New York State Bar Association

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NYSBA

Memorandum providing comments

on certain tax provisions of S.60-A / A.160-A (Revenue Art. VII)

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A. 160-A By: BUDGET
S. 60-A By: BUDGET
Assembly Committee: Ways and Means
Senate Committee: Finance
Effective Date: Various

The Tax Section of the New York State Bar Association offers the following comments on the certain provisions of the above referenced bill.

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Introduction

This report on selected tax provisions of the 2009-2010 New York State Executive Budget legislation was prepared by the Tax Section of the New York State Bar Association.[1] The legislation was submitted by the Governor on January 7, 2009 as Senate bill 60 and Assembly bill 160 (the "Budget Bill"). This report focuses on certain technical, administrative and conceptual issues raised by selected provisions of the legislation with reference to the New York State Tax Law ("Tax Law") and identifies aspects we believe should be reconsidered in their entirety, or clarified by amendments to the legislation or by regulation.

In summary, we recommend:

(i) *Part F: Overcapitalized Captive Insurance Companies*. Part F is intended to prevent captive insurance companies that hold excess investment assets from escaping taxation on their investment income. We recommend that the definition of an "overcapitalized" captive insurance company be modified to make it less likely that a company will qualify as such in one year and not in the next for reasons not related to the purpose of the law; that the legislation be amplified to address issues that arise when a company is subject to two different tax regimes (*e.g.*, for insurance companies vs. other corporations) in successive years; and that consideration be given to whether taxing premium income and non-excessive investment income of overcapitalized captive insurance companies in a manner different from the income of non-overcapitalized captive insurance companies was intended.

(ii) *Part H: Inclusion of Gain from Sale of Pass-Through Entities Owning New York Real Property.* This provision is intended to prevent taxpayers from using pass-through entities to avoid tax on gain on the sale of New York real property. We recommend that further consideration be given to this provision, which as currently drafted may apply in situations where there is no gain attributable to New York real property held by an entity; and in situations

[1] This Report may be referred to as the New York State Bar Association Tax Section Report on Tax Provisions of the 2009-2010 New York State Executive Budget Legislation (S.60/A.160).

The principal drafters of this Report were: Maria T. Jones, Robert E. Brown, Paul R. Comeau, Debra Herman, Carolyn Joy Lee, Peter Leonardis, Joseph Lipari, Jeffrey Reed, Dennis Rimkunas, Arthur R. Rosen, and Bryan C. Skarlatos. Helpful comments were received from Kim Blanchard, Mike Farber, Peter Faber, Sherry Kraus, Robert Plautz, Dexter Samida, and Michael Schler.

where there is such gain, may give rise to several different types of double taxation. In addition, the proposed legislation applies regardless of whether the taxpayer is in a position to know or control the amount of New York real property held by the entity. We believe that there should be a more direct relationship between the gain recognized on sale of an interest in an entity and gain inherent in New York real property held by the entity at the time of sale. We suggest a number of different possible ways of revising the proposed legislation to that end.

(iii) *Part M: Itemized Deductions*. This provision eliminates the use of itemized deductions for individuals with New York adjusted gross income of over $1 million. Because the disallowance is not phased in as income increases, a small amount of additional adjusted gross income may result in a very large difference in New York tax. We recommend that rules more consistent with traditional tax policy principles such as horizontal equity between similarly situated taxpayers be adopted.

(iv) *Part N: Income Received by Non-Resident Partners Performing Investment Management Services.* The objective of Part N is to tax income earned by hedge fund managers and the like on "carried interest." The statutory proposal is very unclear, and technically deficient in a number of very significant respects. As a result, it is both under-inclusive and over-inclusive. Moreover, as compared to a similar federal proposal introduced in the U.S. Congress in late 2007, Part N both omits certain important elements of that proposal, and recreates some of the significant sources of confusion presented by the federal proposal. Finally, by enacting legislation at the State level in advance of any possible federal action in this area, Part N both runs the risk of operating differently from any eventual federal legislation, and would create very real and serious problems of nonconformity with other states' income taxes. We recommend that Part N not be enacted in this form or at this time.

(v) *Part S: Discount Coupons*. Part S would include the face amount of store coupons as a receipt subject to sales tax, as is currently the case for manufacturers' coupons. We note some questions about the administrability of this provision and its revenue estimate.

(vi) *Part CC: Digital Products*. Part CC would create a new class of property or service – the "digital product", meaning property or services delivered electronically – for purposes of imposing new sales and use taxes. We believe the same goal can be better effected by expanding the current statutory scheme for taxing the transfer of tangible personal property and certain services by adding types of property or services, where necessary, rather than defining a new product by reference to its delivery mechanism rather than its content.

(vii) *Part FF: Attributional Nexus Provision*. Part FF creates two new categories of vendors for sales and use tax purposes, affecting remote sellers into the state that have an in-state "affiliate" that uses the same trademark or similar intellectual property or whose actions inure to the benefit of the remote seller. We recommend some modifications to the tests for determining when an in-state affiliate's actions are sufficiently connected to the remote seller to give New York nexus over the remote seller, and suggest that the definition of "affiliate" be revised so that it applies only to parties that are under common control.

(viii) *Part PP: Capital Improvements*. Part PP would limit what qualifies as a capital improvement to real property for purposes of exemptions from the sales tax applying to "capital improvement to real property." We recommend that clarifying changes be made to the legislation, or alternatively that current regulations be modified to address situations identified as abusive.

(ix) *Part SS: Enforcement Provisions*. Part SS would modify the Criminal Procedure Law to confirm that certain tax crimes can be prosecuted by the Attorney General's office in the county in which the alleged transaction took place (rather than in Albany). We applaud this change, and suggest that it apply to a wider set of tax crimes and that defendants also be permitted to change venue to the relevant county. Another provision of Part SS changes the state of mind required for the crime of failure to file a tax return from "intent to evade tax" to "willfully." We are unsure why this change is considered necessary. If it is adopted, we recommend that the law be modified to clarify that it will operate in a manner comparable to the analogous federal provision.

(x) *Part VV: Compliance Provisions*. Part VV would impose a $10 filing fee for taxpayers who choose to file personal returns on paper rather than using New York's electronic filing system. We recommend that this proposal be studied before it is implemented to determine whether it will be effective in increasing the use of electronic filing without harming poor or less sophisticated taxpayers and without increasing non-compliance. We also recommend that the installment payment agreement fee that Part VV would establish be revised to conform more closely with the federal installment payment fee.

While we have commented on only selected provisions of the Budget Bill, we note that the Budget Bill contains a large number of new or increased taxes on a myriad of other activities. We understand the need for increased revenue in order to support the activities of government. We express no view on the appropriateness of these provisions as a matter of policy. However, we note that new taxes (for example, sales taxes on items not previously subject to sales tax) require increased costs of compliance for taxpayers, and, most significantly, increased costs and administrative burdens for the New York State Department of Taxation and Finance (the "Tax Department"), which will be required to provide staff to interpret and enforce these new provisions. With respect to the provisions about which we comment below and with respect to many about which we have not commented, regulations, guidelines, instructions, amendments to forms, and training for auditors will be required. We urge that the ancillary direct and indirect costs of adopting new provisions of this kind be taken into account in determining whether the adoption of these new provisions is preferable as a policy matter to alternative means of raising revenue, such as raising rates on existing taxes for some or all taxpayers.

I. Part F: Overcapitalized Captive Insurance Companies

Part F of the Budget Bill amends the Tax Law as applied to certain captive insurance companies. The amendments are effective for tax years beginning on or after January 1, 2009.

Article 70 of the New York State Insurance Law provides for the licensing of captive insurance companies by the New York State Superintendent of Insurance. A captive insurance company is an insurance company organized to provide insurance to its parent and/or affiliates. Captive insurance companies are used to provide related entities with the ability to manage and finance risks, to lower the cost of coverage, by providing coverage that is customized to the insured's specific needs, and to provide access to otherwise unaffordable or unavailable coverage.

Currently all captive insurance companies are subject to tax under Article 33 of the Tax Law on gross direct premiums and assumed reinsurance premiums (hereinafter referred to collectively as "premiums")[2]. Because captive insurance companies are subject to tax on premiums under Article 33, they are not subject to tax on income under either Article 9-A or Article 32. Thus, income generated from a captive insurance company's investments is not subject to tax by New York.

[2] Tax Law §1502-b(a).

According to the Governor's Memorandum in Support of the Budget Bill ("Memorandum in Support"), taxpayers have been transferring excessive amounts of investment assets to captive insurance companies in an effort to shelter income generated by those assets from New York tax. While transferring assets to a captive insurance company is a legal and necessary activity with respect to the formation and use of captive insurance companies, the Governor takes issue with taxpayers transferring assets to such companies in quantities in excess of capitalization requirements needed to support their insurance activities.

The Governor proposes to subject a captive insurance company that generates significant investment income to tax under Article 9-A or Article 32 through application of the combined reporting rules. Those articles currently prohibit a company subject to tax under one article (*e.g.*, Article 33) to be included in a combined report with a company subject to tax under a different article of the Tax Law (*e.g.*, Article 9-A or Article 32).[3] The changes set forth in Part F of the Budget Bill remove this prohibition.

A. Proposed Changes

1. Combination under Article 9-A and Article 32

Part F requires combination of "overcapitalized captive insurance companies" with related corporations where certain conditions are satisfied. An "overcapitalized captive insurance company" is defined as an entity taxed as a corporation under the Internal Revenue Code ("IRC") that satisfies all of the following conditions:

i. more than 50% of the voting stock of the entity is owned or controlled, directly or indirectly, by a single entity taxed as a corporation under the IRC;

[3] 20 N.Y.C.R.R. § 6-2.5(c); 20 N.Y.C.R.R §§ 21-2.1 to -2.6.

ii. the entity is licensed under state law as a captive insurance company;
iii. the entity's business includes providing, directly or indirectly, insurance or reinsurance covering the risks of the entity's parent and/or members of its affiliated group; and
iv. 50% or less of its gross receipts for the taxable year consist of premiums.

Under the proposed changes, an overcapitalized captive insurance company would be required to file on a combined basis with a corporation directly owning or controlling over 50% of its voting stock. Alternatively, where over 50% of an overcapitalized captive insurance company's voting stock is not owned or controlled by a company subject to tax under either Article 9-A or Article 32, the overcapitalized captive insurance company would be required to file on a combined basis with its closest controlling shareholder.[4]

Further, an overcapitalized insurance company that is not required to file on a combined basis under the two aforementioned provisions still could be required to file on a combined basis under Article 9-A if the ownership requirement is met and (i) the substantial intercorporate transactions requirement set forth in Tax Law §211.4(a) is satisfied or (ii) the agreement, understanding, arrangement, or transaction requirement set forth in Tax Law §211.4(a)(4) is satisfied. Under these provisions, the ownership requirement for an overcapitalized captive insurance company to be combined is 50%, while the usual "substantially all" threshold (*i.e.,* the 80% ownership requirement established by regulation) is applied to the other corporation(s) with which the overcapitalized captive insurance company is to be combined.[5]

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[4]The provisions requiring combination of overcapitalized captive insurance companies are similar to the recent statutory changes made to the treatment of captive REITs and RICs, found in Tax Law § 211.4(a)(6).

[5]20 N.Y.C.R.R. § 6-2.2.

B. Comments

1. Definition of "Overcapitalized Captive Insurance Company"

One component of the definition of "overcapitalized captive insurance company" is: "fifty percent or less of whose gross receipts for the taxable year consist of premiums." This component of the definition presents issues with respect to (i) the use of gross receipts as the factor for measuring whether a captive insurance company is overcapitalized, and (ii) the period for which gross receipts are scrutinized.

(a) Gross Receipts

It is not clear whether the intent of Part F is to tax the investment income of captive insurance companies, in general, or to deter the creation of certain captive insurance companies. As stated in the Memorandum in Support, the changes set forth in Part F are intended to target taxpayers who choose to transfer "assets far exceeding the level necessary to properly insure the risks of the captives." However, under Part F, a captive insurance company's gross receipts, not its assets, are used to test whether it is overcapitalized. By using gross receipts as the point of measurement, it is possible for a captive insurance company with assets that are not excessive for the purpose of insuring the risks of its parent and affiliates to be deemed overcapitalized. For example, a captive insurance company holding only those assets necessary to provide protection for the risks it has insured could be deemed to be "overcapitalized" because less than 50% of its gross receipts in a particular taxable year come from premiums due to active trading of investments or the sale of a single valuable asset, such as a large real estate investment. Thus, using gross receipts as a measuring point may have unintended consequences and arguably, are an unreliable mechanism for determining whether a captive insurance company is "overcapitalized".

If the goal of Part F is to deter placing more assets in a insurance corporation than are necessary to support its insurance activities then perhaps a captive insurance company's assets should be the factor scrutinized or tested, not gross receipts. An asset-based test would need to be constructed, however, in such a manner that it does not impair activities encouraged or mandated by the insurance laws, such as holding adequate assets to support the insurance company's insurance operations. We do not have the expertise to recommend how to construct such a test. We note, however, a possible analogy in the federal income tax rules relating to "passive foreign investment companies" ("PFICs"). A PFIC, generally speaking, is a foreign corporation if either (i) 75 percent or more of the gross income of the corporation for the taxable year is passive income, or (ii) the average percentage of its assets held for that year that produce passive income is at least 50 percent. For this purpose, income "derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business", among other requirements, is treated as "active" rather than "passive" income.[6] Alternatively, if the goal is to tax excess investment income of captive insurance companies, in general it would appear simpler and more straightforward to amend Article 33 to subject some or all such income to tax (see discussion of the treatment of investment income, infra).

(b) Period of Measurement

As drafted, Part F requires taxpayers to make the determination of whether a captive insurance company is "overcapitalized" on a year-by-year basis. Thus, the possibility exists that

[6] IRC Section 1297(b)(2)(B); *see also* Notice 2003-34, 2003-1 C.B. 990 (insurance company with relatively small insurance activities compared to its investment activities may (i) not qualify as an insurance company, or (ii) even if treated as an insurance company, may not be considered to earn income derived in the *active* conduct of an insurance business). These rules have not been the subject of any significant guidance from the Internal Revenue Service.

a captive insurance company would be subject to tax under Article 9-A in one year and under Article 33 the next (and possibly Article 32 the following year). The taxpayer might not know under what tax regime it was taxed until some time after the end of the tax year when it would be able to determine if the premiums received during the year were more or less than 50% of its gross receipts for the year. Accordingly, as currently proposed, taxpayers will likely face annual uncertainty regarding their New York tax liability and filing status.

As a consequence of this uncertainty, taxpayers will likely encounter issues related to estimated taxes. At the beginning of a taxable year, a captive insurance company may have insufficient, or no knowledge of the composition of its gross receipts for that taxable year. Therefore, the proper and accurate calculation of estimated tax payments will be difficult, or impossible. Further, in the event that a taxpayer makes estimated payments under one article and ultimately owes tax under another, uncertainty exists as to how payments made under one article will be properly accounted for and credited to the taxpayer's account, or whether the failure to pay the correct amount under the correct article will subject it to penalties.

We recommend that the proposed legislation be revised to provide a period of review other than the current taxable year. Instead of using gross receipts (or assets) from the current taxable year as the basis for measurement, the prior taxable year could be used. This is similar to the method used to calculate a limited liability company's filing fee as proposed under Part J of the Budget Bill[7]. Alternatively, a multi-year test (*e.g.*, the three years or 36 months prior to the current taxable year) should be considered. A multi-year test would likely mitigate against an

[7] "The filing fee will be based on the New York source gross income of the limited liability company or partnership *for the taxable year immediately preceding the taxable year for which the fee is due*." Part J, Section 1 (emphasis added).

extraordinary event causing an otherwise normal captive insurance company from being deemed overcapitalized.

2. Net Operating Losses

The proposed legislation should also address ancillary issues related to year-to-year variations in filing status. One such issue that arises as a consequence of a corporation being subject to different tax schemes in different tax years relates to net operating losses ("NOLs"). The proposed changes do not address whether taxpayers are permitted to carry over NOLs from a year when taxed under Article 33 (*i.e.*, taxed on premiums) to a year when taxed under Article 9-A or Article 32 (*i.e.*, taxed on net income). If carryovers are permitted, there is no indication whether adjustments or modifications to the NOLs will be required. These matters should be addressed in the legislation, but if not, administrative guidance in the form of regulations will be required.

3. Calculation of Entire Net Income

Inclusion of an overcapitalized captive insurance company in a combined report under Article 9-A raises myriad issues that must be resolved in order for taxpayers to comply. The analysis under Article 32 would pose similar, if not more complex, issues. Unlike insurance companies taxed under Article 33, a taxpayer subject to tax under Article 9-A or Article 32 is subject to tax on its entire net income ("ENI"), subject to various special rules. Without specific guidance, interpretation of the proposed provisions regarding calculation of ENI as applied to captive insurance companies may vary greatly amongst taxpayers. For clarity, we recommend the statutory language address the calculation of ENI where an overcapitalized captive insurance company is a member of a combined group. In the event that statutory guidance is not provided, regulations or administrative pronouncements will be needed to address the calculation of ENI in a combined report including an overcapitalized captive insurance company, under both Article 9-A and Article 32. Such guidance will promote more uniform results, reduce uncertainty, and decrease the expenditure of taxpayer resources (and New York's auditing resources) in attempting to understand the law and pay the proper amount of tax.

Certain aspects of the proposed legislation give rise to results that may or may not have been intended, and that would cause the taxation of "good" income (premiums and non-excess investment income) to vary considerably depending on whether the captive insurance company was deemed to be overcapitalized. We discuss these points below, and offer some suggestions in the event that these results were not intended.

First, a portion of the receipts of every overcapitalized captive insurance company premiums for coverage of the risks it is insuring. Under Part F, these premiums, generated from ordinary insurance business activity, likely will be taxed at a greater rate under Article 9-A than premiums received by a non-overcapitalized captive insurance company taxable under Article 33. Whether this is an appropriate result depends on the goal of Part F. It would presumably serve as an incentive to prevent the creation of overcapitalized captive insurance companies and would therefore be appropriate if that is the goal of Part F. If, however, the purpose of Part F is to subject excess investment income of overcapitalized insurance companies to an appropriate level of tax, then income earned by the insurance company that truly constitutes premiums for insuring risk should not be subject to a higher tax burden than the premiums earned by a comparable non-overcapitalized captive insurance company.

Second, a captive insurance company that does not rise to the level of being "overcapitalized" normally will invest its accumulated premiums or other funds. The income received from the invested funds typically will increase a captive insurance company's pool of accumulated funds, which are intended to cover insurance claims. Under the proposed legislation, all of the investment income of an overcapitalized captive insurance company will be subject to tax. By contrast, a captive insurance company that is not overcapitalized does not incur any tax on its investment income under Article 33. Again, whether the taxation of all of an overcapitalized captive insurance company's investment income is appropriate depends on whether Part F is intended to prevent overcapitalized captive insurance companies or only to tax such companies on excess investment income.

If Part F was intended to tax excess investment income, a bifurcation of the investment income into two categories might better serve that policy. For example, one category would consist of income from investment capital related to the overcapitalized portion of the overcapitalized captive insurance company's assets, and the balance would be in a "nontaxable investment capital" category. Under the IRC, a somewhat comparable set of rules exists for foreign insurance companies that constitute "controlled foreign corporations," under which income derived from reserves allocable to qualifying insurance contracts, or equal to a percentage of premiums earned, is treated as "active" income not subject to anti-abuse rules requiring current inclusion of passive income by such a company's U.S. shareholders.[8] Alternatively, a statutory exclusion from income for a percentage of an overcapitalized captive insurance company's investment income may be administratively less complex, from both

[8] IRC Section 954(i)(2) (defining "qualified insurance income").

taxpayer compliance and New York enforcement points of view, although a bright-line test of this kind inevitably will be either under- or over-inclusive.

4. Apportionment

Specific guidance is needed on the proper allocation of premium income, as the Budget Bill is silent on this point. Under Article 33, premiums are sourced to where the insured property or risks are located. No such rule or other guidance exists in Article 9-A or Article 32. To avoid uncertainty and to minimize the extent to which taxpayers and Tax Department auditors take varying positions with respect to sourcing premiums, we recommend that Part F be amended to provide specific sourcing rules.

II. Part H: Inclusion of Gain from Sale of Pass-Through Entities and Other Corporate Interests as New York Source Income

Part H of the Budget Bill amends Article 22 of the Tax Law to include gain or loss from sales by nonresidents of certain pass-through entities and other corporate interests as New York source income, to the extent the gain or loss is attributed to the entity's ownership of real property in New York. This proposal would significantly alter existing law by recharacterizing currently nontaxable transfers of intangible interests by nonresidents as taxable "real property" transfers.

Currently under Article 22, an individual who is a nonresident of New York has New York source income with respect to items of income, gain, loss and deduction attributable to (i) the ownership of any interest in real or tangible personal property in New York, (ii) a business, trade profession or occupation carried on in New York, (iii) the ownership of shares of stock in an S corporation, (iv) certain lottery winnings, and (v) gains from the sale, conveyance or other disposition of shares of stock in a cooperative housing corporation.

A. Proposed Changes

Part H amends the definition of New York source income in Tax Law §631 to define as "real property" located in New York an interest in a partnership, limited liability corporation, S corporation, or non-publicly traded C corporation with one hundred or fewer shareholders that owns real property in New York if such New York real property has a fair market value that equals or exceeds fifty percent of the value of all of the assets of the entity on the date of sale of the taxpayer's interest in the entity. Part H also includes an anti-stuffing rule under which only the assets that the entity owned for at least two years before the date of sale of the taxpayer's interest are used to determine the fair market value of all of the assets of the entity on the date of sale. An allocation formula to be applied to the taxpayer's federal gain or loss on the sale of the interest is used to determine the nonresident's total New York gain or loss. The formula consists of a numerator that is the fair market value of the real property located in New York on the date of sale and a denominator that is the fair market value of all of the assets of the entity on that date. By way of example, if on the date of sale New York real property constitutes 60 percent of the assets of an entity subject to Part H, and the taxpayer sells its interest in the entity for $1000, of which $100 constitutes gain, $60 of that gain will be subject to tax by New York.

B. Comments

The Memorandum in Support indicates that, as a result of the current law, a nonresident individual may escape taxation on the sale of New York real property by placing the property in an entity and then selling his or her interest in the entity. The Memorandum states that under current law "[a] nonresident can escape taxation [on sale of an interest in real property located in

New York] by placing the New York real property in an entity and then selling his or her interest in the entity," and that the bill "ensures that gain or loss on the direct or indirect sale of New York real property by a nonresident accomplished through the sale of an interest in an entity is subject to New York personal income tax." The proposed legislation would apply, however, in many situations that are not limited to this narrow set of facts. As currently drafted, the legislation applies to a broad range of legitimate business transactions that involve the transfer of interests in entities that own New York real property. As a result, as described in more detail below, the proposed legislation may apply in situations where there is no gain attributable to New York real property held by an entity; may apply where gain on the sale of New York real property held by an entity may be taxed again at a later point; and may give rise to double taxation on the investor's gain from sale of the interest in the entity. In addition, the proposed legislation applies regardless of whether the taxpayer is in a position to know or control the amount of New York real property held by the entity. It is not clear that these results were intended.

For example, A, a New York resident individual, and B and C, nonresident individuals, are partners in a partnership that own two assets. A's and B's interests in the profits and capital of the partnership are each 25 percent, and C's interest in the capital and profits of the partnership is 50 percent. One asset is a parcel of undeveloped land located in New York that the partnership purchased in 2005 for $70,000,000, which has a fair market value of $50,000,000 on January 1, 2010. The partnership's other asset is undeveloped land located in Massachusetts that the partnership purchased in 2005 for $10,000,000, which has a fair market value of $50,000,000 on January 1, 2010. On January 1, 2010, C decides to sell half of his interest in the partnership to D, a Massachusetts based real estate developer, to further the development of the Massachusetts property. Because C is a nonresident of New York and the fair market value of the New York real property on the date of C's sale of his 25% interest in the partnership is 50% of the value of all the assets of the partnership, a portion of C's gain derived from the sale of the interest in the partnership to D, would be New York source income. However, the amount of gain allocated to New York, does not accurately capture the income (loss) attributable to the New York real property, since the New York real property depreciated in value since the partnership acquired the property in 2005, but the entity interest sold to D appreciated in value as a result of the appreciation relating to the Massachusetts real property. Imposing New York tax on this type of transaction goes beyond addressing the tax avoidance purpose articulated in the Memorandum in Support.

If Part H is intended to address only the tax avoidance purpose articulated in the Memorandum in Support, it should be narrowed, as was done in the prior legislative cycle. Specifically, before being rejected by the Legislature last year, the Assembly proposed revised language (*See* Part X, A.9810-B) to legislation initially proposed in last year's Budget Bill that was similar to Part H. However, the Assembly proposal applied "only to sales by a nonresident who, while a resident of this state and within five years of becoming a nonresident, transferred real property located in this state from his or individual ownership to ownership by an entity . . . in which such nonresident had a controlling interest at the time of the transfer." A proposal along these lines (without the reference to a five-year test for becoming a nonresident) that also incorporates a correction to the allocation formula (as discussed below) would appear to satisfy the goals set forth in the Memorandum in Support by more narrowly targeting the provision to potentially abusive situations. Further, such a proposal would address some of the constitutional questions about the current proposal that are discussed below.

We believe that there should be a more proximate relationship between gain recognized on the sale of an interest in an entity holding New York real property and gain inherent in the real property at the time of sale. We describe below a number of other ways to limit the scope of the proposed legislation. The choice of which of these, if any, would be an appropriate modification to the proposed legislation depends on how narrowly the legislation is in fact intended to apply.

One possible alternative would be for the New York real property threshold (the fair market value of the real property that is located in New York) that triggers the provision to be increased from 50% to a substantially higher threshold, for example 95%. A substantial increase in the threshold would ensure that any gain on the sale of the entity is likely to be attributable to appreciation in that real property.

Another possibility would be to impose a "tracing" requirement that would impose tax on gain on the sale of an entity only to the extent that there is gain in the value of New York real property held by the entity. As a practical matter, this likely would require that entities within the scope of Part H be required to report on a periodic basis the relative value of their New York real property vs. other assets to their investors. Investors should be permitted to rely on such information, absent reason to know that it is incorrect. We are not aware of any similar rules under federal or New York law; indeed, tracing rules in other contexts often are rejected as impractical and unadministrable.

Absent a mechanism of the kinds described above to limit Part H to transactions in which gain is clearly attributable to the appreciation in New York real property held by an entity, as currently drafted Part H is unreasonably burdensome for many nonresident taxpayers since it requires such taxpayers to determine the value of the entity's assets when a de minimis amount of the entity is being transferred, such as a 1% or .05555% interest in the entity. An investor with a small ownership interest in the entity may have no access to the information necessary to make that determination. One option to correct this administrative burden would be to revise Part H to apply solely when a controlling interest (i.e. more than 50% of the capital, profits or beneficial ownership of an entity) in an entity has been transferred by a nonresident individual. Such transfers are currently taxed by the State by virtue of the New York State Real Estate Transfer Tax (Article 31, Tax Law, the "RET"). As a practical matter, it will be much easier for taxpayers and the Tax Department to determine when the tax applies.

The application of Part H to C corporations may give rise to double taxation. Under present federal and New York tax law, a C corporation generally is taxed when it sells or exchanges or distributes an appreciated real property interest. Since a C corporation is taxed separately from its shareholders, the specific form of tax avoidance the Governor seeks to address with the enactment of Part H is not present, although the use of a C corporation can provide current tax benefits to a shareholder. Stated differently, a nonresident shareholder of a C corporation that transferred real estate into a C corporation and then sold its interest in the C corporation would not ultimately avoid payment of New York tax since a New York corporate level tax would apply when the real estate is distributed from the C corporation. At the end of the day, New York will receive tax revenues when real property owned by a corporation is distributed or sold. Accordingly, the use of a C corporation under current law may give rise to a timing benefit, but not a permanent avoidance of tax. Part H would eliminate the timing benefit, but its effect would be to give rise to double taxation of the same gain, since both the shareholder and the corporation would eventually be subject to tax on the gain.

Further, Part H applies solely to C corporations that have one hundred or fewer shareholders. As a practical matter, it could be extremely difficult for a nonresident shareholder to determine whether there are 99 or fewer other shareholders at the time of the real property interest transfer, and to determine the value of the corporation's New York real property interest and other asset values. For these reasons (and based on the constitutional reasons set forth below) we recommend that further consideration be given whether it is appropriate for Part H to apply to C corporations, and if so whether these issues can be alleviated.

Consideration should also be given to Part H's potential application to all "items of income, gain, loss and deduction" relating to the entity of which an interest is transferred. As currently drafted, the provision is insufficiently clear as to whether, for example, a partner's entire distributive share of income from the entity of which an interest is transferred will be swept in and characterized as New York source income, rather than the income that relates solely to the gain or loss derived from the sale or exchange of the entity interest or the partner's distributive share of income, gain, loss or deduction entering into his federal adjusted gross income that is derived from or connected with New York sources that is currently subject to tax under § 631(a)(1)(A) of the Tax Law.

While we do not express a view as to the constitutionality of taxing nonresident individuals on gain from the sale of intangible property, including interests in corporations, we believe that there are legitimate questions as to the constitutionality of the proposal. It is likely that constitutional challenges to the legislation, both on its face and as applied, will be made under the U.S. and New York Constitutions. Although the Memorandum in Support indicates that the proposal is consistent with Federal law, specifically IRC §897(c)(1)(A)(ii) (known as "FIRPTA"), FIRPTA does not apply to sales of stock of corporations organized outside the United States (sometimes referred to as "alien corporations"). Part H does not exclude sales of stock of alien corporations and, thus, the reach of the proposed legislation is considerably broader than the reach of the FIRPTA provisions of the IRC. Moreover, the relevant constitutional provisions at issue here are not applicable in the context of FIRPTA.

Further, we believe that the allocation formula in Part H will not accurately capture the income attributable to the New York State real property. The formula used to allocate the federal gain or loss between the New York property and the other assets of the business is based on relative values, not relative appreciation. In situations where, for example, the New York real property has not appreciated in value, but the value of the entity that the nonresident individual owns has appreciated in value due to appreciation in other assets, there would be a windfall to the state based on the value of the business of which the interest is sold, as illustrated in the example set forth above. Conversely, if the New York real property has appreciated in value but other assets have lost value, there could be a windfall to the taxpayer. If the intent of the legislation is to tax nonresidents on the gain attributable to the real property owned by the entity, then the allocation formula should be revised and tied directly to the appreciation of the New York property. In addition, taxing gain that does not bear any relation to activity in the state also gives rise to potential constitutional challenges. See also discussion *infra* in Part VII of this report, discussing Part FF of the budget bill, relating to the complexities of dealing with claims for refund when tax legislation is found to be unconstitutional.

Finally, we are also concerned about the potential double taxation that will occur when New York imposes its personal income tax on the income attributable to the transfer of the entity interest, when tax will also be imposed in the nonresident individual's state of domicile. States typically impose general income taxes upon its own residents on their entire federal taxable income and rely on a credit mechanism to prevent double taxation. However, the credit mechanism fails when the states' sourcing rules are inapposite. Assume the following: (i) State A allows a resident individual a credit for taxes paid to another jurisdiction only if the income subject to tax in the other jurisdiction would be subject to tax under State A's nonresident individual sourcing rules, and (ii) State A, like most other states, considers gain from the sale of an entity interest as a non-taxable sale of an intangible and sources the gain to the individual's state of domicile. A resident of State A that is subject to New York personal income tax as a result of Part H would not be entitled to a credit in its home state, State A, for the taxes paid to New York. Although the U.S. Constitution does not prohibit double taxation, we suggest that consideration be given as to whether this result is intended.

III. Part M: Itemized Deductions

Part M of the Budget Bill eliminates the use of itemized deductions for individuals with a New York adjusted gross income ("AGI") of over $1 million. The proposal adds a new paragraph (3) to Tax Law § 615(f) reducing itemized deductions:

> "With respect to an individual whose New York adjusted gross income (AGI) is over one million dollars, [by] an amount equal to the New York itemized deduction of an individual otherwise

> allowable ...except the portion of the deduction attributable to any charitable contribution...multiplied by fifty percent... ".

Individuals with New York AGI over $525,000 have long had some of their itemized deductions limited by 50% under Tax Law § 615(f), paragraphs (1) and (2). The proposed legislation eliminates any remaining itemized deductions, other than charitable contributions, for residents with incomes over $1 million.

Federal tax law already restricts itemized deductions. If federal AGI exceeds a threshold amount, a taxpayer loses deductions equal to the lesser of 3% of the excess over the threshold or 80% of otherwise allowable deductions. No reduction is required for medical expenses, investment interest and casualty, theft and wagering losses. These limits are being phased out at the federal level, but will be fully reinstated in 2010, absent Congressional action. In addition, many itemized deductions are only available if they exceed a percentage of AGI. For example, medical and dental expenses are only allowable to the extent they exceed 7.5% of AGI. Home mortgage interest is deductible, but only on acquisition debt of $1 million or less. Non-business casualty and theft losses generally must exceed 10% of AGI. These limits greatly restrict the ability to benefit from itemized deductions. New York begins its calculation after taking into account all federal limits. Part M will further restrict or eliminate remaining amounts (other than charitable contributions).

A. Comments

The new provision is different in kind from the current 50% limitation on itemized deductions for individuals with New York AGI over $525,000. The $525,000 figure is reached on a two-stage phased-in basis, with a portion of the deductions subtracted when income reaches certain levels. The full 50% is lost if New York AGI exceeds $525,000. Part M does not have a phase in. Instead, it creates a "cliff' effect for individuals whose AGI exceeds $1 million. We question whether this was intended. The "cliff' results in unequal tax liability for individuals with identical itemized deductions but a one dollar difference in AGI. For example, assume two individuals have $250,000 of itemized deductions (excluding charitable contributions), and one person has AGI of $1 million and the other has AGI that is only $1 higher. Under current law, both lose half of their itemized deductions, but under this proposal, the individual with the extra dollar of AGI also loses the other half. If the individuals both reside in New York City, the individual with the extra dollar of AGI pays full New York State and New York City income taxes on an additional $125,000 of income.

The Memorandum in Support says that the taxpayer can still obtain the benefit of a federal deduction for New York taxes, but the many New York residents who pay the federal alternative minimum tax obtain no federal tax benefit for a New York income tax deduction. Further, as discussed above, the federal benefit is limited for many taxpayers.

Part M would result in a tax increase for certain (but not all) individuals with AGI's exceeding $1 million and who pay large amounts of local tax, home interest, and other deductible expenses. Whether to increase taxes on any particular subgroup of taxpayers is a policy matter on which we express no view. However, we urge that consideration be given to a number of well-recognized principles for constructing a tax system in a manner that is considered by taxpayers to be fair. Such a system should aim for horizontal equity (treating similarly situated taxpayers in a similar manner) and transparency, among other matters. It should also strive to avoid “traps for the unwary” or ill-advised. The “cliff effect” described above is not consistent with either horizontal equity, and it may give rise to highly unintuitive results that taxpayers may find it difficult to understand the reason for. The current rules for limiting itemized deductions are not themselves a model of transparency, as compared to a rate increase on the subgroup of taxpayers that policymakers wish to tax, as the disallowance of deductions makes it difficult for taxpayers to understand New York's actual tax rate structure. Part M does nothing to alleviate the considerable complexity already engendered by the existing federal and New York disallowances of itemized deductions. We recommend that consideration be given to increasing revenue in a more direct manner that treats taxpayers with similar incomes equally.

IV. Part N.: Income Received by Non-Resident Partners Performing Investment Management Services

Part N of the Budget Bill would amend Tax Law §§ 631 and 632 with the objective of reclassifying certain income derived from partnerships as New York source income. As explained in the Memorandum in Support, "[t]his bill would treat income received by nonresident partners for performing investment management services for investment partnerships or other entities doing business in New York as New York source income. This income, characterized as capital gain for federal tax purposes, is in reality a type of compensation to the partners performing the investment management services….This bill will [clarify] that the income is New York source income and properly taxed by the State."[9] The proposed amendments would apply to all taxable years beginning on or after January 1, 2009.

[9] Memorandum in Support, page 22. In the discussion of Part N, the partners at whom the proposal is directed are sometimes referred to as "targeted partners," the income sought to be taxed as "targeted income," and the services triggering the proposal as "targeted services."

While the objective of Part N to tax income earned by hedge fund managers and the like on "carried interests" is made clear by the Memorandum, the statutory proposal is very unclear, and technically deficient in a number of very significant respects. As a result, it is both under-inclusive and over-inclusive. Moreover, as compared to a similar federal proposal introduced in the U.S. Congress in late 2007 ("H.R. 3996"),[10] the Budget Bill both omits certain important elements of that proposal, and recreates some of the significant sources of confusion presented by H.R. 3996. Finally, by enacting legislation at the State level in advance of any possible federal action in this area, Part N both runs the risk of operating differently from any eventual federal legislation, and would create very real and serious problems of nonconformity with other states' income taxes.

For these important reasons, and without expressing any view on the underlying policy that informs this proposal, we believe that Part N is so deeply flawed that it should not be enacted, and certainly should not enter New York's Tax Law while similar federal legislation is under active consideration.

A. Scope

As a threshold matter, it is not clear what Part N is intended to do. There are two aspects to this problem. The first, discussed in this Part IV.A, is a basic question as to the intended

[10] H.R. 3966, introduced by Congressman Rangel on October 30, 2007, and passed by the U.S. House of Representatives on November 9, 2007. The Bush Administration threatened to veto legislation including the carried interest proposal, and H.R. 3966 was eventually enacted, as the Tax Increase Prevention Act of 2007, without such provisions. The Tax Section's 2008 Report on the federal proposal is discussed below.

President Obama's February 26, 2009 summary presented to Congress of the federal government budget for the next fiscal year also includes a proposal to tax "carried interest", although no details are yet available of the legislative language his Administration intends to propose.

scope of the proposal. The second, discussed in Part IV.B. point 1., below, involves more technical questions as to the operation of the specific amendments as proposed.

New York's regulations under Tax Law § 632(b)(1)(B) currently provide that "[i]f personal services are performed within New York, whether or not as an employee, the compensation for such services includible in federal adjusted gross income constitutes income from New York sources…."[11] As set forth below, Part N amends § 632(b)(1)(B) to insert a reference to "investment management services," but it is not clear what this insertion is intended to accomplish.

One possible interpretation of the proposed text of Part N might be that it characterizes as New York source <u>all</u> income derived by an investment management services provider/partner if the partnership has <u>any</u> contact with New York, even if the partner himself performs all of his investment management services outside New York. In other words, if a partner provides investment management services from his office in London to a partnership that has multiple business locations, one of which is in New York, does Part N purport to recharacterize all of the partner's income as New York source? Or some of it, based on the partnership's New York presence (however measured)?

We do not think this is the intended operation of Part N. Treating all of a partner's income as New York sourced based on <u>any</u> partnership presence in New York clearly raises significant constitutional problems. Nor do we know of any policy justification for treating a

[11] 20 N.Y.C.R.R. § 132.4(c).

nonresident service provider as deriving New York source income merely because the partnership receiving the services has some presence in New York.

An alternative reading of Part N, and we think what was intended, is that it recharacterizes the distributive share of partnership income allocated to an investment management service provider/partner as compensation for the investment management services. This is the approach taken in legislation recently considered by the U.S. Congress (discussed below). If this is the intended application of Part N, then presumably the income derived by the service provider from the partnership is intended to be sourced by reference to the location(s) in which the partner performed his investment management services. Thus, a nonresident who works full time in New York providing investment management services would be required to treat 100% of his distributive share of partnership income as New York source income; a partner who worked 50% of the time in New York and 50% in London would treat 50% of his distributive share of partnership income as New York source income.

As discussed below, sourcing the distributive share of an investment service provider/partner's income by reference to his location, rather than by reference to the activities of the partnership, may increase *or* decrease the amount of New York source income, depending upon the facts. If this is the intended application of Part N, however, that needs to be more clearly articulated in the statutory language.

B. Fundamental Technical Issues

1. As noted above, Part N would amend § 631 to insert a new description of the New York source income of a nonresident individual. As amended, the statute would, in relevant part, read as follows:

> "Items of income, gain, loss and deduction derived from or connected with New York sources shall be those items attributable to … a business, trade, profession or occupation carried on in this state, <u>including investment management services performed in exchange for consideration to a partnership or other entity as defined in subsection (h) of this section</u>.
>
> <u>For purposes of this subsection, subsection (d) of this section shall not apply</u>."[12]

Significantly, Part N as introduced[13] makes no changes to Tax Law § 632, which sets forth the treatment of nonresident partners. That section provides:

> "In determining New York source income of a nonresident partner of any partnership, there shall be included only the portion derived from or connected with New York sources of such partner's distributive share of items of partnership income, gain, loss and deduction entering into his federal adjusted gross income, as such portion shall be determined under regulations of the tax commission consistent with the applicable rules of [§ 631]."[14]

That section further provides, referencing Tax Law § 617(b) that:

> "the character of partnership or [S] corporation items for a non-resident partner or S corporation shareholders shall [have the same character for a partner or shareholder under this article as for federal income tax purposes]."[15]

The partnerships at which the proposal is targeted frequently realize dividends and gains from the disposition of capital assets. These partnerships are not themselves engaged in providing investment management services to other entities; they are investment vehicles whose

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[12] Proposed Tax Law § 631(b)(1)(B), with the new language underscored.

[13] The "thirty day amendments," issued January 15, 2009, did amend § 632 to address S corporations, as discussed in part 4, below. That change does not, however, address this problem.

[14] Tax Law § 632(a)(1).

[15] Tax Law § 632(e)(2), which references Tax Law § 617(b), the relevant text of which is incorporated above in brackets.

income, for federal income tax purposes, is classified as income from intangibles, or from the underlying real estate. As a result, the proposed amendment to § 631(b)(1)(B) has no effect on the character of the partnership's income, and § 632 continues to specify that a nonresident partner's New York source income is determined by reference to the source of the partnership's income, and its federal classification.

Moreover, where a nonresident individual is himself or herself providing investment management services for consideration in New York, current law is adequate to tax the compensation earned as New York source income. But Part N as drafted is not adequate to convert a nonresident partner's distributive share of income from a partnership's sale of stocks and securities to New York source income.

This basic flaw in the Budget Bill provision may have been recognized in the thirty-day amendments introduced on January 16, 2009. These amendments made several substantive changes to Part N, including:

> (1) amending § 631(h) to provide that "for purposes of this subsection, subsection (d) of this section shall not apply"; and
>
> (2) amending § 631(d) to render it inapplicable "when subsection (h) of this section applies."

Subsection (h) is the newly proposed definition of "investment management services to a partnership or other entity," defined as "providing a substantial quantity of" certain services to a partnership or other entity. Subsection (d), which is rendered inapplicable under (b)(1)(B) and when (h) applies, provides as follows:

> "A nonresident, other than a dealer holding property primarily for sale to customers in the ordinary course of his trade or business,

> shall not be deemed to carry on a business, trade, profession or occupation in this state solely by reason of the purchase and sale of property or the purchase, sale or writing of stock option contracts, or both, for his own account."[16]

These amendments to Part N, however, still do not cure the basic technical deficiencies in the proposal. And again the problem is that the amended text is both under- and over-inclusive. As one example, a partnership may invest in a single parcel of Florida real estate, and grant a carried interest to a nonresident individual who provides the targeted "investment management services" in New York. When the partnership realizes a gain from the disposition of such real estate it does not rely upon the self-trading exemption to classify such gain as Florida sourced; the gain is sourced in Florida because the real estate is located there.[17] And, for the reasons noted above, proposed § 631(b)(1)(B) does not apply to reclassify the partner's distributive share of partnership income.

On the other side of the issue, the self-trading exemption should not be rendered inapplicable to the entire partnership[18] simply because there are some partners providing investment management services to the partnership. That would, if applied to an investment partnership of the sort to which the exemption is currently relevant, treat all nonresident partners as having New York source income, even though, as to the non-service partners, their gains plainly are from investments, not compensation.

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[16] Tax Law § 631(d).

[17] See Tax Law § 631(b)(1)(A), treating as New York income items attributable to "the ownership of any interest in real or tangible personal property in this State."

[18] Note that the S corporation provisions of the thirty-day amendments refer to a partnership to which subsection (h) applies, suggesting a partnership-level determination of the applicability of the proposed rules.

The approach taken in H.R. 3996 was to characterize the targeted distributive share of partnership income as compensation. That approach has its own problems, as very fully addressed in the Tax Section's Report # 1166, "Report on Proposed Carried Interest and Fee Deferral Legislation," issued September 24, 2008 (the "2008 Report"). As Part N currently stands, however, it does not even accomplish this. It characterizes as New York source income, income earned from providing management services in New York – which is the correct law in any case; and it potentially cuts back in unintended and inappropriate ways the self-trading exemption. Indeed, because the provision of investment management services by a nonresident working in New York clearly constitutes New York source income under current law, enactment of Part N in its current form arguably could be read as *limiting* the kinds of investment services that generate New York source income to those services described in § 631(h).

Assuming that the proposed statutory language were reworked, there remain a variety of significant issues with this proposal. These are discussed below, based on the language as proposed but recognizing that new or different issues may arise if the statutory approach is modified.

2. Timing Issues

It is not clear how to address the sourcing of the targeted income when services are performed in one year, but the partnership income is recognized in a later year. It is not clear how the concept of a "substantial amount" is applied in that situation; nor is it clear which year(s) one tests in sourcing the distributive share.

3. Operating Partnerships

It also is not clear whether the Budget Bill is intended to be limited to "investment" partnerships, or could also apply to operating partnerships engaged in active trades or businesses. As discussed in our 2008 Report, drawing a distinction between the two can be difficult. On the other hand, given the context in which the carried interest proposal has been discussed, consideration should be given to whether New York intends to treat as New York source income only the "hedge-fund" types of carried interests, or distributive shares of income allocated to certain partners by any kind of partnership. And in the latter case, query whether there is a good policy reason to treat as New York source the income of partners providing certain kinds of services (for example, those implementing treasury functions of an operating business) where partners providing other kinds of services would continue to source their income based on the partnership's activities.[19]

4. "Outsourcing" Partnership Income.

The application of the concepts of Part N cuts both ways. If a partnership owns New York real estate, and a partner performs targeted services while physically located in Florida, classifying his distributive share of partnership income as compensation earned for services performed in Florida would have the effect of denying New York the ability to tax gain derived from the real property.[20] While that may be justified to the extent such distributive share represents fair compensation for services performed in Florida, it is of questionable merit to the

[19] Consider, for example, a partnership that acquires a widget factory, whose financial officers are based in New York, but which otherwise has operations in several states.

[20] Although this result may be obtained in some cases if Part H is enacted.

extent the gain represents appreciation in the partner's invested capital. See also point 8, below, regarding the approach of H.R. 3996 to income attributable to invested capital.

5. Meaning of the Phrase "In Exchange For Consideration"

The 30-day amendment inserts the phrase "performed in exchange for consideration" into the new inclusion of investment management services that produce New York source income. This change is helpful in presumably being designed to avoid the unreasonable result of changing the character of true investment income where, for example, a small group of investors band together, and one or more of them provides some of the specified services to their partnership.

Again, that potential problem could be more comprehensively addressed by differentiating between income derived in respect of capital invested in a partnership and income derived as compensation for services. (See Part IV.B.8, below.)

A further problem with the newly proposed language is its potential circularity. If a nonresident partner is directly receiving compensation for his services, then the meaning of "in exchange for consideration" may be clear. But if the concept is that the New York sourcing of partnership income is to be triggered where a service partner is being compensated for his services through the distributive share, and he has also invested in the partnership, it may not be so clear whether he is earning consideration for his services, especially where partnership allocations are complex.

The application of this condition may also be unclear in the very common situation in which there are layers of entities and relationships. As explained in the 2008 Report and noted below, tiered and parallel structures are very common in hedge fund, private equity and real estate deals. Dealing with these structures to get to the "right," intended result can be very complex.

6. S Corporation Proposal

The 30-day amendment added a provision addressing nonresident shareholders of S corporations where the S corporation "is a partner of a partnership to which [§ 631(h)] applies." This provision says that, in determining the income of such a nonresident, "there shall be included the income and losses from intangible personal property" of the partnership; and that "those items" of S corporation income are to be allocated based on the S corporation's business allocation percentage, as determined under regulations consistent with Article 9-A.

This provision raises several questions. First, in keying off a partnership "to which [§ 631(h)] applies," it is not clear how the rule applies to the individual S corporation shareholder. Stated differently, whose provision of services "counts," the S corporation's or the shareholder's?

Furthermore, in creating a rule for one type of tiered structure, it becomes less clear what was intended for other types of tiered structures. See Part IV.B.7, below.

It also is not clear how the proposed apportionment rule is to be applied. Under Article 9-A, New York State currently uses only the receipts factor. But outside the broker-dealer context we do not have clear rules for sourcing receipts from the sale of securities; and indeed the current regulations specify that the business allocation percentages receipts factor does not include receipts from sales of capital assets.[21] Where the underlying partnership is earning a significant portion, or all, of its receipts from trading in securities, therefore, there is a clear possibility that, without significant amendment the receipts factor will not serve as a fair proxy for evaluating the S corporation's New York source income. That situation could be unfair to taxpayers, or could be manipulated to produce an under-allocation of income to New York. Either way, there will be significant confusion.

7. Tiered Entities

Tiered entity structures raise a variety of questions, including whose services one looks to in determining whether the recharacterization test is triggered; whose location governs the sourcing of the targeted income; and whether earning targeted income from one source in an intermediate entity does, or does not, or does in some part, taint income from other sources allocated to the ultimate nonresident targeted partner.

The 2008 Report discusses some of the common structures found in the contexts that are the apparent targets of Part N. [22] Given how commonplace complex structures are, these issues must be addressed in drafting any statutory proposal.

8. Comparisons to H.R. 3966

Our 2008 Report addresses a number of issues that are not directly addressed in Part N. For example, H.R. 3996 reclassified losses as ordinary in circumstances where the situation would (or did) result in classification of income as compensation, However, H.R. 3996 also

[21] 20 N.Y.C.R.R. § 4-4.6(f).

[22] Our 2008 Report, at pages 84 and following, provides some insights into tiered structures currently in use.

limited the amount deductible as ordinary loss to the income previously reported as compensation; and provided rules for "suspended" losses. That detail is not reflected in Part N.

H.R. 3996 also addressed the treatment of gains and losses on the sale of a targeted partnership interest. To avoid an obvious source of confusion, if not abuse, any state level legislation should consider the federal approach to this area, as well as the commentary on that approach.

As referenced above, H. R. 3996 attempted to distinguish income earned from "invested capital" from income to be classified as compensation. As noted in the 2008 Report, the federal proposal had its own issues, but it did at least recognize that the provision of *some* services does not necessarily merit the reclassification of the *entire* distributive share as compensation income. This is a very important and fundamental issue that is ignored entirely in Part N. It should be obvious that to the extent partners are earning income from the investment of their own money, treating that income as New York source purely because the partner also performs services for the partnership is unduly harsh – particularly where the partner is being compensated directly, and on an arm's-length basis, for those services.

The definition of "investment management services" set forth in Part N largely follows that of H.R. 3996. As set forth in our 2008 Report, however, the federal proposals raised a number of difficult issues, including (i) what "a substantial quantity" of service means; (ii) what "activity in support of" services means; and (iii) whether the definitions of "specified assets" is sufficiently broad, particularly in tiered partnership situations.

Part N would add to the federal list the service of "advising the partnership as to the value of any specified asset." In the context of mark-to-market accounting, or implementing Code § 754 elections, this category may be overbroad.

H.R. 3996 also included a rule addressing the distribution of appreciated property by a partnership to a targeted partner. Under H.R. 3996, such a transaction would not be a nonrecognition event, but instead would be taxed as if the partnership sold the asset at fair market value. Under that approach, all of the partners would recognize their distributive shares of gain on the distributed asset. Moreover, under H.R. 3996 the targeted partner's share of such gain was classified as compensation. Part N contains no such provision, meaning that, in the absence of federal legislation, this type of transaction could be utilized, on some fact patterns, to avoid the recognition of New York source income.

Finally, H.R. 3996 included anti-abuse provisions relating to "disqualified interests." As discussed in detail in our 2008 Report, these are quite complex, and raise a number of issues. While not necessarily the best solution, we suggest that New York should consider whether analogous provisions are needed to achieve the intended results of the Bill.

9. Conflicts with Other States' Laws and Tax Credits

As noted above, H.R. 3996 would have classified the targeted carried interest income as "compensation" for federal income tax purposes. Once so classified federally, that classification would generally have followed for State income tax purposes in the common situations where State income is determined by reference to federal income tax principles.

At the present time, however, no federal classification provision has been enacted. As a result, states other than New York will (absent some provision like Part N) continue to source partnership income by reference to traditional sourcing rules. Under those rules, for example, a nonresident's home state may treat the distributive share of investment income as income from intangibles, sourced to the state of domicile. Or a state may characterize income or gain as derived from real estate located in that state, and thus source income from the real property to that state.

Inconsistencies in sourcing rules frequently lead to double taxation. The tax imposed by New York on the distributive share of partnership income earned by a service provider may well not be considered a tax on New York source income under, for example, Connecticut's income tax rule. As a result, Connecticut may source the income to Connecticut as income from intangibles, and may tax it fully under its own internal laws with no credit for the taxes paid to New York.

The appropriateness of such double taxation is an important policy question, involving both tax policy and, potentially, economic development policy as well. It is virtually certain to be an issue that will follow from the enactment of a New York-specific recharacterization rule in the absence of identical federal legislation, and thus it is an important issue that should be fully considered by New York's policymakers.

For example, particularly given that jurisdictions in commuting proximity to New York generally impose income taxes on their residents, New York might seek to address the problem of double taxation created under this proposal, so as to mitigate the incentives to relocate out of New York. It could, for example, allow nonresidents a "reverse" credit, reducing the New York tax due with respect to this targeted income by the home state taxes paid thereon. This would be a rather unorthodox approach, and clearly would affect the revenues generated by the proposal, but it might nonetheless be desirable as a policy matter. These are the kinds of issues and considerations that, in our view, require a fuller airing.

C. Conclusion

As evident from our 2008 Report on the similar federal proposals, changing the current classification of income from "carried interests" presents very difficult technical issues. These issues are compounded at the state level, particularly if New York adopts legislation that is inconsistent with the federal treatment, and with that of other states. Conformity to federal income tax principles has been a fundamental building block of the personal income tax from its inception. Departing from that conformity, particularly in an area rife with difficult technical and policy issues, raises very serious concerns. We believe that this is an area that requires considerably more thought before amending New York's personal income tax.

V. Part S: Discount Coupons

Part S of the Budget Bill would end the disparate treatment of manufacturers' and store coupons by including the face amount of both types of coupons as receipts subject to the sales tax under Article 28 of the Tax Law.

A. Current Law

Under Tax Law §1105, the sales tax is applied to "the receipts from every retail sale." Tax Law §1101(b)(3) defines "receipt" as "the amount of the sale price of any property."

Discount coupons are issued to customers by mail, by inclusion as cut out coupons in newspapers or other periodicals, or on the internet. Customers present the coupon to a store, which credits the face amount of the coupon against the purchase price of the goods sold. Coupons issued by manufacturers or distributors of property may then be redeemed by the store. Consequently, such discount coupons are included as receipts for sales tax purposes on the ground that the seller of the property (the store) receives the full sales price (part from the customer and part from the manufacturer). In contrast, if a store issues its own coupons, the sales tax is due only on the discount price since that is all that the store has received in relation to the transaction.[23]

B. Comments

Under Part S all discount coupons would be included as receipts whether issued by manufacturers, distributors or stores. This provision would significantly alter existing law by subjecting to tax amounts that are never received by a seller. How one evaluates this as a policy matter may depend on whether one considers the issue from the perspective of the consumer or the store.

The Memorandum in Support provides two rationales for Part S. First, the Memorandum states "Some consumers are confused about the circumstances in which the discount obtained with a coupon is included in the amount subject to sales tax." It seems reasonable to believe that a customer is not likely to distinguish between a price reduction that is the result of a manufacturer's coupon as compared to a price reduction that is the result of a store coupon, and that harmonizing their treatment would eliminate one source of confusion over the application of

[23] 20 NYCRR § 526.5(c).

sales tax. It is not clear how significant a policy goal the elimination of such confusion should be, since the burden of determining what receipts are taxable is borne by the stores, which have been required to distinguish between forms of coupons for many years. We express no view on this point.

Second, the change is expected to raise additional revenue (the proposal is estimated to raise $3,000,000). However, since stores will be able to avoid charging their customers additional tax by providing discounts in forms other than coupons, for example, by effecting changes in prices, it is not clear that this proposal change will result in all of the additional revenues it is intended to raise. Stores may be inclined to use such alternative methods of providing discounts in order to avoid having to explain to customers why they are paying tax on an amount that is more than the amount the customer is paying for the goods. Evaluation of the additional revenue to be raised from enacting Part S should take into account possible changes in stores' behavior.

It is difficult to see how the proposed change can be enforced. Currently, manufacturers' coupons are reflected in the sales records of stores as additional receipts when the stores are reimbursed, as are the amounts actually paid by the customer. Tracking these amounts in a store's general ledger is fairly straightforward. Under the proposed legislation, a sales tax auditor would need to determine the amounts attributable to store discounts effected through coupons in order to confirm that the correct amount of tax had been collected, although there seems to be no reason for stores to keep track of these amounts. Assuming a store reports no store discount coupons, how will an auditor confirm that no store discount coupons were offered during the audit period? This change will likely increase the time and complexity of audits of stores. Further, administrative guidance will be required.

A final comment is that the legislation is inconsistent with the statutory structure of New York's sales and use taxes inasmuch as a taxable "receipt" is defined as "the amount of the sale price of any property."[24] The sales price of property subject to a discount store coupon is the amount actually received from the customer. In contrast, the sales price of property subject to a manufacturers' coupon is the sum of the amount received from the customer and from the manufacturer. A possible alternative analysis would be to treat a manufacturer's discount coupon as equivalent to a reduction in the price that the manufacturer charges the store to purchase the property rather than as an additional amount realized by the store, in which case there would be no reason to distinguish between store coupons and manufacturer's coupons. Traditionally, however, discount coupons have been treated differently for sales tax purposes than price reductions of this kind. Accordingly, the taxation of store discount coupons raises conceptual issues.

VI. Part CC: Digital Products

Part CC of the Budget Bill would create the "digital product"[25] as a new class of property or service for purposes of imposing new sales and use taxes under Article 28 of the Tax Law,[26] and for purposes of determining the allocation of entire net income under the corporation

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[24] Tax Law §1101(b)(3).

[25] Sections 1 and 10 of the bill would add definitions in new subdivision 20 of section 208 and new subsection 1101(e) of the Tax Law.

[26] Section 1105(e).

franchise tax and the temporary metropolitan transportation tax surcharge under Article 9-A of the Tax Law.[27] The Budget Bill would also add receipts from advertising by radio and television broadcasters and other electronic services to the determination of the allocation of entire net income.[28] Finally, the Budget Bill would mandate a hierarchy for the determination of the place of delivery of a digital product for purposes of sourcing the income from such products in the allocation of entire net income, and for purposes of determining whether the sale is subject to sales and use tax.[29] The franchise tax sections of the Budget Bill would be effective for taxable years beginning on or after January 1, 2010, and the sales and use tax provisions would be effective for sales and uses occurring on or after June 1, 2009.[30] The Budget Bill also contains compliance provisions relating to pre-written software sold with multiple site licenses.[31]

A. Comments

1. Taxing Digital Products as a New Type of Property

A digital product is defined by Part CC as any product or service, or a combination of both, delivered electronically to the purchaser. The definition does not depend on digital delivery, but describes various methods of electronic delivery and their "similar successor media." The term includes but is not limited to audio, visual and audiovisual works, books or

[27] Section 5 of the bill adding new clause 210 (3)(a)(2)(D) and section 9 of the bill adding new clause 209-B (2)(b).

[28] Sections 2 and 6 of the bill amending Sections 210(3)(a)(2)(B)(v)and (vi) and Section 209-B(2)(b)(2)(v) and (vi).

[29] Bill sections 5, 9 and 11.

[30] Bill Section 101.

[31] Section 112 of the bill amending § 1132(c) of the Tax Law.

other literary works, graphic works, games, information and entertainment services, storage of digital products and computer software.

The proposed statutory changes have a major conceptual problem in that they determine taxability on the basis of the delivery medium rather than on the basis of content. It may be anomalous under current law that songs delivered by compact disc are subject to the sales tax, while songs downloaded from the internet are not. It would be equally strange, however, if, a newspaper or periodical that is received by electronic means is taxable (as they would appear to be because there is no provision exempting them from being considered a “digital product”), but the same newspaper or periodical bought at a newsstand in tangible form is not.

In our view, it is not necessary to develop a new type of property to extend sales and use taxation to certain electronic downloads. Many downloads would already fit the definitions surrounding taxable information services in Tax Law §1105(c)(1). For example many non-custom, pre-written works, including songs, pictures, movies, games and books could easily fit together with pre-written software in the definition of tangible personal property contained in Tax Law §1101(b)(6). That section already provides that the medium for transferring pre-written software is irrelevant. Some other electronically delivered information or programs might warrant the creation of new categories of enumerated services. Dealing with the taxation of electronic content by continuing with and/or adding to the current statutory scheme for taxing the transfer of tangible personal property and certain enumerated services has a better chance of minimizing confusion than developing a whole new set of regulations, technical support bulletins and case law to flesh out the definition of a new kind of property.

As an alternative to creating new digital product definitions, consideration should be given to adopting the definitions and rules for specific items of digital products currently in use by the approximately 20 states that are members of the Streamlined Sales Tax Governing Board.

2. Place of Delivery

The hierarchy set forth in Part CC to determine the place of delivery of a digital product may prove difficult to administer for taxpayers attempting to comply and for Tax Department auditors seeking to monitor and enforce compliance. The first step in the hierarchy prescribes that the destination may be demonstrated by internet protocol address, the geographic location of the equipment to which the digital product is delivered or from which the digital product is accessed or the delivery destination indicated on bill of lading or a purchase invoice. The second step is the billing address of the purchaser and the third is the zip code or other geographic indicator of the purchaser's location. Because of concerns about privacy, many web users are routinely cloaking their true electronic location through the use of anonymizing proxy servers and other techniques. Although many such servers are easily penetrated by system administrators, some are more secure. Furthermore, single use credit cards, and other financial tools that consumers use to prevent identity theft on the web may make it difficult for vendors to comply with the siting rules. It might not prove difficult for a vendor to corroborate the location of a low volume of high value transactions. For a high volume of low priced items like songs, however, the process might prove more daunting and increase the costs of compliance.

It is unclear how the hierarchy would work. The first sentence of new clause D seems to provide that the taxpayer must use the tests in subclauses (i)-(iv) in strict order. The second sentence provides, however, that the taxpayer must exercise "due diligence" before rejecting the test and moving to the next test in line. Suppose, for example, that the delivery internet protocol address indicates that the purchaser has accessed the digital product from New Jersey (or Finland). The billing address of the purchaser is in Connecticut and the purchaser (or its headquarters) is located in New York. May the taxpayer simply conclude that the digital product was delivered in New Jersey (or Finland), or is there some “due diligence” obligation to examine the delivery location further. Suppose in another instance the Internet Protocol address is located in New York, but it is the address of a well-known anonymizing proxy server. Furthermore, the billing address of the purchaser and the location of its headquarters and its sole facility is New Hampshire. Would the taxpayer be justified in determining that the delivery took place outside New York?

Determining the delivery location for digital products downloaded directly to cellular telephones, personal digital assistants or other mobile devices, including laptop computers operating from remote wireless hotspots, could be even more difficult.

It is crucial that there be precise definitions in the sales and use tax area because vendors who err in their interpretation and judgment will be liable for taxes that should have been paid by their customers (while vendors do have the right under Tax Law § 1133(a) to seek the tax retroactively from the customer, this – as a practical matter – cannot be done in most circumstances).

For the reasons set forth above, we believe that the proposed statutory change is unnecessary and confusing. We believe that the extension of tax to information, software and other products delivered digitally could be achieved by amendments to the current statutory scheme that would expand and amplify the concept of information services and that would add certain additional taxable enumerated services. Such statutory amendments would be relatively simple and would leave intact many years of interpretive guidance. In addition, the determination of delivery location should be simplified by using something like the billing location instead of internet protocol addresses or other concepts that are subject to the vicissitudes of continuing technological change.

VII. Part FF: Attributional Nexus Provision

Part FF of the Budget Bill creates two new "vendor" categories for purposes of Article 28 of the Tax Law.[32] The two new categories are (1) remote sellers that have an affiliate conducting activities in New York that otherwise qualify the affiliate as a vendor, when the affiliate "uses in the state trademarks, service marks, or trade names that are the same as those the [remote] seller uses"; and (2) remote sellers that have an affiliate in New York "engag[ing] in activities in the state that inure to the benefit of the seller in its development or maintenance of a market for its goods or services in the state, to the extent that those activities of the affiliate are sufficient to satisfy the nexus requirement of the United States Constitution." For purposes of both definitions, an "affiliated person" has the same meaning as in Tax Law § 1101(b)(8)(V)(B), which provides that persons are "affiliated persons with respect to each other where one of such persons has an ownership interest of more than five percent, whether direct or indirect, in the other, or where an ownership interest of more than five percent, whether direct or indirect, is held in each of such persons by another person or by a group of other persons which are affiliated persons with respect to each other."

[32] Under Tax Law §1133, "vendors" are legally required to collect sales or use tax on sales of tangible personal property and certain enumerated services; they are personally liable for the tax if not collected.

A. Comments

1. Common Marketing Indicia

The first new vendor category is constitutionally suspect in that it imposes sales/use tax collection responsibilities on a seller merely due to an affiliate's in-state use of "trademarks, service marks or trade names." Under United States Supreme Court precedent, a seller must have a "substantial nexus" in a state before the state can impose sales/use tax collection responsibilities on the seller.[33] The Court has written that in-state activities performed by individuals and affiliates can provide a constitutionally sufficient basis for taxing an out-of-state seller if "the activities performed on behalf of the [out-of-state seller] are significantly associated with the [out-of-state seller's] ability to establish and maintain a market in this state...."[34] For example, in-state solicitation performed by a specialty broker can provide a constitutionally sufficient basis for imposing a use tax collection responsibility on a seller.[35] The Court has noted that this is the "furthest extension" of a state's power to tax that the Court has ever countenanced.[36]

Making remote sellers responsible for sales/use tax collection responsibility due to the mere in-state presence of "trademarks, service marks or trade names" used by an affiliate may, in certain cases, exceed what the Court found acceptable in *Scripto*. This is particularly true where

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

[34] *Tyler Pipe Industries, Inc. v. Washington State Dep't of Rev.*, 483 U.S. 232, 250 (1987).

[35] *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).

[36] *Quill*, 504 U.S. at 306.

the trademark, etc., is a well-known national or global brand. It is questionable whether an affiliate's use of common trademarks could always be considered "significantly associated with" a "taxpayer's ability to establish and maintain a market" in New York. Accordingly, we recommend modifying Part FF to create a rebuttable presumption that the in-state presence of "trademarks, service marks or trade names" used by an affiliate creates a substantial nexus thereby engendering a sales/use tax collection responsibility. This change would afford sellers an opportunity to rebut the presumption and to prove that an affiliate's use of trademarks is not significantly associated with that particular seller's ability to establish or maintain a market in New York. This, in turn, would ensure that the statute comports with Constitutional requirements.[37]

2. Inure to the Benefit Category

The second new vendor category is vague because it does not define what type of activities will be considered to "inure to the benefit of the seller." Moreover, the category does not use the *Tyler Pipe* attributional nexus test language. This could cause confusion. Arguably there could be some situations where an affiliated person conducts activities in New York that "inure to the benefit of the seller" but that "are not significantly associated with a taxpayer's

[37] Promulgating an unconstitutional sales tax statute can create an administrative nightmare. Many companies affected by the statute will simply refuse to collect the tax from customers or will be unaware that the activities of their affiliates subject them to sales tax collection responsibilities. To enforce the statute, the Tax Department would need to audit and assess the companies that are not complying with the statute, potentially leading to costly and wasteful appeals, conferences and litigation. Companies with a mechanism in place to track customers might collect the sales tax, and then file a refund claim. Constitutional challenges take many years during which time there is substantial uncertainty for taxpayers and the Tax Department. A single unconstitutional verdict by a New York court will trigger numerous refund claims, potentially large payouts covering a number of tax periods, and continued uncertainty as the state of the law as a result of the court decision.

ability to establish and maintain a market in the state." For example, suppose that pursuant to an inter-company agreement a company operates a New York-based call center in which call center employees field questions and complaints from an affiliated remote seller's customers; the callers are located all around the country and do not know where the call center is located. In this situation, the activities of the call center company inure to the benefit of the remote seller. However, there is no significant association between the call center company's presence and the remote seller's ability to establish and maintain a New York market, since the activities conducted at the call center are not directed at New York customers, and the presence of the call center in New York, rather than in another jurisdiction, does not make New York customers any more likely to buy the remote seller's products. This conclusion is even starker if the employees at the call center have their phones screened so that they are not taking calls from New York customers – under those circumstances, the activities of the call center company inure to the benefit of the remote seller but there is no association at all between the call center's activities and the remote seller's penetration of the New York market.

As noted above, the "inure to the benefit of" language may produce different results than the Constitutional test established in *Tyler Pipe*. However, it does not appear that the new language is designed to reach further than *Tyler Pipe*, since the language contained in the definition provides that it only seeks to tax based on in-state presence "to the extent that those activities of the affiliate are sufficient to satisfy the nexus requirement of the United States Constitution."

To avoid confusion regarding the interaction between the first and second clauses, we recommend that the "inure to the benefit of the seller" language be replaced with the *Tyler Pipe* "significantly associated with a taxpayer's ability to establish and maintain a market in the state" standard. Alternatively, we recommend that the category state simply that New York will tax a seller as a vendor if (1) there is an affiliated in-state party and (2) the activities of the affiliated in-state party are sufficient to establish nexus for the seller under the federal Constitution. This would make clear that the *Tyler Pipe* standard will control and eliminates any possibility of confusion regarding how, if at all, the standard in the category differs from the *Tyler Pipe* standard.

3. <u>Affiliated Person Definition</u>

Part FF treats persons as affiliated for vendor collection purposes based on the "ownership interest of 5% or more" standard used in the fulfillment services exclusion. It is not clear why the 5% fulfillment services exclusion standard is appropriate in the attributional nexus context. The exclusion for purchases of fulfillment services prevents persons who own property in New York from being taxed as vendors where the property they own is located on the premises of an unaffiliated person performing fulfillment services for them.[38] For purposes of the fulfillment services exclusion, the definition of "affiliated person" has a low threshold because the exclusion is meant to apply broadly so as to encourage the purchase of New York fulfillment services; in other words, the state is declining to tax in these circumstances although it has the Constitutional right to do so.

[38] Tax Law § 1101(b)(8)(v).

In stark contrast, the goal of the new vendor categories, according to the Memorandum in Support, is to target internet vendors that are tightly integrated with related in-state brick and mortar companies. Based on this goal, it would seem most logical to use a "control" test, perhaps in combination with ownership of more than some de minimis amount, and/or a "more than 50%" test, for the "affiliated person" standard in the context of the new vendor categories. This would ensure that the definition is catching companies with coordinated internet and brick and mortar operations that are intentionally creating separate corporate entities for parts of these operations. On the other hand, the definition would not catch corporations unable to coordinate operations because neither corporation, due to lack of ownership, is able to control the activities of the other corporation.

VIII. Part PP Capital Improvements

Part PP of the Budget Bill would limit what qualifies as a capital improvement to real property for purposes of exemptions from the sales tax applying to a "capital improvement to real property".

A. Current Law

Under Article 28, the sales tax does not apply to amounts charged for any "capital improvement to real property." Contractors' sales of property in connection with a capital improvement are not taxable.[39] Further, charges for labor involved in making capital improvements are not within the list of enumerated taxable services. Contractors are, however,

[39] Tax Law §1115(a)(17).

required to pay the sales tax on their purchases of materials for incorporation into a capital improvement, and cannot treat such purchases as sales for resale.[40] Any charge for "maintaining, servicing or repairing real property" is subject to sales tax.[41] Therefore, work that is considered a "repair" or "maintenance" of real property is a taxable service.

The sales tax significance of classification as a "capital improvement to real property" thus lies in (a) whether it is the contractor or the purchaser who is obligated to pay the sales tax on the cost of the materials used or consumed in the project; and (b) whether the charges for labor involved in the project are subject to sales tax. If a project qualifies as a "capital improvement" under the sales tax law, the contractor (or the owner, if the materials are purchased directly) must pay sales tax on the relevant materials, but the labor charges, and any mark-up on the materials, are not subject to sales tax.

To qualify as a capital improvement it must be shown that the improvement (addition or alteration to real property) (i) substantially adds to the value of the real property or appreciably prolongs the useful life; (ii) becomes part of the real property or is permanently affixed to the real property so that removal would cause material damage to the property or article itself; and (iii) is intended to become a permanent installation.[42] A specific exception is provided in the

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[40] Tax Law §1101(a)(4).

[41] Tax Law §1105(c)(3).

[42] Tax Law §1101(b)(9).

statute for floor coverings, pursuant to which only the initial installation of floor coverings is exempt from sales tax.[43]

B. Proposed Change

Part PP would add a fourth statutory requirement for qualification as a capital improvement. In the case of a building or other structure, the addition or alteration to real property must constitute "new construction or a new addition to or total reconstruction of existing construction."

C. Comments

Whether a project is a capital improvement or taxable repair has been the subject of substantial litigation, rulings and audit debate. Clarification of the standards and the creation of a bright line test would be welcome. However, we believe the proposed legislation does not provide sufficient clarity as to the types of work that will now be subject to tax or continue to be exempt. The Memorandum in Support provides that the main goal of the proposal is to "narrow the definition of the term 'capital improvement' and thus narrow the exemption for services rendered in conjunction with work that constitutes a capital improvement." Yet, it is unclear from the Memorandum in Support and from the legislative provision how narrow the Governor wants the exception to be. Is the intent of the legislation to eliminate the exemption, except under certain limited circumstance (such as, initial construction of a building or the addition of

[43] Tax Law §1101(b)(9)(iii).

square footage to an existing building), or to fine tune existing law to clarify that work (such as, "merely adding a new door or new windows")[44] is not treated as a capital improvement?

Although the Memorandum in Support states that the proposed "standard of 'new construction or a new addition to or total reconstruction of existing construction' is the same standard that currently applies in determining whether the installation of floor covering constitutes a capital improvement," this comparison is technically flawed inasmuch as the language of the current statute makes clear that only the <u>initial</u> installation of such floor covering qualifies, thus providing a bright line test. Further, regulations have provided definitions of the terms in the statute as they apply to floor covering, for example: original construction of a building or structure that did not exist before such construction ("new construction"), the original construction of a new room, wing or other discrete, substantial unit of a building or structure that enlarges the exterior of the existing building or structure ("new construction of an addition to an existing building or structure") and complete rehabilitation or replacement of most of the major structural elements of an existing building or structure, such as the roof, ceiling trusses, floor joists, walls, support columns, support beams, girders and the foundation ("total reconstruction").[45]

It is not clear whether the floor covering regulatory definitions would apply when determining under Part PP whether an improvement qualifies as a capital improvement to real property, or whether new definitions will be provided by regulation. If the floor covering definitions of such terms as "new construction" are applied to all capital improvements, such

[44] Memorandum in Support, Part PP.

[45] 20 N.Y.C. R.R. §541.14.

definitions will undoubtedly generate confusion. For example, the floor covering regulations provide that floor coverings installed as the initial finished floor covering shall be deemed to be installed in new construction, a new addition or total reconstruction where it is installed within six months of the date of completion of the new construction, new addition or total reconstruction.[46] This six month rule would result in situations that the Governor is apparently seeking to eliminate, namely the categorization of work and services as exempt capital improvements that would otherwise be taxable based on their completion as a part of a larger project that qualifies as a capital improvement.

In light of the above, the legislative intent of Part PP should be clarified, as well as the statutory text to effectuate such intent. If the intent is to severely limit or eliminate the exemption, a bright line test, such as limiting the exemption to new buildings or the addition of square footage, would be clearer and easier to administer.

In lieu of enacting Part PP, consideration should be given to revising the current regulations to address the "related services" situations that the Governor believes are abusive. The Memorandum in Support gives as example of such situations where "the contractor or a sub might install property on a temporary basis to facilitate the building process" or "the contractor might purchase the service of removing construction debris." In each of these instances, the services are subject to tax when performed outside the context of a capital improvement, but when "performed in conjunction with, or as a necessary perquisite to, or resulting from the capital improvement process they would be exempt." Changes to the "end result rule" set forth in the current regulations, which provides that certain repair work and services are exempt from

[46] 20 N.Y.C.R.R. § 541.14(b)(3).

tax if part of an overall plan of capital improvement, would address the perceived abuses without eliminating the entire capital improvement exemption.

IX. Part SS: Enforcement Provisions

In general, Part SS of the Budget Bill reorganizes and simplifies the statutory scheme for civil and criminal tax penalties. In addition, several provisions designed to enhance taxpayer compliance are added.

A. Current Law

Section 20.40 of the Criminal Procedure Law provides that the Attorney General's Office may bring tax prosecutions in Albany County, whereas prosecutions by local District Attorneys' offices may be brought only in the county in which the underlying acts occurred.

Tax Law §1801 provides that a person is guilty of a misdemeanor for failing to file a report, supply information or supplying false information if the person "with intent to evade any tax…shall fail to make, render sign, certify or file any return, or to supply any information within the time required…or who with like intent, shall supply any false or fraudulent information."

B. Proposed Changes

Subpart J, section 1 of the Budget Bill adds a new subdivision to §20.40 of the Criminal Procedure Law that reads:

> (m) An offense under the tax law or the penal law of filing a false or fraudulent return, report, document, declaration, statement, or filing, or of tax evasion, fraud, or larceny resulting from the filing of a false or fraudulent return, report, document, declaration, or filing in connection with the payment of taxes to the state or a political subdivision of the state, may be prosecuted in any county in which an underlying transaction reflected, reported or required

> to be reflected or reported, in whole or part, on such return, report, document, declaration statement or fling occurred.

Subpart J, section 15 of the Budget Bill repeals §1801 of the Tax Law and creates a new statutory scheme that changes the state of mind necessary to support the misdemeanor charge of failure to file a return or report from "intent to evade any tax" to "willfully." Specifically, new §1802 states as follows:

> § 1802. Criminal tax fraud in the fifth degree. A person commits criminal tax fraud in the fifth degree when he or she commits a tax fraud act. Criminal tax fraud in the fifth degree is a class A misdemeanor.

A "tax fraud act" is defined in §1801 to be, among other things:

> "willfully engaging in an act or acts or willfully causing another to engage in an act or acts pursuant to which a person:
>
> (1) fails to make, render sign, certify or file any return or report required under this chapter or any regulation promulgated under this chapter within the time required by or under the provisions of this chapter or such regulation…

C. Comments

1. Venue

We applaud the decision to confirm that certain tax crimes can be prosecuted in the county in which the alleged transaction occurred. Under prior law, the Attorney General's office typically chose to prosecute tax crimes in Albany County. Prosecutions in Albany County can be very prejudicial to taxpayers who live far from Albany for several reasons. It can be very difficult, or even impossible, for a taxpayer who lives in a county far from Albany, such as Suffolk or Erie County, to transport witnesses or evidence necessary to support the taxpayer's defense to Albany for pre-trial proceedings and trial. Taxpayers who live far from Albany also have to face the increased burden of hiring and working with a defense lawyer in Albany. The physical distance between the taxpayer and the taxpayer's attorney can hamper effective communication and preparation for the case. Finally, it is unfair and unduly burdensome to force an accused taxpayer to travel to Albany to attend court appearances and trial.

The proposed amendment to §20.40 confirms that the Attorney General's office can choose to prosecute certain tax crimes in the county where the underlying transactions occurred, and goes a long way to avoiding the above described problems for those types of tax crimes. However, we strongly suggest that the proposed amendment be expanded in two ways. First, new §20.40(m) of the Criminal Procedure law should apply to all tax fraud acts defined under Tax Law §1801, as opposed to just filing false returns, evasion or larceny. The problems described above arise in every tax criminal prosecution where the accused is forced to mount a defense far from home.

Second, venue for prosecution still remains viable in Albany County because, even after enactment of Criminal Procedure Law §20.40(m), the choice of venue will still be at the sole option of either the Tax Department or the Office of the Attorney General. As a result, it is quite possible that taxpayers charged with a tax crime will still end up defending themselves far from their home or far from where the underlying transactions occurred. As described above, this can be very prejudicial to the accused.[47] Accordingly, we suggest that Part SS be amended

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[47] This does not apply to local district attorneys who prosecute Tax Law crimes. Local district attorneys are limited to prosecuting crimes that occur within their county of jurisdiction only. Apparently, to complement new Criminal Procedure Law § 20.40(m), the Budget Bill amends County Law § 702 and provides that employees of the Tax Department can be cross-deputized as assistant district attorneys in counties where Tax Law crimes are being investigated. We support this amendment to the extent it is necessary to allow tax crimes to be prosecuted in counties around the state. At the same time, guidelines should be developed to

to include a provision similar to the federal law codified at 18 U.S.C. § 3237(b), which would give defendants the right to change venue to the county in which the taxpayer resides or the underlying transaction is alleged to have occurred.[48]

18 U.S.C. § 3237(b) states that

> (b) Notwithstanding subsection (a), where an offense is described in section 7203 of the Internal Revenue Code of 1986, or where venue for prosecution of an offense described in section 7201 or 7206(1), (2), or (5) of such Code (whether or not the offense is also described in another provision of law) is based solely on a mailing to the Internal Revenue Service, and prosecution is begun in a judicial district other than the judicial district in which the defendant resides, he may upon motion filed in the district in which the prosecution is begun, elect to be tried in the district in which he was residing at the time the alleged offense was committed: Provided, that the motion is filed within twenty days after arraignment of the defendant upon indictment or information.

Federal courts have consistently held that 18 USC § 3237(b) is absolute. *See, e.g., United States v. Ostrer*, 458 F. Supp. 540 (S.D.N.Y. 1978) ("[18 USC § 3237(b)] has been interpreted to give defendants charged with the enumerated offenses an absolute right to have charges tried in

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insure that employees from the Tax Department do not collect information for use in a criminal case under the guise of a civil audit. Such activity would violate defendants' Fifth Amendment rights and could result in defective indictments. *See, e.g., United States v. Tweel*, 550 F.2d 297 (5th Cir. 1977) (Indictment against defendant was dismissed because civil revenue agent did not advise defendant that information was being collected for use in a criminal case.)

[48] In 1990, the Tax Section wrote a report in support of legislation then pending in the New York Legislature that would have been similar to 18 U.S.C. § 3237(b). *See* Report of the New York State Bar Association Tax Section on Venue of Criminal Prosecution for Tax Crimes Alleged under Article 38 of the New York State Tax Law (June 1990). The report and legislation was supported by the Criminal Justice Section of the New York State Bar Association. The legislation itself also was supported by the House of Delegates of the New York State Bar Association.

the district of their residence.") In *United States v. Youse,* 387 F. Supp. 132 (E.D.Wisc. 1975), the court reasoned that:

> The intent of Congress in passing §3237(b) was to permit a defendant to be tried in the district of his residence, thus avoiding the necessity of a defendant charged with specified violations...from having to defend a charge in the district chosen by the Government. A motion under § 3237(b) is not directed to the court's discretion, but rather Congress intended that defendants be given an absolute right to be tried...in the district of their residence regardless of considerations of convenience. Id., at 134.

The same considerations should apply to taxpayers accused of committing New York State tax crimes and such taxpayers should have the same rights that they have under the federal system.

2. <u>Failure to File a Report or Return</u>

Section J, subpart 15 of the Budget Bill changes the state of mind required for the crime of failure to file a return or other document from "intent to evade taxes" to "willfully". As an initial matter, we question why it is necessary to remove "intent to evade tax" as an element of the crime of failing to file a return. Under current law, a taxpayer who fails to file a return or other document cannot be prosecuted unless the government can demonstrate an "intent to evade tax." This standard has been part of the statute for the past 25 years. A previous proposal to change this part of the Tax Law was rejected by the Legislation in the 1980's. By removing the element of "intent to evade tax" it is more likely that a taxpayer could be prosecuted for failing to file a return even when no tax is due. It seems that there would be very few cases in which it would be appropriate to impose criminal penalties on a taxpayer for failing to file a return if no taxes are due, even if the failure to file was willful.

We recognize that federal law does provide a misdemeanor for a willful failure to file or other document even if no additional tax is due[49] and that the amendments contained in new §1801(1) of the Tax Law may be designed to do nothing more than make the New York crime the same as the federal crime. Absent the changes we recommend below, which would clarify that state of mind required for the New York crime is in fact the same as the federal crime, there are reasons why this is not necessarily a good idea. New York imposes no less than twenty-three different types of taxes ranging from the tax on boxing and wrestling expeditions to the personal income tax. Further, many of these taxes are relatively obscure, such as the Organization tax or the License fee. There are a multitude of forms that taxpayers may be required to file in connection with all these different taxes. Under these circumstances, it is likely taxpayers will fail to file returns in circumstances in which it would not be appropriate to impose criminal penalties.

If the willfulness standard is adopted, the proposed statute should be redrafted to avoid confusion regarding the state of mind required to support a misdemeanor charge of failure to file a return or report. Current §1801 of the Tax Law provides that

> Any person who, with intent to evade any tax…shall fail to make, render, sign, certify or file any return, or to supply any information within the time required by or under the provisions of such article or any such statute, or who, with like intent, shall supply any false or fraudulent information, shall be guilty of a misdemeanor.

This language clearly requires that the failure to file a return or supply information be done with the intent to evade tax.

[49] 26 U.S.C. § 7203.

In contrast, the new statute provides that a taxpayer commits tax fraud in the fifth degree and shall be guilty of a misdemeanor if the taxpayer commits a tax fraud act. A "tax fraud act" means "willfully engaging in an act or acts or willfully causing another to engage in an act or acts ***pursuant to which*** a person (1) Fails to make, render, sign, certify or file an return or report…" (emphasis added.) As written, all that is required to trigger criminal sanctions is for a taxpayer to willfully undertake an act that leads to non-filing. Thus, taken literally, this language could include a situation in which a taxpayer "willfully" failed to sign or file a return for any reason, even if the reason is a result of negligence or an innocent mistake. For example, if a taxpayer consciously chooses not to sign or file a return that is due on a Friday because the taxpayer mistakenly believes that the deadline for filing is on the following Monday, the taxpayer could still be convicted of willfully failing to sign or file a return under the new law. Clearly, this is not the type of conduct the criminal laws are designed to punish.

Two changes are necessary to prevent this result. First, the requirement of "willfulness" should be more closely connected to the operative act in the language of the statute. Engaging in acts "pursuant to which" a person fails to sign or file creates too much ambiguity in the statute. It would be preferable to require simply that a person "willfully fail to make, render, sign, certify or file…any return or report…" This change would clarify the conduct prohibited under the proposed law and would bring it into conformity with the analogous federal provision under 26 U.S.C. 7203.

Second, the term "willfully" should be defined to mean the "intentional violation of a known legal duty." This is the state of mind required for tax crimes under federal law. *E.g., United States v. Bishop,* 412 U.S. 346 (1973). This definition of willfulness requires two things:

that the taxpayer knows of the duty to sign or file on or before a specific date; and that the taxpayer intentionally fails to comply with that duty. These two requirements protect taxpayers who innocently or negligently make a mistake and insure that criminal prosecutions are used only in the most egregious cases.

We also note that the new criminal tax statutes as set forth in Part SS use several different words to describe the states of mind that are required elements of the various crimes. Throughout Tax Law §§1801-1806, the words “willfully”, “knowingly” and “intentionally” are used to describe states of mind. This will undoubtedly create confusion about whether the different words are intended to have different meanings. The use of different words to connote a guilty state of mind has been criticized in the past. The commission that drafted Article 15 of the Penal Law stated:

> One of the main defects of the former New York statutes defining offenses involving culpability was their use of a host of largely undefined and frequently hazy adverbial terms, such as "intentionally," "willfully," "designedly," "maliciously," "knowingly," "recklessly," "negligently," "with culpable negligence," "with criminal negligence," and many more. The new article designates only four culpable mental states, defines each, and stipulates that, unless an offense is one of absolute liability, at least one of these particular mental states is essential for commission of the offense; the four terms in question are "intentionally," "knowingly," "recklessly," and "criminal negligence" [§§ 15.00(6), 15.05, 15.15(1)]. [italics added].

We suggest that the Budget Bill define a particular term, such as “willfully,” to mean “an intentional violation of a known legal duty” and then use only that term throughout the statutes.

X. Part VV: Compliance Provisions

A. $10 Paper Filling Fee

Part VV of the Budget Bill creates a new $10 filing fee for taxpayers who choose to file personal returns on paper rather than using New York's electronic filing system. The measure seeks to increase incentives for e-filing, thereby lowering the costs to New York of processing returns.

Although the goal of increasing electronic filing is reasonable, the measure is likely to hurt individuals who are least able to afford the additional fee, particularly the elderly and the poor. Only 26% of low-income households have broadband internet access at home, according to a recent study by New York State's Broadband Advisory Committee. Even if some of those individuals might have the ability to e-file from a public library or a workplace, these may not be practical alternatives for all taxpayers, and some people may not be comfortable sending personal financial information from a public computer.

Many more people who have computers are not comfortable with the idea of electronic filing. In particular, the elderly, who may not make frequent use of computers, may be unable or reluctant to file their returns electronically. Even those individuals who have easy access and frequently use the internet may not feel comfortable filing their state tax returns electronically, either for security reasons or because they might feel less confident that they have properly filed the return. Further, individuals without bank accounts will be unable to file electronically and will, therefore, be forced to pay the fees.

One of the primary goals of the Tax Department is to increase tax compliance. Very few individuals – only those with an adjusted gross income below $4,000 – are not required to file a return at all. All such taxpayers will now be required to pay a fee for the privilege of complying with their tax filing requirement of filing a proper return. As this applies to all filings, including estimated taxes, this can result in five separate $10 fees a year. With paper tax forms no longer mailed to taxpayers and a new $10 filing fee for filing paper returns, compliance, especially among the elderly and low-income households, could suffer. These individuals could then be subject to criminal penalties, under the proposed penalties for willful failure to file (see Part SS) and civil penalties for failure to file. Whatever revenue the State is likely to generate from the new fee - $6,800,000 projected for the next fiscal year – may be lost in unfiled tax returns

We recommend that this proposal be studied before it is implemented to determine whether it will be effective in improving the use of electronic filing without harming poor or less sophisticated taxpayers, and without increasing non-compliance.

B. Installment Payment Agreement Fee

Taxpayers who do not have the financial resources to satisfy an outstanding tax liability may enter into an Installment Payment Agreement ("IPA") to pay off the liability over a period of time. Part VV would establish a $75 fee for a taxpayer to enter into such an agreement with the Tax Department.

The Internal Revenue Service ("I.R.S.") already imposes a fee for setting up or reinstating an IPA. However, the I.R.S. fee is structured so as to provide several ways to decrease the fee and to encourage compliance. For example, the I.R.S. reduces the fee if the taxpayer pays the required installment via direct deposit. It also sets a lower fee for reinstating the IPA after the taxpayer has defaulted on the agreement. It reduces the fee for low-income taxpayers, lowering the fee to $45 for a household making less than $17,600.

Unlike the Federal fee, which creates incentives for taxpayers to enter into these agreements and pay off outstanding tax liabilities, the Part VV proposal creates a flat $75 fee to reinstate an IPA. This may result in less of an incentive to get “back on board” with the Tax Department following a default. We suggest that Part VV be amended to conform more closely to the federal law.