bill's proposal to lower the dollar threshold for suspending the New York State driver's licenses of taxpayers with past-due tax liabilities or the proposal to create a new professional and business license tax clearance program. We are concerned, however, that these provisions could have the unintended consequence of imposing unnecessary and unjustified hardships on some taxpayers, without adequate appeal rights to ensure that these highly punitive consequences do not create severe financial hardships, or result in the Department collecting tax that it would otherwise not have been able to collect under the current collections provisions.

Unlike the Internal Revenue Service, New York State does not have a collection due process hearing system whereby a taxpayer may challenge adverse collection determinations made by the Department's Civil Enforcement Division. By way of example, this means that a taxpayer who has proposed to make payments under an installment payment agreement for a certain monthly amount over a certain period of time may have his or her proposal rejected with no recourse other than to discuss the matter with the collection agent's superiors (an option that is often unknown or that may be intimidating to unsophisticated or unrepresented taxpayers). If the agent's superiors do not agree to override the agent's determination, the taxpayer is left with the option of accepting the installment payment agreement offered by the Department or having his or her driver's license, business license, or professional license suspended. This is potentially problematic, as some members of the Tax Section are aware of situations in which either (i) taxpayers have felt forced to accept an installment payment arrangement that resulted either in a hardship to the taxpayer or a minimal payment arrangement, the monthly amount of which was a fraction of the additional interest and penalties that accrued on the debt each month (meaning the debt will never be satisfied), or (ii) unsophisticated or unrepresented taxpayers that did avail themselves of formal appeal rights, feel forced to pay a tax debt that may not be owed at all.

Consider a situation where an elderly widow has an income source of only social security payments that are not subject to collection by New York. However, she owes more than $5,000 to New York State. Although she is barely covering her personal living expenses, she does not fall within the poverty guidelines to have non-collectible status in New York. To retain her driver's license, she will be forced to enter into an installment payment agreement with the Department that will require her to pay over amounts that New York could not have otherwise collected. In addition, under current Department guidelines, the amount she will have to pay under the installment agreement will not be determined by what is left over after payment of her personal living expenses.

In short, the Tax Section is concerned that, absent adequate safeguards, the various license suspension and revocation provisions may provide the Department with inappropriate leverage in certain circumstances. Though beyond the scope of this report, the Tax Section suggests the Department consider adopting safeguards, such as a collection due process hearing system, to protect against these potentially untoward consequences.

The Tax Section is also concerned that the proposed professional and business license tax clearance program may be constitutionally flawed. We note a recent case, *Berjikian v. California Franchise Tax Board*, Cal. Ct. App., No. B25242, unpublished (Cal. Ct. App., Jan. 12, 2015), in which the California Court of Appeals held a similar statute to be unconstitutional under the Due Process Clause because the taxpayers were not afforded adequate procedural safeguards to ensure against a deprivation of their property interests in their state-issued licenses. In particular, the Court held that the statute's hardship provisions, which allows the Franchise Tax Board (the "FTB") to forgo a license suspension where such a suspension would create a financial hardship for the taxpayer, does not outline how the FTB is to make such a determination. According to the Court, this raised the unacceptable risk that a taxpayer's license could be suspended arbitrarily. Moreover, the Court disagreed with the FTB's claim that the taxpayers had forfeited their rights to contest the license revocation by failing to assert a timely administrative protest to challenge the underlying tax assessments. The Court noted that the license revocation provisions were enacted after the taxpayers' time to challenge the tax assessments had expired. Accordingly, they did not have a meaningful opportunity to contest the suspension of their licenses.

We note that similar concerns may exist with the Budget Bill's proposed professional and business license tax clearance program. First, the provision does not appear to specifically contemplate a hardship exception. The Department does, however, have the authority to consider hardships when determining an appropriate installment payment arrangement, which if entered into by the taxpayer would avoid a license revocation under the proposal. Since the Commissioner's authority to consider hardships in this context is also not defined or constrained, similar constitutional problems as those raised in *Berjikian* may arise if a taxpayer is denied an installment payment agreement despite a claim of hardship and the taxpayer's professional or business license is subsequently suspended.

Additionally, while the Budget Bill does provide taxpayers with administrative protest rights in the event of a professional or business license revocation, any such appeal is limited by the Budget Bill to certain specific grounds, none of which include the right to contest the underlying tax liability. As in *Berjikian*, procedural due process concerns may exist in this regard, at least with respect to past-due tax liabilities that become fixed and final prior to the enactment of the Budget Bill.

Finally, we note that the Budget Bill requires any entity applying for a professional or business license to provide all information deemed necessary by the Department to efficiently and accurately provide an electronic tax clearance, including but not limited to a list of the entity's responsible officers and their social security numbers. If such information is not provided, the entity's application will be deemed incomplete and a tax clearance will not be issued.

The Tax Section is concerned about this provision for two reasons. First, it is not clear to us why information regarding third-parties (*e.g.*, corporate officers) is relevant to determining whether the entity does or does not have a past-due tax liability for purposes of issuing a business or professional license to the entity. If the Budget Bill is contemplating authorizing the denial of such licenses to entities where its responsible officers themselves owe past-due taxes that should be made clear, as it would raise a host of other potential problems and considerations. Second, we note that the phrase "responsible officer" (or "responsible person") is a term arising in the sales and use tax and withholding tax areas. In this regard, disputes frequently arise as to whether an individual is or is not a responsible officer, the outcome of which can hinge on a variety of highly fact specific inquiries. Accordingly, we believe it is inappropriate to condition the contemplated tax clearances and license issuances on the requirement that an entity to provide a list of persons that may be deemed liable for the entity's taxes where the facts and circumstances surrounding the individual's liability as a responsible officer in any given tax period may be unknown or unclear. Moreover, taxpayers may be understandably concerned that providing such a list is equivalent to making an admission of liability on behalf of the individual "responsible officers" named. No taxpayer should be required to make such an admission simply because the individual holds a certain title as an officer. Indeed, it is well-established in New York that an individual's status as an officer is insufficient to deem that individual a responsible person.

V. Part QQ: New York City Corporate Tax Reform

Part QQ of the Budget Bill proposes to substantially conform the New York City regime for the taxation of general business corporations and banks that conduct business in New York City to the New York State tax regime. It does so by adopting many of the New York State corporate tax reform proposals enacted in 2014, which went into effect for tax years beginning on or after January 1, 2015.[29] The Tax Section prepared reports commenting on those New York State corporate tax reform proposals, and also made recommendations for technical changes and areas that require guidance.[30]

A. Proposed Changes

Part QQ creates a new tax (under a new Subchapter 3-A) that will apply to corporations for tax years beginning on or after January 1, 2015, except for federal S corporations and qualified subchapter S subsidiaries, which will continue to be subject to the general corporation tax ("GCT") under Subchapter 2 of Title II, Chapter 6 of the Administrative Code. Overall, the thrust of the proposed changes is to substantially conform the New York City corporate tax regime to the recently overhauled New York State regime. The new proposals also conform to the technical changes to Article 9-A proposed in Part T of the Budget Bill, which are discussed earlier in this report.[31]

Among the most significant conforming changes are the following:

1. Merger of bank tax into general corporate tax. Repeals the bank tax and subjects banking corporations to the new Subchapter 3-A tax applicable to most general business corporations.

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[29] Chapter 59, Part A, N.Y. Laws of 2014.

[30] *See* Tax Section Comments Regarding Corporate Income Tax Reform, Report No. 1301, March 13, 2014; Tax Section Memorandum re Recommended Technical Corrections to 2014 New York State Corporate Tax Reform Legislation, Report No. 1309, September 5, 2014; and Tax Section Letter to Tax Commissioner Thomas H. Mattox Regarding Guidance Under the New York State Corporate Tax Reform Provisions, Report No. 1312, November 20, 2014.

[31] Our comments to Part T of the Budget Bill are also applicable to the similar provisions contained in Part QQ.

2. *Adopts economic nexus*. Adopts a "bright-line" economic nexus standard for taxation for corporations deriving at least $1 million of receipts annually from activities in New York City, regardless of whether the corporation has employees, tangible real property or any physical presence in the City.

3. *Modifies the categories of income (business, investment and other exempt income), with only business income subject to tax.* The proposal modifies the categories of a corporation's reportable income, with only apportioned business income being taxable.

4. *Subsidiary capital treatment eliminated*. The proposal eliminates the long-standing subsidiary capital classification, including the exclusion for 100% of income from subsidiary capital.

5. *Investment income exempted from tax*. Net investment income will no longer be taxable, and the New York City investment allocation percentage ("IAP") will no longer be used to apportion investment income (except for S corporations under the GCT, and unincorporated businesses subject to the New York City unincorporated business tax ("UBT"), which will continue to have their investment income apportioned using the IAP). The definition of investment capital will be significantly narrowed to include only investments in the stock of non-unitary corporations held for more than six consecutive months.

6. *Limited interest expense attribution*. Nontaxable investment income and other exempt income will be reduced by *interest* expenses (but not non-interest expenses) directly or indirectly attributable to those items of income. Taxpayers will be permitted to make an election to reduce their nontaxable investment and other exempt income by 40% in lieu of computing an interest expense attribution.

7. *Market-based sourcing*. The proposal adopts market-based sourcing for all types of receipts and gains in the apportionment factor, and prescribes clearly-defined hierarchies for determining the market state. This includes new market-based sourcing rules for receipts from digital products and for income from financial instruments.

8. *Adopts water's-edge unitary combined filing*. The proposal requires corporate taxpayers to file combined returns with unitary corporations in which there is a more than 50% stock ownership interest. It contains several exceptions to unitary combined filing, including an exception for alien corporations that have no federal effectively connected income. Taxpayers will be allowed to make a binding seven year election to file on a combined basis with all commonly owned corporations that meet the more than 50% stock ownership test.

9. *New treatment for net operating losses*. A net operating loss ("NOL") will now take into account the taxpayer's apportionment factors from the loss year. The NOL carryforward period will conform to the 20-year federal carryforward period, and allow the taxpayer to elect a three-year carryback. Unabsorbed NOLs that arose in tax years beginning before January 1, 2015– under the GCT or the bank tax– cannot be taken under the new Subchapter 3-A tax. Instead, the proposal introduces a "prior NOL conversion subtraction," which would be deductible in 1/10 amounts over a 20-year period, taking into account the taxpayer's apportionment factor in the base year. Alternatively, taxpayers may elect to claim the conversion subtraction in up to 50% amounts in each of the first two tax years under the new tax.

There are several areas where the proposed changes do not conform the new Subchapter 3-A tax to Article 9-A. The most significant areas of nonconformity are as follows:

1. *Tax on capital*. Unlike the reforms under Article 9-A, the New York City corporate tax proposal would not phase-out the alternative tax on allocated capital. Under Article 9-A, the tax on capital will be phased-out by 2021, and until that time is capped at $5 million annually. In contrast, the New York City proposal retains the tax on allocated capital at the existing tax rate, and increases the cap to $10 million annually, with a $10,000 subtraction.

2. *Retains graduated phase-in of single sales factor*. The proposal incorporates the existing phase-in under the GCT of the single sales factor through 2018. In contrast, Article 9-A has employed single sales factor apportionment since 2007.

3. *Reduced tax rates for small businesses and for manufacturing corporations*. The proposal provides for lower tax rates on business income for corporations with business income (without the deduction of the prior net operating loss conversion subtraction) of less than $3 million during the tax year. It also provides for lower tax rates on income for a new category of "qualifying New York City manufacturing corporations." For such manufacturing corporations, the tax rate will depend on the amount of the corporation's allocated business income, as well as on the amount of its unallocated business income, in a given year. In contrast, beginning in 2014, Article 9-A imposes a 0% tax rate on the business income of qualified New York manufacturing corporations. Lower rates on allocated capital and for the fixed dollar minimum tax also apply.

Part QQ contains two additional significant provisions. First, the new Subchapter 3-A tax does not apply to federal S corporations and qualified subchapter S subsidiary corporations. Therefore, such corporations will remain subject to the existing New York City GCT or bank tax. Those taxes would remain in effect – without the conforming changes discussed in Part QQ – solely to apply to such corporations.[32]

Second, the proposal would change the current rules regarding the effect of New York State changes to a taxpayer's taxable income or other tax basis. Under the existing GCT and the bank tax, final changes to State taxable income or any other basis of tax under Article 9-A and former Article 32 ("State Changes"), must be reported to New York City within 90 days of the final determination of the change (within 120 days for taxpayers filing their returns on a combined basis). The taxpayer must either "concede the accuracy of such determination or state wherein it is erroneous."[33] Where the taxpayer reports final State Changes to New York City, the statute of limitations for assessment or refund is either extended or entirely re-opened with respect to those changes for up to two years from

[32] Unlike the New York State tax regime, New York City does not afford pass-through tax treatment to S corporations, which have always been taxable as ordinary C corporations under the GCT.

[33] Admin. Code § 11-605(3).

the reporting of those changes.[34] Under the current law, New York City may not change the allocation of the taxpayer's income or capital during this additional period of limitation.[35] This means that the Department of Finance may not change a corporate taxpayer's allocation factors during the additional period of limitation, even in those instances where the State Changes are to the taxpayer's Article 9-A allocation factors.[36]

Under the proposal, New York City would be permitted to change a taxpayer's allocation factors during the additional period of limitation to the extent the changes relate to the State Changes. For example, even if a taxpayer's year is closed for assessment, the issuance of final State Changes would allow New York City during the additional limitation period to adjust the taxpayer's allocation factors stemming from those changes. The proposal would be applicable to new Subchapter 3-A, as well as to the existing GCT and bank tax, for tax years beginning on or after January 1, 2015.

B. Comments

The Tax Section has previously issued reports acknowledging the many benefits from the enactment of last year's Article 9-A corporate tax reform legislation. Those benefits included the needs of businesses, the State's administrative and financial needs, and the overall climate of tax jurisprudence. We commend both New York City and New York State government officials for now proposing legislation to substantially conform the New York City corporate income tax with that legislation. Although we have generally been cautious in supporting retroactive tax legislation– particularly where, as here, it retroactively creates a new tax that would represent a significant change to the long-standing New York City income tax system– we believe the important goal of substantial

[34] Admin. Code § 11-674(3)(c).

[35] Admin. Code § 11-674(3)(g).

[36] *See In re Ethyl Corp.*, TAT(E) 93-97(GC) (N.Y.C. Tax App. Trib., June 28, 1999).

conformity between the State and City income taxes far outweigh any concerns regarding the limited retroactivity of new Subchapter 3-A.[37]

As noted above, the Tax Section has previously provided comments on the 2014 Article 9-A reform legislation, and accordingly we do not repeat them here with respect to the conforming New York City provisions. Certain non-conforming aspects of the proposal do merit comment, however, as discussed below:

1. Continued Application of GCT and Bank Tax to Federal S Corporations

Under the Budget Bill, federal S corporations will remain subject to the GCT or to the bank tax. This will leave the New York City taxation of federal S corporations out of conformity with Article 9-A, which generally does not apply to electing New York State S corporations. This will cause S corporations to be taxed by New York City in a substantially different manner than the way C corporations are taxed under the new Subchapter 3-A tax.

We do not express a view as to the appropriateness as a matter of policy of retaining the GCT and bank tax solely to apply to federal S corporations, and of taxing those S corporations in a significantly different manner than C corporations. We note, however, that the retention of those taxes will likely have unintended administrative complications. For example, by retaining the GCT for S corporations, C corporations may still be required to compute an issuer's allocation percentage for use by its S corporation shareholders, even though corporations under the new Subchapter 3-A tax would otherwise have no reason to compute such a percentage. In turn, the Department of Finance would need to continue to publish and monitor taxpayer issuer's allocation percentages. Such administrative complications would not arise if all corporations were subject to Subchapter 3-A.

We understand that the Department of Finance has recently commenced a study of the New York City taxation of all pass-through entities, including S corporations, partnerships, and limited

[37] We anticipate that the Department of Finance will adopt a reasonable and flexible policy regarding potential underestimated tax penalties that could result in the first year the changes apply due to the scope of the changes, particularly for estimated tax payments that will be due for the first quarter of 2015.

liability companies. It has formed a working group comprised of Department officials and outside practitioners and taxpayers. Its purpose is to make recommendations for how all pass-through entities should be taxed by New York City. Among the concerns publicly expressed by Department officials are the revenue implications of adopting the market-based sourcing under new Subchapter 3-A to pass-through entities, including S corporations. The Tax Section recognizes the legitimate concerns of the Department, but at the same time believes that the retention of the GCT and bank tax will result in administrative burdens both to taxpayers and to the Department. Therefore, we strongly encourage the Department to proceed expeditiously with the conduct of its study, with the stated goal of making recommendations by the end of 2015. The Tax Section remains willing to provide assistance in this worthwhile endeavor.

2. Tax Rates for Qualified New York City Manufacturing Corporations

The Budget Bill introduces the category of a "qualified New York City manufacturing corporation," which would be entitled to lower tax rates on income based on the amount of the corporation's allocated or unallocated business income. A qualified New York City manufacturing corporation is generally defined as a corporation principally engaged in manufacturing and having property located in the City either (i) with an adjusted basis for federal income tax purposes at the close of the tax year of at least $1 million or (ii) where more than 50% of the corporation's real and tangible personal property is located in the City.[38]

The income tax rate for a qualified New York City manufacturing corporation would depend on the amount of the corporation's business income each year. For example, an otherwise qualifying manufacturing corporation with allocated business income to the City of less than $10 million (without

[38] Under Article 9-A, beginning in 2014, qualified New York manufacturing corporations are entitled to a 0% tax rate on income. The definition of a qualified New York manufacturing corporation depends on the maintenance of a threshold amount of real or tangible personal property in the State. The Tax Section has previously expressed concern that conditioning a lower tax rate for certain manufacturers based on whether the corporation maintains a sufficient level of property in the State is susceptible to constitutional challenge as discriminating against interstate commerce. *See* Tax Section Report 1128 (May 31, 2007) and Tax Section Report 1301 (March 13, 2014).

taking into account the prior net operating loss conversion subtraction) would be subject to tax at the reduced rate of 4.425% of allocated business income. The reduced tax rate changes if certain thresholds are met for the tax year (*i.e.*, where allocated business income is at least $10 million but less than $20 million, and where unallocated business income is at least $20 million but less than $40 million, with no rate reduction for manufacturing corporations having unallocated business income of at least $40 million for the tax year).

While the Tax Section does not take a position regarding reduced tax rates for certain manufacturing corporations as a matter of policy, we note that the imposition of varying tax rates based on the amount of a corporation's business income for the year adds both a level of complexity and uncertainty as to a corporation's tax liability for the tax year. This is because the amount of a corporation's business income (whether allocated or unallocated) may not be known until after the close of the tax year. A manufacturing corporation could be subjected to different tax rates from year to year if its business income is susceptible to large variations between years. Creating a single uniform tax rate applicable to all qualified New York City manufacturing corporations would avoid these uncertainties.

3. Apportionment for Certain Financial Instruments

Similar to the Article 9-A corporate tax reform legislation, the Budget Bill creates a new category entitled qualified financial instrument ("QFIs"), the receipts and gains from which generally are sourced to the location of the customer or counterparty. Alternatively, the taxpayer may elect to use the "fixed percentage method" for sourcing income from QFIs. Under that election, 8% of the receipts and net gains from all QFIs are included in the numerator, and 100% are included in the denominator, of the apportionment fraction.

For receipts and net gains from certain financial instruments, however, the proposal would mandate that a fixed 8% of the receipts and net gains be sourced to New York City. This mandatory 8% sourcing would apply to such items as receipts and net gains from asset backed securities or other securities issued by government agencies, reverse repurchase agreements, securities borrowing agreements, and federal funds.

We note that the New York State Department of Taxation and Finance has previously indicated that the 8% sourcing methodology under the Article 9-A corporate tax reform legislation was based on New York State's approximate contribution to the U.S. gross domestic product ("GDP"). As such, consideration should be given to determining New York City's approximate contribution to the U.S. GDP, and to setting both the QFI sourcing election percentage and the mandatory sourcing percentage for certain financial instruments based upon the City's approximate contribution to GDP.

4. Changes to Allocation Factors Resulting from Changes to State Taxable Income

We note that the proposed changes to allow the Department of Finance to change a taxpayer's allocation factors during the additional limitation period is not a proposal to conform to changes made under the Article 9-A tax reform legislation. We believe any changes regarding the impact of final State Changes for tax years that are otherwise closed for assessment should be made as part of a broader examination of those provisions, and not as part of legislation intended to conform to last year's amendments to Article 9-A.

The proposal would allow the Department of Finance to assess additional tax against a taxpayer in otherwise closed years by increasing the taxpayer's allocation factors with respect to the State Changes. This would be permitted even if the Department had previously conducted a field audit of the taxpayer's returns for the same years and had examined the taxpayer's allocation factors as part of that audit. This would represent a significant change to existing law, and would further limit the finality that results from the expiration of the three year limitations period for assessment. We understand the rationale behind the proposal in permitting the Department to adjust the allocation factors for receipts increased or decreased as a result of State Changes. The proposal as written would limit the Department's ability to make allocation factor adjustments only with respect to such State Changes. In the case of changes to a taxpayer's federal taxable income, however, to the extent those federal changes must also be reported to New York State, the proposal could conceivably also be triggered by those federal changes.

Moreover, the proposal addresses only one aspect of the Department of Finance's ability to assess additional tax following the re-opening of an otherwise closed year resulting from State Changes. An examination of the policy implications could lead to the conclusion, for example, that the law should be amended to eliminate the reporting requirement where the City previously conducted a field audit for the tax years covered by the State Changes. While we do not advocate such changes in this report, we raise it as an example of another issue that should also be considered if the Department desires to reform the reporting and impact of federal or State changes. Inasmuch as the proposal addresses only one aspect of the issue, and may compound the concerns regarding the finality that the limitations period is intended to protect against, we believe this proposal should be enacted only as part of a broader examination of the reporting of State Changes.

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