NEW YORK STATE BAR ASSOCIATION
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February 22, 2010

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Re: 2010-11 New York State Executive Budget—Comments on Certain Revenue Provisions

Gentlemen:

We are writing with comments of the Tax Section of the New York State Bar Association[1] on certain revenue provisions of the 2010-11 New York State Executive Budget (the "Budget Bill") released by Governor Paterson on January 19, 2010.[2] We are providing comments on Part G of the Budget

[1] Opinions expressed in the report are those of the Tax Section of the New York State Bar Association, and do not represent those of the New York State Bar Association unless and until they have been adopted by the Association's House of Delegates or its Executive Committee.

Bill, which proposes changes to the definition of resident trust, under separate cover.

1 Income Received by Non-Residents for Termination, Non-Compete Covenants and Other Compensation

Part E of the Budget Bill would add a new subparagraph (F) to section 631(b)(1) of the Tax Law, to include as New York source income "income received by nonresidents related to a business, trade, profession or occupation previously carried on in this state, . . including but not limited to, covenants not to compete and termination agreements."[3] Where the income is related to a trade, business, profession, or occupation previously carried on partly within and partly without the state" it would be allocated in accordance with section 631(c) of the Tax Law ("Income and deductions partly from New York sources")

The Memorandum in Support states that as a result of two Tax Appeals Tribunal decisions in 1997,[4] there has been "widespread abuse of post-employment severance packages . . . result[ing] in a significant revenue loss for the state." The objective of Part E is to treat the payments made to nonresidents who previously conducted a trade or business[5] in the State as having the same source as the past activities and therefore as New York source income. Although the Memorandum principally discusses termination payments and payments for noncompete covenants, it appears based on the statutory language that, with respect to income received by a nonresident following the termination of a trade or business, new subparagraph (F) would supersede existing subparagraph (B) (which treats payments attributable to a New York trade or business as New York source). The new provision would apply to all taxable years beginning on of after January 1, 2010.

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2 This principal drafters of the comments on Part E, Part F, and Part L are Irwin M. Slomka, Elizabeth Kessenides, and Sherry Kraus, respectively. Helpful comments were received from Carolyn Joy Lee, Peter H. Blessing, Maria T. Jones, Peter Faber and Michael Schler.

3 We believe that the words "income received pursuant to" should be inserted before "the word "covenants" in this sentence.

4 *Matter of Haas*, DTA No. 812971, N.Y.S. Tax Appeals Trib. (Apr. 17, 1997) and *Matter of Penchuk*, DTA No. 812646, N.Y.S. Tax App. Trib. (Apr. 24, 1997). These cases held that payments for covenants not to compete were not "attributable" to services performed in New York, even where the previous services had been entirely performed in New York. Accordingly, Part E refers to payments "related to" activities "previously" performed. The term "termination agreements" seems to refer to agreements of the sort in the case of *Matter of McSpadden*, DTA No. 810895, NYS Tax App. Trib. (Sept. 15, 1994) (holding that a payment to a nonresident to buy out the remainder of his employment contract did not constitute New York source income)

5 We refer herein to a "trade, business, profession or occupation" as a "trade or business."

We believe that enactment of Part E without additional clarification would lead to considerable uncertainty. Part E would provide for the allocation of income received for a trade or business previously carried on within and without the State in accordance with section 631(c) of the Tax Law, but that section provides only that income may be allocated "under the regulations of the Tax Commission." Income Tax Regulation Part 132 sets forth detailed rules for allocating and apportioning income earned partly within and partly outside New York, and those methods vary based on the type of income. We assume that the existing allocation rules for "pensions and other retirement benefits" under section 132.20 and for stock options, restricted stock and stock appreciation rights under section 132.24 will continue to apply. Section 132.4(d) defines "retirement benefits" for purposes of section 132.20 as including payments for a covenant not to compete received upon retirement. It is unclear, however, whether a similar rule would apply to payments under termination agreements and payments for covenants not to compete more generally (e.g., not received upon retirement).[6]

Specifically, we are concerned that proposed section 631(b)(1)(F) does not provide guidance as to how far back in time a taxpayer must look in such a context to determine whether covered payments are "related" to a trade or business formerly conducted in the State and for determining the New York allocable percent thereof.[7] In seeking a reasonable standard for this purpose, we do believe that the allocation rules relating to "pensions and other retirement benefits" contained in Regulation section 132.20, which currently covers payments for covenants not to compete received upon retirement, is most relevant. That regulation provides that the portion of pension and retirement income considered to be New York source is generally based on the proportion that the nonresident's total compensation from the employer from New York sources for the portion of the year prior to retirement plus the three taxable years immediately preceding the year of retirement bears to the total compensation from the employer earned both within and outside the State during that same period.[8] While there are differences between pension and retirement payments on one hand, and payments not received on retirement on the other, we believe that a similar three-year look-back for determining whether the payments for termination agreements and for noncompete covenants are "related" to a trade or business previously conducted in the State would strike a reasonable balance

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6 If Part E is intended to supersede section 631(b)(1)(B) with respect to post-trade or business income, then we recommend that Regulation section 132.4(d) ("Pensions and other retirement benefits") should be made a separate section of the regulations applicable to new subparagraph (F).

7 Relevant scenarios would include where activities are conducted in the State for, e.g., four years and then outside the State for, e.g., four years (followed by retirement), as well as where they are conducted both within and without the State in varying percentages in each of the four (or eight) years preceding retirement.

8 We note that under Federal law states are precluded from taxing a nonresident on many types of pension and retirement income. 4 USC § 114

between the desire to prevent manipulation and the objective of looking to a period of reliable comparability and for which records are readily available.[9] A fixed period also would provide certainty for administrators and taxpayers alike.

We believe that in the interest of certainty legislative guidance in this regard is preferable to awaiting guidance by regulation. Legislative guidance could be provided by having proposed Tax Law section 631(b)(1)(F) expressly provide that, except as otherwise provided by regulation, amounts received under termination agreements or covenants not to compete that relate to a trade or business previously conducted within and without the State (including where conducted within the State for certain years and without the State for other years) generally should be allocated within and without the State by reference to services performed (or relevant activities conducted) during the three taxable years immediately preceding the year the nonresident ceased substantial conduct of the trade or business to which the payment relates (e.g., ceased performing services for a particular employer) and the portion of the current year preceding such cessation. An alternative could be to provide generally that a fixed period rule analogous to that applicable under section 132 20 is intended to apply and shall be presumed to apply except as otherwise provided by regulation.

2. S Corporation Gains; Transactions Involving Elections under Section 338(h)(10) (and Installment Sales under Section 453) of the Internal Revenue Code where Nonresident Shareholders

Part F of the Budget Bill would reverse the result reached in the recent New York State administrative decision, *Matter of Gabriel S Baum*[10], by amending section 632(a) of the personal income tax provisions to clarify that in the case of a sale of S corporation stock where, for federal income tax purposes, an election has been made under section 338(h)(10) of the Internal Revenue Code (the "Code"), the tax treatment of such transaction will conform to the federal tax treatment and that the sale shall be treated as a sale of the underlying assets for purposes of determining New York source income of a nonresident. As currently proposed, the legislative revisions in Part F, section 2 would apply on a retroactive basis to all tax years for which the statute of limitations for seeking a refund or assessing additional tax remains open

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9 In theory, payments for covenants not to compete may be sourced differently than payments for past services. Under Federal law there is precedent for sourcing payments for covenants not to compete as U.S. or non-U.S. source by reference to where the competition or activity is agreed to \be foregone (which might not be only the places in which activity was previously conducted by the recipient). In the context of sourcing payments under covenants not to compete within and without the State, however, in certain circumstances covenants not to compete may be used to provide payments for previous services, and hence we believe that the possibility for manipulation outweigh the considerations motivating a difference in treatment.

10 *Matter of Gabriel S. and Frances B. Baum*, DTA No. 820837 and 820838, NYS Tax Appeals Trib. (Feb. 12, 2009).

The holding in *Baum* leads to a lack of conformity between the federal income tax treatment of a transaction and the state tax treatment of the same transaction; furthermore, the ruling in *Baum* raises significant uncertainty for buyers, as well as New York resident selling shareholders, of stock in an S corporation where an election has been made under section 338(h)(10).[11]

In *Baum*, the Tax Appeals Tribunal upheld a non-resident selling shareholder's position that a sale of stock in an S corporation, despite its classification as a deemed asset sale for federal income tax purposes, should be characterized as a sale of stock for state tax purposes. Because the Tribunal determined that the sale was a sale of an intangible asset, the non-resident selling shareholders prevailed in their position that the gain realized on the sale was not sourced to, or subject to tax in, New York State. The Tax Appeals Tribunal in *Baum* focused on the fact that in actuality there had been no sale of assets by the S corporation. Sections 631 and 632 of Article 22 of the Tax Law provide that, in determining the New York source income of nonresident S corporation shareholders, one looks to the New York source portion of the shareholder's federal inclusions in adjusted gross income; Section 632 references the applicable methods and rules for allocation under Article 9-A.[12] The Tribunal focused principally on the statutory provisions under section 208(9) of Article 9-A of the Tax Law, which provides as a general rule that the "entire net income" of an S corporation (against which the allocation percent is applied) is computed by reference to the income the corporation would have been required to report "if it had not made an election under subchapter S of chapter 1 of the Internal Revenue Code."[13] The Tribunal read this language to require that the deemed asset sale that arises under section 338 of the Code must be disregarded for New York state purposes (because in the case of a C corporation, a section 338(h)(10) election would not have been possible), even though the issue before the Tribunal related to the character and source of income of an electing selling shareholder.

The *Baum* decision has left the door open for potential uncertainty and inconsistency in tax treatment between buyers and sellers in the same transaction. For example, the result in *Baum* could put resident taxpayers who have sold S corporation shares in a section 338(h)(10) transaction at a significant disadvantage; if *Baum* requires that the sale be characterized as a sale

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11 Decisions of the Tax Appeals Tribunal in favor of taxpayers cannot be appealed by the Division of Taxation

12 Article 22 deals with individuals, whereas Article 9-A deals with corporations.

13 We note that, under prior law, New York imposed tax on S corporations' entire net income, at a rate equal to the excess of the corporate tax rate over that imposed on individuals. In that context, it was necessary to determine a corporation's taxable income with reference to section 208(9). See *Matter of Zweig Total Return Advisors*, DTA 819390, et seq., NYS Div. of Tax Appeals (Dec. 16, 2004).

of stock, and the entire gain is New York source income, taxes imposed by other state or local jurisdictions would not be creditable against New York state taxes for New York residents. Further, purchasers of stock in these circumstances may adopt the position that *Baum* does not extend so far as to prevent a purchasing corporation from adjusting (*ie*, increasing) inside asset basis when a federal section 338(h)(10) election has validly been made. Part F of the Bill would eliminate this potential for inconsistent treatment between the purchaser and the selling shareholders. It would mandate conformity of the treatment of the transaction for New York State tax purposes to the tax treatment under federal income tax rules.

We strongly endorse the proposed change contained in Part F, section 2 relating to sales of S corporations in a transaction treated as a deemed asset sale under section 338 of the Code. The changes will serve to clarify results for taxpayers involved in sales and liquidations of S corporation stock and will eliminate uncertainty that has existed in this area for some time. *Baum* may leave many taxpayers in an uncertain and potentially unwelcome position, as it may call into question the validity of a federal section 338(h)(10) election for New York state tax purposes more broadly. Furthermore, the complexity and confusion that can arise as a result of inconsistent tax treatment of a transaction (whether as between the federal tax treatment and the state tax treatment, or as between buyers and sellers in a single transaction) is unwarranted.

The proposed retroactive effective date provision is unusual, particularly so in a situation involving long standing statutory provisions. Although retroactive changes in tax law are not unheard of and have been adopted from time to time by Congress and by state legislatures, we note that changes in law to address unintended, and sometimes even abusive, tax results are normally adopted on a prospective basis. In the limited recent examples where retroactive changes in law have been adopted to fix abusive or unintended results, the ambiguity or inappropriate result that followed from a gap in statutory provisions was a recent one, not one that had existed for a period of many years. In *Baum*, the operative provisions in section 208(9) and the provisions addressing the source of income for nonresidents have been in existence for years. Further, there was sufficient ambiguity in these provisions in the case of a section 338(h)(10) election under the Code as to lead certain nonresident sellers of S corporation stock to take the position upheld by the Tribunal in *Baum* and others, possibly, to have followed the holding of the Tribunal.

In addition, a retroactive change in law in this situation presents concerns over process and reliance. The New York State legislature has previously considered the question of process, and in enacting the legislation establishing the Tax Appeals Tribunal, decided that the State could not appeal decisions of the Tribunal. Overriding this decision by adopting retroactive legislation to address Tribunal decisions with which the Division of Taxation disagrees is problematic.

However, we also recognize (as discussed above) that this specific situation is unique, principally because of the ongoing tax significance for purchasers of S corporations in transactions involving section 338(h)(10) elections. Post-B*aum*, it is not clear whether a purchaser of S corporation stock is properly entitled to adjust the inside basis of the corporation's assets. A situation in which parties on different sides of a single transaction have chosen to adopt (or, are able to adopt) inconsistent tax positions, allowing nonresident sellers to escape New York tax on gain realized, while at the same time allowing purchasers to reflect a stepped-up basis in the assets of the purchased S corporation, presents a somewhat confusing and troublesome factual context that could justify retroactive application of the legislative changes to section 632(a)

A majority of the Committee believes that the changes proposed in section 2 of Part F of the Budget Bill should be adopted only on a prospective basis, from January 19, 2010 (the date the Budget Bill was released) or January 1, 2010 (the customary date for prospective changes). A substantial minority, while generally not in favor of retroactive changes in law, would nevertheless support the application of the retroactive effective date in this context.

The proposed revisions to section 632(a) of the Tax Law do not serve to perfectly equalize tax consequences as between New York State resident sellers of S corporation shares and non-resident sellers, but we believe the benefits of clarity and consistency referred to above outweigh any concern over this discrepancy. The potential discrepancy can arise in cases where a Section 338(h)(10) election is made because the proposed legislation requires that any loss recognized on the deemed liquidation that follows the deemed asset sale by the S corporation will be treated a loss on the disposition of an intangible asset, and will not be available to offset New York source gain recognized on the deemed asset sale. A New York resident taxpayer, however, would be able to offset any allocable share of gain realized on the deemed asset sale with a loss recognized on the subsequent liquidation, and therefore on a net basis a New York resident could have less gain as a result of the transaction than a non-resident with the same outside basis in S corporation shares. While this discrepancy may seem objectionable, the same discrepancy could arise in the transactions that involve an actual asset sale followed by a liquidation of the S corporation. Similar discrepancies could also arise where a partnership interest is sold by a non-resident, if the partnership had not made an election under Section 754 of the Code and conducts business in New York State.

We note that the proposed revisions in Part F do not address section 620 of the Tax Law, dealing with credits residents can claim for taxes paid to other states. Assuming the proposed legislative revisions contained in Part F are enacted, we think it will prove helpful, both to taxpayers and to the Department, if the regulations under section 620 are amended to specifically address the creditability of taxes imposed by other states on the deemed asset sale that arises as a result of a section 338(h)(10) election. If it would be helpful, we will be happy to discuss such an amendment to the regulations at a future date.

3. Offers in Compromise

Part L of the Budget Bill contains recommendations for statutory amendments to Tax Law section 171 subdivision Fifteenth. This is the law which empowers the Commissioner of the New York State Department of Taxation and Finance to administer the New York Offer in Compromise Program. The New York State Offer in Compromise Program, as currently being administered, often does not provide adequate relief to tax debtors for resolving overwhelming tax debts. This is the result, in part, of underlying statutory differences between the New York Offer program and the more effective federal Offer in Compromise program.

For example, under the present provisions of subdivision Fifteenth, a taxpayer must demonstrate that he/she has been discharged in bankruptcy or is insolvent as a threshold requirement to be eligible for consideration of a New York State Offer in Compromise. This requirement eliminates from the New York Offer program all tax debtors who are technically "solvent" at the time of submission of their offers even though they may have no likelihood of ever paying the tax liability in full. In contrast, under the federal offer in compromise program, there is no such restriction on taxpayer net worth in order to be eligible for Offer relief. Since the federal tax debtor must make a minimum offer which equals or exceeds his/her net equity in assets, the tax debtor will be required to pay down all equity and assets to the point of "insolvency" if the federal Offer is accepted. The New York requirement, which denies Offer in Compromise relief to "solvent" taxpayers, does not advance the overall goals of the New York Offer program and denies relief to many taxpayers who will never be able to pay their liability in full while, at the same time, depriving the State of revenue from the pay down of the equity of solvent taxpayers. The proposed change to subdivision Fifteenth would allow the Commissioner to accept offers from a broader pool of applicants, including those who can demonstrate undue economic hardship or other exceptional mitigating circumstances.

Further, Subdivision Fifteenth presently requires that the amount payable in the Offer in Compromise equal or exceed what the Tax Department could recover through legal proceedings. This requirement often results in an unrealistically high offer amount required from the tax debtor because the Commissioner must assume a full exercise of the Department's levy and garnishment powers over the remainder of the collection period (which can be twenty years or more) even if circumstances render enforcement of the debt impractical, contrary to public policy or unlikely to succeed. The present statutory provisions leave too little flexibility to the Department to compromise a liability for an amount that (a) more accurately reflects the true collection potential of the file, (b) avoids undue economic hardship or (c) because of special circumstances, would justify acceptance of an offer at a lower amount. The proposed change to the law gives needed flexibility to the Department to accept an Offer on the basis of the above additional criteria similar to the federal Offer in Compromise program.

The proposed changes to subdivision Fifteenth in the Budget Bill incorporate many of the changes that the Tax Section has recommended in our various reports throughout the years.[14] We strongly endorse the proposed amendments to the law

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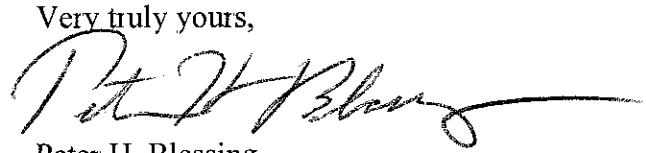
We appreciate your consideration of this letter. If it would be helpful, we would be pleased to speak with you or members of your staff to discuss our comments or assist in any other way we can.

Very truly yours,



Peter H. Blessing
Chair

cc: Hon. Robert Megna, Budget Director, Office of the Governor
Hon. Jamie Woodward, Acting Commissioner, Department of Taxation and Finance

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14 The Tax Section has made a number of recommendations in the past for changes to the New York State OIC program: "Letter Re: Conformity of Federal, State and City Offers in Compromise Statutes" (Report No 983, Nov. 29, 2000); "Report on Proposed Regulations for New York State Offers in Compromise" (Report No 913, Oct. 2, 1997). Sections III.B.3, III B.4 and III.B 5 of the 1997 report are no longer relevant; Sections III B 2 (b) and III B 6 remain relevant with some modifications