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Report No. 1449
March 6, 2021

The Honorable Andrew M. Cuomo
Governor of New York State
NYS State Capitol Building
Albany, NY 12224

Re: *Report No. 1449 – Report on Governor Cuomo's New York State FYE 2022 Executive Budget*

Dear Governor Cuomo:

I am submitting herewith for your consideration materials developed by the New York State Bar Association's Tax Section, relating to the above-referenced issue.

Thank you for your attention to this matter.

Respectfully submitted,

Gordon E. Warnke
Chair

Enclosure

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Report No. 1449

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMENTS ON 2021-2022 NEW YORK STATE EXECUTIVE BUDGET

March 6, 2021

New York State Bar Association ("NYSBA") Tax Section

Comments on 2021-2022 New York State Executive Budget[1]

1. Introduction

This report on selected tax provisions of the 2021-2022 New York State Executive Budget (the "Budget Bill") was prepared by the Tax Section of the NYSBA (the "Tax Section"). It focuses on certain technical, administrative and conceptual issues raised by selected provisions of the Budget Bill with reference to the New York Tax Law (the "Tax Law") and the New York City Administrative Code, and identifies aspects we think should be clarified or reconsidered prior to adoption by the Legislature.

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

Part A: Enact Temporary Personal Income Tax ("PIT") High Income Surcharge

Part C: Enact a Pass-Through Entity Tax

Part E: Mandate S Corporation Election Conformity

Part H: Enact the Cannabis Regulation and Taxation Act

Part I: Modernize Tax Law to Include the Vacation Rental Industry

[1] The principal drafters of this report were: Michelle Chionchio, Patrick Cox, Yvonne R. Cort, Jeremy Gove, Elizabeth Pascal, Jack Trachtenberg, and Jennifer S. White. Helpful comments were received from Lee E. Allison, Alan Appel, Robert Cassanos, Paul R. Comeau, Martin T. Hamilton, Craig M. Horowitz, Daniel W. Hudson, Elizabeth T. Kessenides, Jiyeon Lee-Lim, Shannon McNulty, Tony Ray Meyer, Adrian Musca, John Narducci, Andrew W. Needham, Elliot Pisem, Michael Schler, Irwin M. Slomka, Jonathan R. Talansky, Joseph Toce, Marina Vishnepolskaya, Philip Wagman, and Gordon E. Warnke. This report reflects solely the views of the Tax Section and not those of its individual members, the NYSBA Executive Committee or House of Delegates, or any other party.

Part T: Allow the Department of Taxation and Finance (the "Department") the Right to Appeal Division of Tax Appeal ("DTA") Tax Appeals Tribunal ("Tribunal") Decisions

2. Discussion

I. Part A: Enact Temporary PIT High Income Surcharge

A. Summary of Changes

The Budget Bill seeks to raise over $4 billion in revenue by imposing a surcharge of between 0.5 percent and 2 percent on the highest income earners in tax years 2021, 2022, and 2023. Taxpayers with New York taxable income over $5,000,000 will be subject to the surcharge at the time the return is filed. Personal income tax credits cannot be used to reduce the surcharge amounts.

The proposed legislation provides an opportunity for taxpayers who expect to owe the surcharge in 2022 and/or 2023 to prepay some or all that amount in 2021. Prepayment amounts will be applied to the surcharge tax due first in 2022 and then in 2023. Taxpayers who make a prepayment of 2022 and/or 2023 surcharge taxes may be eligible for a deduction beginning in tax year 2024 for some of the prepaid surcharge amounts. The deduction is equal to the lesser of: (i) the taxpayer's unearned income (interest, dividends and capital gains) taxable in the State; or (ii) 50 percent of the "prepayment income equivalent." The prepayment income equivalent is calculated by dividing the prepaid surcharge amount by 8.82 percent (the personal income tax rate), thereby converting the prepaid amount from a credit to a deduction from income. Thus, a taxpayer would be

potentially eligible to get a maximum of half of the 2022 and 2023 surcharge amounts prepaid in 2021 back in 2024 or carry forward any unused amounts to subsequent years until the entire prepayment income equivalent is deducted. For example, if a resident taxpayer has $15,000,000 in taxable income in 2021, she will pay a surcharge of an additional $150,000 in tax (1 percent surcharge multiplied by $15,000,000 of taxable income). If she decides to prepay the surcharge for 2022 and 2023, and estimates her taxable income to be roughly the same, she will pay in an additional $300,000 in prepaid surcharge. Assuming she correctly estimated her taxable income in 2022 and 2023, she will not pay any additional surcharge in those years, but instead will credit a $150,000 prepayment against the surcharge owed for each year. In 2024, the same taxpayer has $10,000,000 in capital gains (i.e. unearned income) taxable in New York as a resident. The prepayment income equivalent is calculated as $1,700,680 (50 percent multiplied by $300,000 divided by 8.82 percent). Thus, the taxpayer will be able to take a deduction against her New York taxable income in 2024 (subject to state and possibly city taxes) in the amount of $1,700,680—the lesser of her unearned income in that year and the prepayment income equivalent. Accordingly, assuming she has a personal income tax rate of 8.82 percent, in addition to receiving an aggregate credit of $300,000 in 2022 and 2023 with respect to the $300,000 surcharge prepayment in 2021, she will also be able to reduce her 2024 tax liability by $150,000 (8.82 percent multiplied by $1,700, 680).

A taxpayer who dies prior to deducting the full prepayment income equivalent will receive a credit on the taxpayer's final return equal to 8.82 percent of the remaining

prepayment income equivalent, and will be entitled to receive any credit amount in excess of tax for that year as an overpayment to be refunded without interest.

B. Comments

The proposed surcharge is calculated as a percentage of New York taxable income. As proposed in the legislation, the surcharge percentage increases at various income thresholds. More specifically, a surcharge of 0.5 percent is imposed on New York taxable income over $5,000,000 but not over $10,000,000; a surcharge of 1.0 percent is imposed on income over $10,000,000 but not over $25,000,000; a surcharge of 1.5 percent is imposed on income over $25,000,000 but not over $50,000,000; a surcharge of 1.75 percent is imposed on income over $50,000,000 but not over $100,000,000; and a surcharge of 2.0 percent is imposed on income over $100,000,000.

Unlike the regular personal income tax rates in Tax Law § 601, the surcharge as written in the proposed legislation is not imposed only on income over the threshold amounts, but on <u>all</u> income. In other words, whereas the top regular personal income tax rate of 8.82 percent is imposed on the *excess* of amounts over $2,000,000, the surcharge percentages appear to be imposed on the first dollar of taxable income, not only on amounts in excess of the relevant income threshold. While this may be the intent of the legislation, it may be helpful to take steps to alert taxpayers to the difference in how the surcharge is calculated in comparison with the regular personal income tax rates.

Similarly, the proposed surcharge appears to create various "cliffs," so that New York taxable income of $10,000,001 will result in double the surcharge percentage and amount ($50,000 in additional tax) in comparison to New York taxable income of $10,000,000. As with the calculation of the surcharge amount above, this may be the intent of the legislation, but it could result in some taxpayers taking steps to reduce taxable income where taxable income would otherwise not be significantly in excess of the relevant income threshold.

Moreover, the income levels for the surcharge amounts do not specify whether they apply to total taxable income for joint filers or to individual taxpayers. This should be clarified in the legislation.

Lastly, the proposed legislation states that, "[t]he surcharge imposed by this section shall be included for purposes of computing and remitting estimated tax pursuant to section six hundred eighty-five of this article." But it also states that "[a] taxpayer shall pay the tax surcharge when the taxpayer files his or her personal income tax return required to be filed pursuant to" Tax Law § 651. While this language is consistent with language otherwise found in the personal income tax, it presents a unique problem where a taxpayer is subject to the "cliff." Due to the cliff, and as discussed in more detail above, a taxpayer could face significant additional surcharge tax amounts due based on unexpected income, resulting in substantial estimated tax penalties if the calculation includes the surcharge amounts. Accordingly, consideration should be given to clarifying the language governing when the surcharge amounts are due.

II. Part C: Enact a Pass-Through Entity Tax

Part C of the Budget Bill creates the "Pass-Through Entity Tax", an elective entity-level tax on partnerships and S corporations whose owners are comprised exclusively of individuals. Under the Pass-Through Entity Tax, the electing entity will generally be subject to a 6.85 percent tax on its ordinary income sourced to New York, and its partners and shareholders will receive a corresponding credit against their New York personal income tax liability. The Pass-Through Entity Tax is intended to minimize the impact on New York taxpayers of the $10,000 state and local tax deduction limitation ("SALT Deduction Limitation") enacted as part of the Tax Cuts and Jobs Act of 2017.[2]

A. Current Law

New York State does not impose a tax on unincorporated businesses. Specifically, a partnership does not pay income tax directly on its income. The partnership's income or loss is passed through to its partners and is included as income on each partner's income or franchise tax return. Similarly, New York S corporations merely pay a fixed-dollar minimum taxed based on New York receipts. Shareholders then pay New York tax on their pro rata share of income, gain, loss and deduction that are includable in their federal adjusted gross income.

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2 As part of the federal Tax Cuts and Jobs Act of 2017, for tax years beginning after December 31, 2017, and before January 1, 2026, an individual taxpayer's itemized state and local tax deduction pursuant to § 164(a) of the Internal Revenue Code ("IRC") is limited in the aggregate to $10,000. Taxes to which this limitation applies include: (i) real property taxes; (ii) personal property taxes; (iii) income, war profits, and excess profits taxes; and (iv) general sales taxes.

B. Proposed Change

Part C of the Budget Bill amends the Tax Law by enacting Article 24-A, the Pass-Through Entity Tax. The proposal allows an "eligible partnership" or "eligible S corporation" to elect to be taxed at the entity level on certain New York-sourced income and provides a corresponding personal income tax credit to the entity's partners or shareholders. The new regime goes into effect for tax years beginning on or after January 1, 2022.

An "eligible partnership" is defined as any partnership provided for in IRC § 7701(a)(2) that consists solely of partners that are individuals, including any limited liability company ("LLC") that is treated as a partnership for federal income tax purposes.[3] An "eligible S corporation" is similarly defined as an S corporation, or any LLC that is treated as an S corporation for federal income tax purposes, that consists solely of individual shareholders.[4]

Any eligible partnership or S corporation must make an annual election to be taxed pursuant to the Pass-Through Entity Tax. For calendar year taxpayers, the annual election must be made by December 1 of each calendar year for the succeeding calendar year; fiscal year taxpayers must make the election by the first day of the last month prior to the start of the fiscal year for the succeeding fiscal year. An election is terminated if, during the taxable year, the taxpayer ceases to be an eligible partnership or S corporation.[5] This includes the

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[3] Proposed Tax Law § 860(a).

[4] *Id.* § 860(b).

[5] *Id.* § 861(e).

circumstance in which an individual member, partner or shareholder dies during the taxable year, and the successor to the decedent's interest is not an individual.[6] If the election of an electing partnership or S corporation is terminated, no Pass-Through Entity Tax is due for the taxable year.

The Pass-Through Entity Tax is in addition to any other taxes imposed by the Tax Law. It is imposed at a rate of 6.85 percent for each taxable year on the "partnership taxable income" or "S corporation taxable income" of the electing entity.[7] Partnership taxable income is defined as the sum of the electing partnership's (i) "pass-through adjusted net income" (not less than zero) that is allocated to New York, and (ii) the proportionate share of any pass-through adjusted net income (not less than zero) from a partnership of which it is a partner to the extent the income was sourced to New York by the partnership.[8] "Pass-through adjusted net income" is defined as the sum of: (i) IRC § 702(a)(8) federal taxable income (not less than zero) earned directly by the partnership; (ii) taxes paid or incurred during the taxable year by a partnership pursuant to Article 24-A to the extent they are deducted in computing federal taxable income; (iii) taxes "substantially similar to the tax imposed pursuant to [Article 24-A] paid or incurred during the taxable year" to another state, municipality, or the District of Columbia, to the extent the tax is deducted when computing federal taxable income; and (iv) guaranteed payments made by the partnership

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6 *Id.*

7 *Id.* § 862(a).

8 *Id.* § 860(h).

to its partners pursuant to IRC § 707(c).[9] Partnership taxable income is allocated to New York "pursuant to the principles of article twenty-two" which governs New York's individual income tax.[10]

Similarly, "S corporation taxable income" is the electing S corporation's "pass-through adjusted net income" allocated to New York State.[11] The S corporation's pass-through adjusted net income is the sum of: (i) IRC § 1366(a)(2) federal non-separately computed income (not less than zero)—whether earned directly by the S corporation or by a partnership to which the S corporation is a partner; (ii) taxes paid or incurred during the taxable year by an S corporation pursuant to Article 24-A to the extent they are deducted in computing federal ordinary income; and (iii) taxes "substantially similar to the tax imposed pursuant to [Article 24-A] paid or incurred during the taxable year" to another state, municipality, or the District of Columbia, to the extent the tax is deducted when computing federal taxable income.[12] Pass-through adjusted net income is allocated to New York by multiplying the S corporation's adjusted net income by its business apportionment factor as calculated under Tax Law § 210-A.[13]

A partner or member in an electing partnership or a shareholder in an electing S corporation is allowed a credit against personal income tax liability, imposed under Article 22 of the Tax Law, computed by reference to that individual's allocable share of the Pass-

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[9] *Id.* § 860(g)(1).

[10] *Id.* § 862(b).

[11] *Id.* § 860(i).

[12] *Id.* § 860(g)(2).

[13] *Id.* § 860(i).

Through Entity Tax paid.[14] The amount of credit available to an individual taxpayer equals the product of: (i) the taxpayer's profit percentage of the electing partnership or pro rata share of the electing S corporation; (ii) 92 percent; and (iii) the Pass-Through Entity Tax paid by the electing partnership or S corporation for the taxable year.[15] If the individual is a partner, member, or shareholder in multiple partnerships or S corporations electing to be taxed under the Pass-Through Entity Tax, the individual's credit is the sum of the credits calculated for each entity.[16] If the credit allowed exceeds the individual's tax due for the taxable year, the excess credits are treated as an overpayment and credited or refunded to the taxpayer.[17] The proposal also provides that every individual eligible to claim a credit as an owner of an eligible entity is jointly and severally liable for the tax imposed on the electing entity.[18]

Part C of the Budget Bill also specifically provides that New York residents will be allowed a credit against the tax due under Article 22 for any entity-level tax paid to another state where the tax is "substantially similar" to the Pass-Through Entity Tax.[19] The credit for the entity-level tax payments made to other states is computed in the same manner as the credit allowed for the Pass-Through Entity Tax paid to New York.[20]

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14 *Id.* § 863.

15 *Id.* § 606(kkk).

16 *Id.* § 606(kkk)(3).

17 *Id.* § 606(kkk)(4).

18 *Id.* § 867(c).

19 *Id.* § 620(b).

20 *Id.* § 620(b)(2).

C. Comments

We begin by providing some background. In response to the SALT Deduction Limitation, (i) Louisiana; (ii) Oklahoma; (iii) Rhode Island; (iv) Wisconsin; (v) New Jersey; (vi) Maryland; and (vii) Connecticut enacted entity-level income taxes on partnerships, S corporations, and, in some cases, sole proprietorships. These entity-level taxes provide a corresponding owner-level tax benefit in the form of a deduction from the tax base or, alternatively, a partial or full tax credit.[21] These mechanisms shift the tax burden from the individual owners—where the state and local tax deduction would be subject to the SALT Deduction Limitation—to the business entity, where the deduction remains uncapped. On November 9, 2020, the Internal Revenue Service (the "IRS") issued Notice 2020-75 (the "Notice") which confirmed that state and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction to the partnership or S corporation in computing its non-separately stated federal taxable income or loss in the year of payment. The Notice thus permits the use of pass-through entity taxes to avoid the SALT Deduction Limitation, as it applies to taxes imposed on the income of a partnership or S corporation.

Accordingly, the proposed introduction of Article 24-A to the Tax Law should be an effective tool to reduce the impact of the SALT Deduction Limitation on New York taxpayers. We support the proposal's elective nature, allowing partnerships and S corporations to make independent determinations as to whether they want to subject

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[21] *See* La. Stat. Ann. § 42:287.732.2; Okla. Stat. tit. 68, § 2355.1P-1, *et seq.*; 44 R.I. Gen. Laws § 44-11-2.3; Wis. Stat. § 71.05(6)(a)(14); N.J. Rev. Stat. § 54A:12-3; Md. Code Ann., Tax-Gen. § 10-102.1; Conn. Gen. Stat. § 12-699(f).

themselves of the Pass-Through Entity Tax. Electivity is important because, for example, not all partners in a partnership may be residents in a state that allow a credit for the Pass-Through Entity Tax. Absent electivity, those partners would automatically become subject to full double taxation on the same earnings – once in New York and once in their state of residence. The elective nature also has the benefit of not binding taxpayers to a tax regime that may no longer be warranted once the SALT Deduction Limitation phases out, or is otherwise eliminated.

However, as discussed in more detail below, the proposal is relatively limited in its application, and provides a number of disincentives for participation. In order to maximize the intended goal—to "mitigate the impact of the [SALT Deduction Limitation]" [22]—and to avoid putting New York at a competitive disadvantage vis-à-vis neighboring states Connecticut and New Jersey, whose pass-through entity taxes are broader, we recommend that the application of the Pass-Through Entity Tax be modified as set forth below.

1. *Application of the Pass-Through Entity Tax Solely to Entities with Individual Partners or Shareholders*

Pursuant to the proposal, an eligible partnership or S corporation may be comprised only of individual partners or shareholders.[23] This prevents individual owners from benefiting from this tax regime even if just one of numerous owners is, for example, a corporate entity. In fact, many partnerships have a diverse owner base—for example, a

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[22] FY 2022 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support, available at https://www.budget.ny.gov/pubs/archive/fy22/ex/artvii/revenue-memo.pdf (the "Support Memorandum"), p. 8.

[23] Proposed Tax Law § 860(a), (b).

service partnership composed of individuals and PCs, a manufacturing partnership whose members consist of corporations, partnerships, individuals, etc., and a professional service partnership whose members consist mostly of individuals and a small number of corporations. Contrary to the legislative intent of the proposal to minimize the impact of the SALT Deduction Limitation, permitting only partnerships and S corporations comprised solely of individuals to elect into the Pass-Through Entity Tax may drastically reduce the beneficial impact to New York taxpayers.

Indeed, of the seven states that have enacted an entity-level pass through tax since the passage of the SALT Deduction Limitation, none has a similar requirement mandating that all the entity's partners or shareholders be individuals. Each tax regime has found a way to account for the treatment of a non-individual owner—and the means of accounting for the tax paid and corresponding credits/deduction. For example, Louisiana allows partnerships and S corporations that have partners or shareholders that are not individuals to elect to be subject to the entity-level tax, but only those partners or shareholders that are individuals receive the benefit of the corresponding credit. In contrast, Connecticut requires entities subject to its entity level tax to account for both their "direct pro rata share of the tax imposed on the partnership [or S corporation]" as well as "the indirect pro rata share of the tax imposed on any upper-tier entity" when computing its tax liability.[24] Connecticut provides the corresponding credit to both individual and corporate partners and shareholders.[25] These are two alternatives to consider that eliminate the restriction of

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[24] Conn. Gen. Stat. § 12-726(a), (b).

[25] *Id.* § 12-699(g).

participation in the proposed Pass-Through Entity Tax to only those entities made up entirely of individuals.

To the extent that this "solely individual owners" limitation is intended to avoid complications that may arise in coordinating the Pass-Through Entity Tax with the taxes imposed under other articles of the Tax Law on corporations, the New York City Unincorporated Business Tax provides a template for how to handle the application of the credit, based on entity tax paid, to a corporate partner. Specifically, a credit is provided against the corporate tax, which can be carried forward for up to seven years if not used. The Tax Section believes that this would be a suitable way to permit partnerships and S corporations with non-individual owners to elect into the Pass-Through Entity Tax. This is especially true in light of the fact that the Pass-Through Entity Tax is elective.

The proposed legislation also ends an entity's eligibility when an owner dies and the successor to the decedent's interest is not an individual. While the proposal provides penalty relief for the remaining partners based on underpayment of estimated tax, a simpler and fairer response is to allow the partnership to remain eligible for the rest of its taxable year if the deceased partner's interest is owned by his or her estate or disposes of the interest to a qualifying partner. In the alternative, for purposes of the Pass-Through Entity Tax, an "individual" can be defined to include the estate of a deceased owner and any grantor trust through which an owner holds their interest.

2. *Definition of "Pass-Through Adjusted Net Income"*

The proposed Pass-Through Entity Tax is computed by reference to the partnership's federal taxable income under IRC § 702(a)(8). An S corporation's Pass-

Through Entity Tax is determined by reference to the S corporation's non-separately stated federal taxable income under IRC § 1366(a)(2). It is questionable whether IRC § 702(a)(8) sets the appropriate boundaries for the benefit intended to be conferred by the Pass-Through Entity Tax, and the Tax Section urges the Legislature to clarify what is intended to be included in the tax base.

IRC § 702(a)(8) encompasses "taxable income or loss [of the partnership], exclusive of items requiring separate computation under other paragraphs of this subsection." In other words, the scope of IRC § 702(a)(8) is determined by subtraction. One starts with all the items that enter into computation of the partnership's taxable income or loss and then subtracts the items listed in the seven paragraphs of IRC § 702(a) that precede paragraph (8). Six of those preceding paragraphs describe readily identified and discrete classes of items.[26] The seventh class of items subtracted before arriving at a partnership's IRC § 708(a)(8) amount is more amorphous: "other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary."[27]

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[26] More specifically, the items described in the six preceding paragraphs are short-term capital gains and losses, long-term capital gains and losses, IRC § 1231 gains and losses, charitable contributions, dividends, and income taxes of foreign countries and possessions of the United States. At least some of these items may be more likely to arise in connection with investment, rather than business, activities. Although we express no view as to whether the Pass-Through Entity Tax regime should be applied to investment income, we note that at least some of the types of income set forth in the above list seem to be clearly business income related. For example, IRC § 1231 gains and losses arise with respect to business property.

[27] IRC § 702(a)(7). Prior to enactment of the Tax Reform Act of 1976, this provision was paragraph (8) of IRC § 702(a), and what is now IRC § 702(a)(8) was paragraph (9) of IRC § 702(a). The paragraph numbers in Treasury Regulation § 1.702-1(a) correspond to the statutory paragraph numbers prior to the 1976 amendment; thus Treasury Regulation § 1.702-1(a)(8) corresponds to what is now IRC § 702(a)(7), and Treasury Regulation § 1.702-1(a)(9) corresponds to what is now IRC § 702(a)(8).

Treasury Regulation § 1.702-1(a)(8)(i) begins its description of this seventh class with a laundry list of specific items that must be taken into account by each partner separately before one reaches the residual taxable income or loss of IRC § 702(a)(8).[28] The final clause of Treasury Regulation § 1.702-1(a)(8)(i) then requires that each partner must separately account for "any items of income, gain, loss, deduction, or credit subject to a special allocation under the partnership agreement which differs from the allocation of partnership taxable income or loss generally." We believe that the special allocation of an item should not lead to its exclusion from the tax base for the Pass-Through Entity Tax because, among other considerations:

- Special allocations are ubiquitous for good business reasons in modern partnership agreements, and it is difficult to understand why the fact that an item is specially allocated makes it appropriate to exclude that item from the tax base.
- Creative taxpayers and their advisors may be able to use special allocations of deductions to exclude such deductions from the IRC § 702(a)(8) amount, while leaving the gross income of the partnership to be allocated in "residual percentages," and thereby increase artificially the amounts eligible for the Pass-Through Entity Tax beyond anything that could reasonably be intended.

Treasury Regulation § 1.702-1(a)(8)(ii) excludes a further category of items from IRC § 702(a)(8), by requiring that partnerships separately account for, and therefore not include

[28] While some of the listed items are clearly associated with personal expenditures (for example, medical and dental expenses and alimony payments) or with investment activities (for example, nonbusiness expenses deductible under IRC 212), others could readily arise in the context of business activities. Accordingly, we recommend that thought be given to whether all the specific items listed in Treasury Regulation § 1.702-1(a)(8)(i) should necessarily be excluded from the tax base.

in their IRC § 702(a)(8) amounts, "the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately." There are many items that, if taken into account by a partner, could result in a change to the partner's tax liability. Just to give one example, if a partnership is engaged in one activity eligible for the IRC § 199A "qualified business income" deduction and in another that is not, the items of at least one of those activities seem to be subject to separate accounting under IRC § 702(a)(7), and thus to be excluded from IRC § 702(a)(8). As such, the excluded items would appear to be outside the scope of the Pass-Through Entity Tax. We cannot articulate any reason for this result.

For the foregoing reasons, we recommend that the categories of income intended to be subject to the Pass-Through Entity Tax be described substantively in the legislation, and that the scope of the Pass-Through Entity Tax not be determined by reference to IRC § 702(a)(8).

3. *Clarify When an Election May Be Terminated*

According to § 861(e)(1) of the proposal, "[a]n election pursuant to subdivision (a) of this section shall be terminated whenever, at any time during the taxable year, the taxpayer ceases to be an eligible partnership or eligible S corporation." The statute as drafted is unclear as to whether ceasing to be eligible is the *only* instance in which an election may be revoked during the taxable year. Specifically, can the election be

terminated, mid-year, by choice? Providing a mid-year revocation right would save taxpayers who want to terminate from having to engage in a disqualifying act to do so.

4. *Clarify the Meaning of "Profit Percentage"*

The proposed credit, used to offset an individual partner's New York personal income tax liability arising from the Pass-Through Entity Tax is the product of (i) the individual's "profit percentage" of the electing partnership, (ii) 92 percent, and (iii) the Pass-Through Entity Tax paid by the electing partnership or S corporation.[29] Similarly, the proposed credit for New York residents arising from substantially similar taxes paid to other states is also calculated by reference to the taxpayer's "profit percentage" of the tax-paying entity.[30]

In regard to partnerships, the proposal does not include a definition for the term "profit percentage". And in fact, we doubt that the commonly understood meaning of this term reflects the proper meaning for purposes of computing the credit. This is because "profit percentage" does not naturally align with the base upon which with Pass-Through Entity Tax is imposed. Specifically, the tax base for the Pass-Through Entity Tax consists only of an electing partnership's income under IRC § 702(a)(8). Accordingly, we recommend that "profit percentage" is also computed solely by reference to the individual's share of IRC § 702(a)(8) income (or if our recommendation above is adopted, whatever the scope of the tax base is in lieu thereof) that is subject to the tax. This is

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29 Proposed Tax Law § 606(kkk)(2)(i).

30 *Id*. § 620(b)(2)(A).

necessary in order to have parity between the tax base upon which the tax is computed, that passes to each individual, and the credit granted to each individual owner.

For example, assume Partnership X, an eligible partnership, had $100 of capital gain allocated to Individual A, and $100 of business income allocated to Individual B. As the Pass-Through Entity Tax is currently drafted, Partnership X would owe tax of $6.85 (6.85 percent of the $100 of business income). The owner credit should be allocated 100 percent to Individual B, and not 50/50 to Individual A and Individual B.

5. *Potential Guidance on Combined Reporting*

The proposed Pass-Through Entity Tax does not address the issue of combined reporting—and therefore presumptively does not allow for combined reporting. The Legislature may consider whether permitting combined reporting would be beneficial. For example, Connecticut's entity-level tax permits pass-through entities with common ownership (i.e., more than 80 percent of the voting control is directly or indirectly owned by common owners) to file combined returns. Connecticut requires a combined return election to be made annually, and that all entities included in the combined return compute the tax using the same tax base.

6. *Joint and Several Liability*

The Tax Section believes that owners eligible for a credit should not be jointly and severally liable for the tax owed by the partnership. Imposing this burden on all partners—whether general or limited—is distinct from New York's treatment of other entity-level taxes. Specifically, a similar provision does not exist under New York City's Unincorporated Business Tax. We recommend the following two alternatives be

considered: (1) owners will be liable for their proportionate share of the entity-level tax; or (2) the owner level credit will only be granted if the entity-level tax is paid.

7. *Addback of Entity-Level Tax*

The proposal is silent as to whether an individual owner is required to addback its proportionate share of the entity-level tax to its tax base. While we assume that no addback is intended, so that taxpayers obtain nearly all the benefit of the credit, we recommend that this be explicitly stated in the statute to ensure clarity.

8. *Pass-Through Entity Tax Rate*

As drafted, the Pass-Through Entity Tax would be imposed at the rate of 6.85 percent. Individuals subject to a personal income tax rate higher than this amount will receive a lesser benefit as a percentage of their New York tax than those individuals subject to a personal income tax rate at or below 6.85 percent. One solution to maximize the benefits to all individuals would be to impose the tax at the highest personal income tax rate, and adjust the credit mechanism so that the impact of such an increase is neutral to the state and to taxpayers in lower tax brackets.

9. *Credit for Pass-Through Entity Taxes Paid to Other States*

Section 620(b) of the proposed Pass-Through Entity Tax allows a New York resident to receive a credit against their New York individual income tax liability for taxes paid pursuant to other states' entity-level taxes which are "substantially similar" to the proposed Pass-Through Entity Tax.

The Tax Section supports the Legislature's intention to ensure that the resident tax credit is provided in relation to pass-through entity taxes paid to another jurisdiction.

However, as discussed in more detail in our report on New York State's potential response to IRS Notice 2020-75 (Report No. 1446 (January 20, 2021)), the Tax Section believes that the language of Tax Law § 620 as currently enacted and corresponding binding case law supports a finding that —regardless of this change—a resident tax credit may be available to resident partners and S corporation shareholders for entity-level income taxes paid to other states. Thus, we think it is important to make clear that this proposal is intended as clarifying language, and not as a change.

In addition, we would like to draw attention to the potential issue with the use of the term "substantially similar". As previously discussed, to date there are seven states that have implemented entity-level taxes since the enactment of the SALT Deduction Limitation.[31] While these states have all implemented entity-level taxes, they are not uniform to one another, or to New York's proposal. That is to say, it is debatable which of these entity-level taxes are "substantially similar" to the proposed Pass-Through Entity Tax. Further, it is probable that additional states will implement entity-level taxes now that the Notice has blessed this approach to minimizing the impact of the SALT Deduction Limitation. We therefore recommend additional clarity and certainty regarding what qualifies as a "substantially similar" entity-level tax.

[31] Louisiana, Oklahoma, Rhode Island, Wisconsin, New Jersey, Maryland and Connecticut.

III. Part E: Mandate S Corporation Election Conformity

A. Summary of Changes

Under the Article 9-A regime currently in place, corporations doing business in New York and which have elected to be taxed under Subchapter S of the Internal Revenue Code, could choose whether to elect S corporation status in New York. Corporations treated as S corporations for federal but not New York purposes (so-called "hybrid S corporations") are offered advantages in certain situations. For example, shareholders could take advantage of New York's favorable treatment of investment income under the pre-2015 corporate tax regime and exempt income under the current corporate tax regime. It also provided a planning opportunity for nonresident shareholders, whereby the corporation paid tax to New York, with shareholders relieved of New York tax on distributions treated as dividends for New York tax purposes and potentially relieved of any obligation to file in New York.

On the other hand, the requirement of separate S elections for federal and New York purposes proved problematic for some corporations and their shareholders. Many out-of-state corporations and their tax preparers were caught unaware of the requirement to separately elect S corporation status in New York, often requiring them to get shareholders' and New York's permission to make the election retroactively. In addition, resident shareholders were sometimes unaware that a hybrid S corporation could prevent them from

claiming resident credits for taxes paid to other state jurisdictions where S corporation status meant that the shareholders were subject to tax on income sourced to that state.[32]

The 2007-2008 Budget Legislation added new subsection 660(i), mandating that a New York S corporation election will be deemed to have been made in that year "if the eligible S corporation's investment income for the current taxable year is more than 50 percent of its federal gross income for such year." The new mandatory S election created a new and broader definition of "investment income" for this purpose, including a wider array of items of income than the existing Article 9-A definition of "income from investment capital." While the provision was designed to close perceived loopholes, it also resulted in disputes over the interpretation of the new "investment income" definition, as well as unintended consequences, such as an unusual gain from an asset sale pushing a hybrid corporation into the mandatory S election category.

In 2017, the proposed budget introduced S corporation election conformity but that provision was ultimately left out of the final legislation. The Budget Bill once again proposes to require federal and New York conformity regarding S corporation elections.

B. Comments

S corporation election conformity does, indeed, simplify certain aspects of the tax law and reduces the risks of uninformed shareholders or tax preparers either neglecting to make the separate New York S election or assuming that credits for taxes paid to other

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32 Tax Law § 620(d).

jurisdictions at the shareholder level will still be available in New York. Indeed, the vast majority of states have adopted S corporation election conformity. Nevertheless, eliminating the option for hybrid S corporation status could have unintended consequences on certain businesses.

First, a qualified manufacturing company that has elected federal S corporation status loses any advantage of locating in New York, undermining the incentive of the zero percent tax rate enacted with corporate tax reform.

Second, conformity eliminates a valuable tax planning tool for corporations and a valuable tool for New York to attract businesses to the state. Whereas a hybrid S corporation could capitalize its state tax credits (e.g. a film production credit) and monetize them strategically in New York, such tax planning is no longer possible where the credits are passed to the shareholders and no longer "belong" to the corporation that earned them. Moreover, a hybrid S corporation may have valued certain tax credits on the basis of their use by the corporation rather than the shareholder (particularly refundable credits) for purposes such as obtaining bank financing, seeking a buyer, or attracting investors. Eliminating the hybrid model could change the value of those credits once they are in the hands of shareholders, potentially undermining plans based on corporate-level tax credits.

Accordingly, considerations might be given to ameliorating the impact of conformity on certain corporate taxpayers, such as qualified New York manufacturers who may have relied on the hybrid option in deciding to locate in New York, or to existing corporations with carryover state tax credits that relied upon those credits being available

at the corporate level, and that would be detrimentally effected by the elimination of the hybrid option.

IV. Part H: Enact the Cannabis Regulation and Taxation Act

A. Recent History

We last reported on The Cannabis Regulation and Taxation Act as drafted in the proposed FY 2020 New York State Executive Budget (the "2020 Budget Bill")[33], but ultimately these cannabis provisions were not a part of the enacted 2020 Budget Bill. Part H of the Budget Bill is modeled after its 2020 counterpart, legalizing recreational cannabis use, with important departures that we highlight below.

B. Current Law

The use of cannabis for recreational purposes is currently illegal in the state of New York. The use of medical cannabis, however, is legal in New York under § 3362 of the Compassionate Care Act.[34] To obtain medical cannabis, a patient must be diagnosed with one of several serious conditions, and the patient must receive certification from a medical professional.[35] Additionally, the patient must register with the Department of Health's Medical Marijuana Program and obtain a Registry Identification Card.[36]

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33 *See* NYSBA Tax Section report on the 2019-2020 New York State Executive Budget (Report No. 1413, March 4, 2019) ("NYSBA Tax Section Report No. 1413").

34 Pub. Health Law § 3362.

35 *Id.* § 3361.

36 *Id.* § 3363.

The current excise tax on medical cannabis is seven percent of the gross receipts from medical marijuana sold or furnished by a registered organization to a certified patient or designated caregiver.[37] The law defines "gross receipt" as the amount charged for the provision of medical cannabis, without any deduction for the cost of materials, labor, or services; other costs, interest, or discount paid; or any other expenses.[38]

C. Proposed Changes

Part H of the Budget Bill proposes to legalize the recreational use of cannabis, and Article 20-C of the Tax Law would impose a number of requirements on prospective cannabis businesses, including taxation, registration and renewal, and keeping returns secret. Additionally, Article 20-C enumerates penalties in the case that a person violates one of the provisions.

The Budget Bill would impose three separate taxes on the sale of cannabis. The first tax imposed would come through amending Tax Law § 1115 to clarify that retail sales of adult-use cannabis are now subject to the general sales tax imposed on retail sales of tangible property under Tax Law § 1105. We note that this is a departure from the 2020 Budget Bill, under which sales of adult-use cannabis were exempt from State sales tax.

In addition to subjecting retail sales of cannabis to the regular sales tax, the Budget Bill would create a new Tax Law § 493 which would impose two additional taxes.[39] The

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[37] Tax Law § 490(2).

[38] *Id.* § 490(1).

[39] The 2020 Budget Bill similarly would have introduced new Tax Law § 493, which would have imposed two taxes: (i) a tax on the cultivation of cannabis, based on weight, paid on the sale from the cultivator (either on the sale to a wholesaler, a retailer, or directly to a customer) and (ii) a twenty percent excise tax paid by the wholesaler (either on sale to a retailer, or (when a wholesaler is also a retailer) on the

first tax is based on the milligrams of total THC in adult-use cannabis products with a different per milligram of total THC rate depending on the product category. Edibles will be taxed at a rate of $0.04 per milligram of the amount of total THC, concentrates will be taxed at $0.01 per milligram of the amount of total THC, and cannabis flower will be taxed at a rate of $0.007 per milligram of the amount of total THC. The total THC per milligram tax is imposed on the sale from the wholesaler to a retail dispensary. If the wholesaler is also retail dispensary, the tax accrues at the time of retail sale.

The second tax under Tax Law § 493 is a surcharge imposed on the sale by the retail dispensary to the consumer at a rate of 10.25 percent of the selling price.

The Budget Bill also proposes to modify the taxpayer secrecy provisions under Article 20-B, Excise Tax on Medical Marihuana, by removing any references to the sharing of information with the federal government. Similarly, § 496 of Article 20-C, as proposed by the Budget Bill, does not explicitly address whether New York intends to share the information it obtains with the federal government.

D. Comments

i. *Interaction of IRC § 280E with the Proposed Cannabis Legislation*

IRC § 280E states:

> No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.

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wholesaler's sale to a customer). The differences between the taxes imposed by the 2020 Budget Bill and the current Budget Bill are discussed in greater detail in Section D(ii) below.

Currently, New York law follows IRC § 280E through its conformity to the IRC. As a result, cannabis businesses may not claim the same deductions that other businesses may because the federal government continues to list cannabis as a Schedule I drug. New York's conformity with the IRC puts an additional fiscal burden on cannabis businesses, which appears inconsistent with New York's position that cannabis is a legitimate business undertaking. The Legislature may therefore want to consider following in the footsteps of some other states, such as Washington and Colorado, that have decoupled from IRC § 280E.

ii. *The Imposition of the THC-Content Tax and 10.25 Percent Tax*

The taxes imposed by the Budget Bill differ from those in the 2020 Budget Bill in a few important aspects. Most notably, the Budget Bill no longer imposes a tax on the cultivation of cannabis. The 2020 Budget Bill would have imposed a tax on the cultivation of cannabis at the rate of $1 per dry weight gram of cannabis flower and $0.25 per dry weight gram of cannabis trim. This tax would have been paid at the point of transfer (sale) by the cultivator. As federal legislation allowing for interstate cannabis commerce may become a possibility, either in the short or long term, moving the focus of the tax away from cannabis cultivation and towards the milligrams of total THC in the cannabis product is likely a more efficient approach for collecting revenues by the state.

The Budget Bill also differs from the 2020 Budget Bill in a manner that relieves some of the main concerns raised by the twenty percent excise tax contained in the 2020 Budget Bill. Under the previously proposed 2020 Budget Bill, the tax base subject to the twenty percent excise tax would have changed depending on whether a wholesaler and a

retailer were two separate entities or a single entity. In the separate entity context, the tax would have been imposed on the wholesale price and in the single entity context, the twenty percent tax would have been imposed only on the retail price. This proposal would have likely resulted in materially different tax amounts collected due to the margins built into the retail price. Possibly, the proposed statute would have treated similarly situated taxpayers differently, conceivably resulting in a constitutional challenge. For example, a difference in treatment could arise when a retailer that is also a wholesaler would be forced to collect the twenty percent excise tax on the final retail price (which would presumably need to be raised in order to cover other expenses of the business), as opposed to a retailer who purchased the cannabis from a wholesaler, where the tax base would be smaller due to the lower prices paid at the wholesale level.

The Budget Bill similarly collects the first of its two taxes imposed under § 493 at the point of transfer (sale) from the wholesaler (i.e., either at the sale between wholesaler and retailer when the entities are separate, or collecting only at the level of the retail sale when the wholesaler and retailer are one entity). But this tax is imposed on the THC-content of cannabis product, not on the price of the product transferred. As such, the issue of the tax base shifting materially based on the relative margins built into retail pricing should be alleviated, along with any constitutional challenges claiming that similarly situated taxpayers were treated differently.

The second tax imposed by the Budget Bill is a 10.25 percent tax imposed on the retail selling price. As this tax will always be based on the final retail price, it likewise does not raise the same issues presented by the 2020 Budget Bill twenty percent excise tax,

which could have alternatively been based on the price paid between wholesalers and retailers (or between retailers and customers). We note that in NYSBA Tax Section Report No. 1413 we suggested replacing the proposed twenty percent excise tax with a lower tax imposed only on the retail price of the product, as seen here.

V. Part I: Modernize Tax Law to Include the Vacation Rental Industry

A. Current Law

In general, Article 28 of the Tax Law imposes sales tax on "[t]he rent for every occupancy of a room or rooms in a hotel."[40] If the rent is for occupancy of a room in a hotel located in New York City, a charge of $1.50 per day (the "Hotel Unit Fee") is also imposed.[41] Both sales tax and the Hotel Unit Fee are administered by the New York State Department of Taxation and Finance (the "Department"),[42] and the same definitions and exemptions applicable to sales tax also apply to the Hotel Unit Fee.[43]

Sales tax and the Hotel Unit Fee are only imposed on the rental of hotel occupancy, and not on the rental of real property.[44] Under current law, it is unclear whether the definition of "hotel" encompasses a "vacation rental." A "hotel" is defined as "a building or portion of it which is regularly used and kept open as such for the lodging of guests," and includes "an apartment hotel, a motel, boarding house or club, whether or not meals

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40 Tax Law § 1105(e)(1).

41 *Id*. § 1104(a).

42 *Id*. §§ 1105, 1210, 1109, 1104(b); N.Y. Comp. Codes R. & Regs. tit. 20, § 527.9(a)(2)(ii).

43 *Id*. § 1104(b).

44 TSB-M-12(4)S, *Elimination of One-Week Stay Test to Determine if the Rental of a Bungalow or Similar Living Unit is Subject to Sales Tax* (N.Y.S. Department of Taxation & Finance Mar. 16, 2012).

are served."[45] The Regulations exclude certain "bungalows" and similar living facilities from the definition of "hotel."[46] The exclusion hinges on the presence of a landlord-tenant relationship, exhibited by a lack of common hotel amenities, including housekeeping, food, entertainment, and linen services, provided to the occupant.[47]

Sales tax is imposed on the "rent," or consideration received, for hotel occupancy, including any charge required to be paid as a condition for occupancy.[48] The Hotel Unit Fee, however, is not subject to sales tax and must be separately stated on a customer invoice.[49] Sales tax and the Hotel Unit Fee are collected and remitted by the person operating the hotel,[50] which includes a "room remarketer;" that is, a person who furnishes occupancy, directly or indirectly, for rent.[51]

For purposes of imposing sales tax on the receipts from retail sales of *tangible personal property*, the Tax Law contains rules for "marketplace providers". Under the rules, a "marketplace provider" and "marketplace seller" are both deemed vendors for purposes of sales tax collection. A "marketplace provider" is a "person who, pursuant to an agreement with a marketplace seller, facilitates sales of tangible personal property by

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45 Tax Law § 1101(c)(1).

46 N.Y. Comp. Codes R. & Regs. tit. 20, § 527.9(e)(5).

47 *Id.*

48 Tax Law § 1101(c)(6).

49 TB-ST-331, *Hotel and Motel Occupancy* (N.Y.S. Department of Taxation & Finance, May 9, 2012).

50 Tax Law § 1131(1).

51 *Id*. § 1101(c)(4),(8).

such marketplace seller."[52] "Facilitating" includes providing the forum in which the sale takes place, and collecting the receipts paid by a customer to the marketplace seller.[53] The Tax Law's "marketplace provider" provisions only apply to sales of tangible personal property.

A marketplace provider has all of the obligations and rights of a typical vendor, including the duty to collect and remit the tax, to obtain a certificate of authority, to file returns, and the right to accept a certificate of exemption or exclusion from tax.[54] A marketplace seller is relieved of the duty to collect and remit sales tax, and of the requirement to include the receipts from the sales of tangible personal property on its return, so long as the marketplace provider is facilitating the sale and the marketplace seller receives a properly completed certificate of collection from the marketplace provider. Additionally, any failure of the marketplace provider to collect and remit sales tax must not be caused by the provision of incorrect information by the marketplace seller.[55]

B. Proposed Changes

Part I of the Budget Bill would amend several sections of Article 28 of the Tax Law. Generally, the net effect of the amendments would be to: (i) update the Tax Law to impose sales tax and the Hotel Unit Fee on "vacation rentals;" and (ii) require "vacation rental marketplace providers" to collect sales tax on the vacation rentals they facilitate.[56]

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52 *Id.* § 1101(e)(1).

53 *Id.* § 1101(e)(1).

54 *Id.* §§ 1101(b)(8); 1132(l)(1); 1133(a).

55 *Id.* § 1132(l)(2).

56 *See* Support Memorandum, pp. 15 and 16.

1. *Definitions*

The Budget Bill would amend Tax Law § 1101(c) by including definitions for "vacation rental" and "vacation rental marketplace provider." Additionally, the definition of "room remarketer" would remain limited to rent for occupancy in a hotel (i.e., it would not apply to "vacation rentals"), and the definitions of "occupancy," "occupant," "operator," "permanent resident," and "room" would be expanded to include "vacation rentals" (and those who operate and occupy them). As proposed, the Budget Bill defines the term "vacation rental" as:

> A building or portion of it that is used for the lodging of guests. The term 'vacation rental' include a house, an apartment, a condominium, a cooperative unit, a cabin, a cottage, or a bungalow, or one or more rooms therein, where sleeping accommodations are provided for the lodging of paying occupants, the typical occupants are transients or travelers, and the relationship between the operator and occupant is not that of a landlord and tenant.

The term "vacation rental" would include a "bungalow" regardless of whether meals, daily housekeeping, concierge service, linen service, and other similar amenities are provided.

A "vacation rental marketplace provider" is defined by the Budget Bill, in relevant part, as:

> A person who, pursuant to an agreement with an operator, facilitates the occupancy of a vacation rental by such operator or operators. A person 'facilitates the occupancy of a vacation rental' . . . when the person meets both of the following conditions: (A) such person provides the forum in which, or by mean of which, the sale of the occupancy takes place or the offer of such sale is accepted, including a shop, store or booth, an internet website, catalog, or similar forum; and (B) such person or an affiliate of such person collects the rent paid by a customer to an operator for the occupancy of a vacation rental, or contracts with a third party to collect such rent.

As noted above, the term "vacation rental marketplace provider" would not include a "room remarketer," which is generally defined as a person who "reserves, arranges for, conveys, or furnishes occupancy, whether directly or indirectly, to an occupant in a hotel for an amount determined by the room remarketer."

2. *Imposition of the Hotel Unit Fee and Sales Tax*

The Budget Bill would amend Tax Law § 1105(e) to impose sales tax on the rent for "occupancy" in a "vacation rental" located in New York. Similarly, the Budget Bill would amend Tax Law § 1104(a) to impose the Hotel Unit Fee on the rent for "occupancy" in a "vacation rental" located in New York City.

3. *Administrative Provisions*

The Budget Bill would amend Tax Law § 1131(1) to impose a tax collection obligation on an operator of a "vacation rental" and on a "vacation rental marketplace provider," with respect to the rent for occupancy in a "vacation rental" that it facilitates.

The Budget Bill would amend Tax Law §§ 1132, 1133, 1134(a), and 1136(a) to delineate the rights and obligations of "vacation rental marketplace providers" and operators of "vacation rentals." Per the Budget Bill, "vacation rental marketplace providers" would have the same obligations and rights as a vendor, including the duty to collect and remit tax, to obtain a certificate of authority, to file returns, and the right to accept a certificate of exemption or exclusion from tax. Operators of "vacation rentals" would be relieved of: (1) registering with the State to collect sales tax and the Hotel Unit Fee; (2) collecting sales tax and the Hotel Unit Fee; and (3) including rent from occupancy in a "vacation rental" on its return, so long as "vacation rental marketplace providers" are

facilitating the rentals and provide operators of "vacation rentals" with a properly completed certificate of collection. Additionally, any failure on behalf of the "vacation rental marketplace provider" to collect and remit tax must not be caused by incorrect or insufficient information provided by the operator of "vacation rentals." If the operator of "vacation rentals" provides incorrect or insufficient information, the "vacation rental marketplace provider" is relieved of liability.

The Budget Bill would amend Tax Law §§ 1132 and 1142 to expand the authority of the Department to have the discretion to allow a "vacation rental marketplace provider" to obligate itself to collect and remit tax, on behalf of the operator of "vacation rentals" for which it facilitates rentals in the State, without having to furnish a certificate of collection to the operator of "vacation rentals." The Department would also have the authority to publicize, on the Department's website, the "vacation rental marketplace providers" whose certificates of authority have been revoked. Additionally, the tax commission would have the authority to impose the duties otherwise assigned to the "vacation rental marketplace provider" on the operators of "vacation rentals," where the "vacation rental marketplace provider" facilitating the operator's rentals has had its certificate of authority revoked.

C. Comments

1. *Ambiguity in definitions*

The Support Memorandum states that the Budget Bill will improve taxpayer compliance and level the playing field for New York hotel operators. We question whether the Budget Bill will improve taxpayer compliance in all respects. The proposed definitions

of "operator" and "vacation rental" introduced by the Budget Bill are in some ways vague and seemingly inconsistent with the current law's "bungalow" exception.[57]

Per the Budget Bill, an "operator" is defined as "any person operating a . . . vacation rental."[58] "Vacation rental" is in turn defined as:

> A building or portion of it that is used for the lodging of guests . . . . includ[ing] a house, an apartment, a condominium, a cooperative, a cabin, a cottage, or a bungalow . . . where sleeping accommodations are provided for the lodging of paying occupants, the typical occupants are transients or travelers, and the relationship between the operator and occupant is not that of a landlord and tenant. It is not necessary that meals are served. A building or portion of a building may qualify as a vacation rental whether or not amenities, including but not limited to daily housekeeping services, concierge services, or linen services, are provided.[59]

Despite the Budget Bill's use of the term "vacation", this term, and its definition would arguably encompass *all* occupancies and not only those sought for vacation purposes; for example, the tax would likely reach a homeowner that rents his or her Manhattan apartment to an occupant visiting the city on business. Furthermore, because the definition of "operator" does not include a threshold (either in dollars or in length of stay), the homeowner could be considered an operator even where he or she only rented the apartment for one week out of the tax year. This raises compliance concerns as homeowners renting their properties for business purposes may be unaware of their potential tax liability for providing "vacation rentals." Additionally, homeowners that

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57 N.Y. Comp. Codes R. & Regs. tit. 20, § 527.9(e)(5).

58 FY 2022 New York State Executive Budget, pg. 304-05

59 *Id*.

engage in only a handful of rentals per year may be unaware of their status as an "operator" and their resulting obligation to collect and remit tax.

Although the definition of "vacation rental" purports to exclude rentals of real property from the tax (i.e., where there is a landlord-tenant relationship), it removes from consideration several indicators that have historically been looked to by the Department and the courts to distinguish between a landlord-tenant relationship (which is not taxable) and that of an innkeeper-guest relationship (which is treated as a hotel subject to tax). For example, under the provisions of the Budget Bill, a homeowner would have to determine if a landlord-tenant relationship exists with the occupant without taking into account typical hotel amenities (such as housekeeping, linen, and concierge services). Under the current law, single-family "bungalows" are excluded from the definition of "hotel," and thus exempt from the tax on hotel occupancy, where common hotel amenities are not provided.[60] The term "bungalow" is used within the proposed definition of "vacation rental;" however unlike the current law, bungalows are *not* excluded, regardless of whether meals, daily housekeeping, concierge service, linen service, and other similar amenities are provided. As a result, it is unclear whether the "bungalow" exception would apply to "vacation rentals," even though the Budget Bill purports to exclude accommodations from tax if the relationship between the owner and the occupant is that of a landlord and tenant. This would raise compliance concerns and would put operators of "vacation rentals" at a disadvantage compared to "hotel" operators.

[60] N.Y. Comp. Codes R. & Regs. tit. 20 § 527.9(e)(5).

As drafted, the Budget Bill also creates potential ambiguity on the tax base that is subject to tax in the context of a "vacation rental". Specifically, the Budget Bill does not modify the current definition of "rent", which is defined as the consideration received for occupancy in the hotel or vacation rental:

> The consideration received for occupancy, including any service or other charge or amount required to be paid as a condition for occupancy, valued in money, whether received in money or otherwise and whether received by the operator or a room remarketer or another person on behalf of either of them.

In the context of a "vacation rental" that is facilitated by a "vacation rental marketplace facilitator," the definition of rent, which is focused on the amount received for occupancy, raises the question of whether the fees received by the vacation rental marketplace facilitator for the use of its platform is subject to tax. By way of example, assume an individual books a rental of a taxable accommodation through an online home-sharing platform for one night at $100 per night. In consideration for using the vacation rental marketplace facilitator's platform, assume the operator of the accommodation (e.g., the homeowner) is obligated to pay the platform a $7 fee and the individual booking the accommodation is obligated to pay the platform a $3 fee. In this scenario, the vacation rental marketplace facilitator will receive and process a payment from the individual booking the accommodation in the amount of $103. The vacation marketplace facilitator will keep $10 for the use of its platform and remit $93 to the homeowner. Does the definition of "rent" subject to tax include the $10 paid to the vacation rental marketplace facilitator for the use of its platform? Or is the "rent" subject to tax limited to the amount remitted to the homeowner (i.e., $93)? Alternatively, perhaps amount subject to tax is $100

on the basis that this is the amount paid to the homeowner for the rental, out of which the homeowner pays as an expense $7 to the vacation marketplace facilitator. The Budget Bill should clarify how rent is defined in the context of a "vacation rental" facilitated by a "vacation rental marketplace facilitator".

2. *Tax collection burdens*

The Support Memorandum states that the Budget Bill will help ease tax collection burdens for operators of "vacation rentals."[61] Although the Budget Bill seeks to relieve operators of their tax collection obligation, some questions arise as to how and when such relief would apply. For one, operators of "vacation rentals" are required to provide correct and sufficient information to "vacation rental marketplace providers," so that such providers can collect and remit the sales tax and Hotel Unit Fee due. Failure to provide correct and sufficient information will relieve the "vacation rental marketplace provider" of liability.

It is unclear, however, whether an operator will be liable for the entire tax liability, or a reduced amount based on the incorrect/insufficient information provided. For example, if an operator provides an incorrect address for a taxable rental, such that the sales tax rate imposed is 8.25 percent instead of 8.5 percent, is the operator liability for the entire 8.5 percent in tax or just the incremental 0.25 percent associated the operator's error? More broadly, the Budget Bill does not specify what information needs to be provided. Specifically, it is unclear whether the operator is only required to provide accurate factual

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[61] Support Memorandum, p. 15.

information or whether the operator must communicate correct taxability determinations to the vacation rental marketplace facilitator. For example, it is one thing to require the operator to provide a correct address for the rental, but should the operator be responsible for determining and communicating whether the accommodation is exempt because the rental constitutes a landlord-tenant relationship? Or should the operator only be required to provide information regarding the characteristics of the rental, leaving the taxability determination to the vacation rental marketplace facilitator?

The Budget Bill also suggests that "vacation rental marketplace providers" would be allowed to collect on all "vacation rentals," without determining whether each rental is subject to sales tax and the Hotel Unit Fee. In this case, although the obligation to collect tax is removed from the operator, the operator is required to include tax in every rent for occupancy of "vacation rentals," even where the rental is exempt. This raises concerns for individuals booking the rental, such as who should be entitled to a refund of the tax collected and remitted? The Tax Section is concerned that many individuals will be unaware of their right to a refund and suggests the Budget Bill adopt a requirement that the individual booking the accommodation be notified of the potential right to a refund in such circumstances.

VI. Part T: Allow the Department the Right to Appeal DTA Tribunal Decisions

A. Current Law

The statute that created the DTA within the Department has, since its enactment in 1986, provided a mechanism for taxpayers to appeal adverse decisions rendered by the

Tribunal. Such appeals are made to Supreme Court, Appellate Division (Third Department) under a specially modified procedure under Article 78 of the Civil Procedure Law and Rules; Article 78 provides the sole mechanism in New York State for review of decisions made by administrative agencies. While taxpayers have the ability to appeal adverse decisions, the Department has been provided with no such appeal opportunity and thus decisions of the Tribunal in which the taxpayer prevails are final. Consequently, inasmuch as Tribunal decisions are precedential, the Department has occasionally resorted to seeking legislative changes to substantive Tax Law provisions when it has believed the law should be different than as interpreted by the Tribunal.

Even though taxpayers do have the right to appeal adverse decisions of the Tribunal to the Appellate Division, the standard of review for overturning a Tribunal decision is high. The Appellate Division is limited to overturning a Tribunal decision only if it determines that the Tribunal's decision is not "supported by substantial evidence" or "was affected by an error of law or was arbitrary and capricious or an abuse of discretion."[62] This is a heavy burden to meet. For example, with respect to the second standard, "[i]t is well established that [j]udicial review of an administrative determination is limited to whether the administrative action is arbitrary and capricious or lacks a rational basis . . . . Such a determination is entitled to great deference . . . , and [a] reviewing court may not substitute its own judgment for that of the agency."[63]

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62 CPLR § 7803(3), (4).

63 *Matter of Walker v. State Univ. of N.Y. [Upstate Med. Univ.]*, 19 A.D.3d 1058, 1059, *lv. denied* 5 N.Y.3d 713 [internal quotation marks omitted].

B. Proposed Changes

Part T of the Budget Bill would modify the Tax Law by providing the Department with the same appeal rights as currently afforded taxpayers.

C. Comments

From the time that the original DTA legislation was being developed in the early 1980s through as recently as 2018, the Tax Section has supported placing the Department on equal footing with taxpayers in the context of appeal rights. This position was based on two important considerations. First, unlike the former State Tax Commission, which exercised adjudicative as well as administrative and regulatory functions, the Tribunal is an independent, adjudicative body. Thus, whereas there was no need for a right of appeal when the State Tax Commission (i.e., the Department) made its own final determinations of tax cases (because it had ultimate control of such determinations), each litigant before the independent Tribunal should have the right to appeal. Such a procedure would be consistent with the procedure at the United States Tax Court, which permits the Internal Revenue Service to appeal adverse United States Tax Court decisions.[64]

Second, the Tax Section's historic support for granting the Department a right to appeal an adverse Tribunal decision was based on the belief that in cases where (a) the degree of the persuasiveness of the adverse parties' positions are approximately equal and (b) only one party can appeal further, a decision-making body will tend to rule against the

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64 *See* NYSBA Tax Section report on the need for and feasibility of a New York Tax Tribunal (Report No. 382, January 4, 1983); *see also* Letter from Erika W. Nijenhuis, Chair, Tax Section, NYSBA to Hon. David A. Paterson, Governor, New York State (Apr. 24, 2009); NYSBA Tax Section report on 2018-2019 New York State Executive Budget, (Report No. 1391, March 9, 2018) ("NYSBA Tax Section Report No. 1391").

party that has the opportunity to pursue such an appeal. This seems to be especially true when broad questions, such as Constitutional issues, are being decided. The Tax Section's concern has been that this will create the perception, whether valid or not, that the system lacks fairness because the Tribunal will decide close cases involving important tax principles against taxpayers. The Tax Section sees no reason why these considerations do not remain valid.

With the passage of time, however, some members of the Tax Section (the "Status Quo Members") have come to believe that the existing process for adjudicating tax disputes before the DTA has worked well and that the prohibition on the Department appealing adverse Tribunal decisions should not be changed. The primary concern of these members is that granting the Department an appeal right would create undue burdens on taxpayers that are not justified by the reasons being asserted for granting the appeal right.

By the time a taxpayer's case has reached the Tribunal, the taxpayer (whether an individual or a corporation) will typically have gone through several stages of administrative proceedings, including an audit by the Department, a protest before the Department's Bureau of Conciliation and Mediation Services, and a hearing before an administrative law judge at the DTA. These proceedings frequently take years to resolve and often require taxpayers to expend significant resources. If the proposed amendment is adopted, the Department would have the power to extend the litigation process beyond these proceedings, not just to the New York State Supreme Court, Appellate Division, Third Department, but potentially to the New York State Court of Appeals. The Status Quo Members are concerned that a large segment of the taxpayer community will be unable

to endure an extended litigation process due to financial, time or other resource constraints, or even because the taxpayer does not have the psychological stamina to proceed.

The Status Quo Members argue that, in this regard, the potential imbalance in "staying power" between the government and taxpayers should be considered, as should the legislative history behind the 1986 legislation creating the Tribunal. They say that legislative history makes it clear that the Tribunal was created primarily to benefit taxpayers by, among other things, establishing an independent adjudicative body and providing for a "rapid" system for resolving tax dispute.[65] As such, they believe permitting the Department to extend litigation beyond the Tribunal arguably goes against the purpose of the 1986 legislation.

As justification for making the change, the Support Memorandum mentions that the Department should be granted the right to appeal adverse Tribunal decisions because currently the Department's only recourse to an adverse Tribunal decision "is to seek legislation to reverse significant Tribunal decisions with which the Department disagrees as a matter of law . . . ." However, the Status Quo Members argue that this does not seem detrimental as the judicial appeal process can take years to complete, whereas the Department has routinely succeeded in quickly persuading the Legislature to adopt legislation—often retroactive in nature—to overturn Tribunal decisions with which it disagrees.[66] They also argue that the Department has been successful in overturning,

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[65] *See* Memorandum of State Executive Department, L.1986, c.282 at 2898-2899 (July 19, 1986).

[66] Recent examples include legislation to retroactively overturn the Tribunal's decisions in *Matter of Baum*, Tax Appeals Trib. (February 12, 2009) and *Matter of Weber*, Tax Appeals Trib. (August 25, 2016).

through legislation, adverse decisions of the very judicial courts that it now says it must be permitted to appeal to for redress when the Tribunal issues a decision with which it disagrees.[67]

They also note that the Department has successfully utilized the Tribunal's rehearing process to convince the Tribunal to overturn its own decisions. The rehearing process permits a party to a proceeding before the Tribunal, including the Department, to file a motion with the Tribunal to reargue its case. In recent times, the Department has used the rehearing process to demonstrate to the Tribunal that its original decision misapprehended important issues of fact or law.[68]

The Support Memorandum notes that a recent decision, wherein the Tribunal refused to apply a legislative clarification retroactively to a sale of S corporation stock, neutralizes the Department's ability to seek legislative change to correct a Tribunal decision. Specifically, the Support Memorandum cites the Tribunal's decision in *Matter of Lewis*, wherein the Tribunal determined that legislation passed to clarify the intent of the Legislature in light of the Tribunal's incorrect determination in *Matter of Baum* should not be applied retroactively to the taxpayer at issue. However, the Status Quo Members argue that the Tribunal in the *Lewis* decision merely held that the legislation was not retroactive with respect to the situation in front of it—a transaction that was structured in a specific manner after the Tribunal's decision in *Baum* and, significantly, in reliance on the decision in *Baum*. The Tribunal made it clear that its decision was limited to the

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[67] *See, e.g.*, *Tenn. Gas Pipeline Co. v. Urbach*, 96 N.Y.2d 124 (2001).

[68] *See e.g.*, *Matter of Gaied*, Tax Appeals Trib. (June 16, 2011).

specific situation before it and that retroactivity does apply to all transactions structured prior to the issuance of the Tribunal's decision in *Baum*.

Accordingly, the Status Quo Members believe that the statement in the Support Memorandum that "[s]ince this and other decisions against the State cannot be appealed, the Tribunal has as a practical matter neutralized the Legislature's authority to correct what it determines are erroneous interpretations of law" seems to be overstated as such "neutralization" will occur in only a small segment of situations.

The Support Memorandum also notes that the Legislature does not have the authority to overturn certain of the Tribunal's decisions. As examples, the Support Memorandum notes certain recent decisions that were adverse to the Division of Taxation where the Tribunal relied upon the scope of the federal Employment Retirement Income Security Act of 1974 and interpretation of the tax treaty between the United States and Germany. In addition, the Tribunal regularly addresses issues concerning applicability of the federal Constitution to the New York Tax Law. That the Tribunal can issue decisions that the Division cannot overturn by legislation is concerning, although the Status Quo Members note that this has always been the case from the beginnings of the Tribunal. For example, the Tribunal can and does render decisions interpreting federal statutes, such as Public Law 86-272, which cannot be overturned by the Legislature. Yet, the Support Memorandum references only four such decisions in the 35-year history of the Tribunal, suggesting that the concerns may be limited in scope.

While the majority of the Executive Committee of the Tax Section continues to support granting the Department an appeal right, it also acknowledges the validity of the

concerns of the Status Quo Members who believe that providing such an appeal right will impose an undue burden on taxpayers, especially those with limited resources and/or limited tax amounts at issue in a particular case. Several approaches to addressing these concerns have been raised since the early 1980s. Among the procedures (some of which are not mutually exclusive of some others) that we believe should be considered if the Division is granted the right to appeal adverse Tribunal decisions are[69]:

1. Provide the Division of Taxation the right to seek leave to appeal from the Appellate Division, Third Department, based on specified criteria (i.e., the Division would need permission from the Third Department before being permitted to proceed with the appeal).
2. Require the Division of Taxation to reimburse the taxpayer's reasonable litigation costs if the Department is unsuccessful in its appeal.
3. Provide that the Attorney General must approve of the Division of Taxation's request to appeal and provide written justification as to why: (1) an appeal is in the best interest of the State; and (2) imposing the litigation burden on the particular taxpayer is warranted.
4. Provide a mechanism by which the Division of Taxation may move the Tribunal to render its decision non-precedential (similar to "unpublished decisions" in many states), rather than appeal.

[69] We note that all the following considerations, *except* for number 6, were included in NYSBA Tax Section Report No. 1391.

5. Provide that the Division of Taxation may appeal an adverse Tribunal decision only where either the dollar amount at issue exceeds a certain threshold and/or the taxpayer's net worth exceeds a certain threshold.
6. Provide the Division of Taxation with the right to appeal an adverse Tribunal decision only where the decision is based on the federal Constitution, a federal statute, or the provisions of a treaty between the United States and a foreign government, with the result that the decision cannot be corrected by the Legislature. The scope of this alternative would require some further consideration but should apply to decisions barring taxation under the United States Constitution or under Public Law 86-272 (as Public Law 86-272 is federal law). Presumably any such determination that the law could not be overturned legislatively would have to ultimately be determined by the Supreme Court, Appellate Division (Third Department).

It should further be noted that if the Division of Taxation is granted appeals rights, the Tax Section believes the Department should be held to the same standard of review for overturning a Tribunal decision as are taxpayers. Article 78 provides that the Appellate Division is limited to overturning a Tribunal decision only where it determines that the Tribunal's decision is not "supported by substantial evidence" or "was affected by an error of law or was arbitrary and capricious or an abuse of discretion."[70] Either this same

[70] CPLR § 7803(3), (4).

standard should be applicable to appeals initiated by the Division or the standard should be changed and de novo review of the law should be the standard for appeal of decisions by either the taxpayer or the Division of Taxation, even though the record should continue to be set at the Administrative Law Judge level.

It is important to note that virtually all these approaches would require a change to the current Article 78 principles and procedures. Since Article 78 is the codification of the common law proceedings for mandamus, prohibition, and certiorari, which are proceedings against the government, if the Division of Taxation has the right to undertake an appeal, the situation would be one where the government is proceeding against a taxpayer and Article 78 would apply. We believe that these present mere "mechanical" issues that can be addressed by relatively simple legislation.