

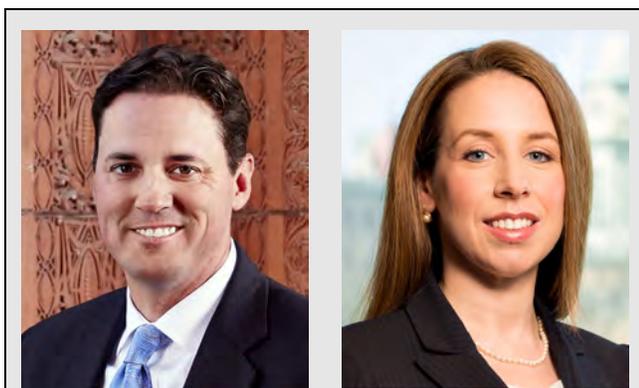
A Quick Look at Proposed Legislation in New York

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Reprinted from *State Tax Notes*, March 13, 2017, p. 919

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In this edition of Noonan's Notes, the authors discuss tax changes in the New York governor's proposed budget and related legislation. Of particular interest to tax practitioners is a proposal that would consolidate all of the state's administrative hearing functions, including operations of the Division of Tax Appeals, under a single executive department.

Every year around this time, New York's governor submits his executive budget to the State Legislature, and the Assembly and Senate introduce amended versions of the governor's proposed appropriation bills and related legislation. We here at Noonan's Notes aren't all that interested in the vagaries of budget forecasting or government funding. But we do care about what Gov. Andrew Cuomo (D) and lawmakers are thinking in terms of new tax laws, rates, rules, and so forth. We get to see all that in the budget proposals. Over the next couple weeks, negotiations will continue over

what's left in and what gets removed, until the budget is finalized at the end of March. This article will summarize what's on the table.

Administrative Hearing Consolidation

We'll start here, since this is the provision that could affect tax practitioners the most. Tucked away from the normal tax provisions in the governor's budget is a proposal that would create a new Division of Central Administrative Hearings under the executive department. That new body would effectively replace the administrative hearing functions in all state agencies, including the Division of Tax Appeals (DTA).¹ As noted, the proposal is not located in the tax portion of the budget bill or in the administrative sections. Rather, it is in the Education, Labor and Family Assistance Article VII Legislation, which deals with school performance and funding, child abuse, public assistance, and housing for veterans, among other things. Whatever the case, the proposed legislation includes the power to "establish, consolidate, reorganize, or abolish any administrative hearing function within any civil department as [the chief judge] determines to be necessary for the efficient operation of the division [subject to approval of the budget director]."² The statement in support³ explains the rationale for this change, which reflects:

¹Education, Labor and Family Assistance (ELFA) Bill, Part U.

²*Id.*, Part U, section 1.

³See "FY 2018 New York State Executive Budget, Education, Labor and Family Assistance Article VII Legislation — Memorandum in Support" (ELFA Statement in Support).

a national movement to consolidate State agency hearing processes, with over half of the states participating in some form. Benefits of this consolidation accrue to the public, the State and the impacted employees. An office independent of other agencies can result in a more impartial and efficient hearing process, a more skilled workforce, and possible cost savings in personnel management, administration, and other backoffice functions. ALJs will be more adaptable, receiving training in multiple areas of the law, providing flexibility in managing caseloads and addressing backlogs when needed. A corps of ALJs trained as adaptable generalists will have the opportunity to gain expertise in multiple areas resulting in greater advancement opportunities.⁴

But is this really a good idea? The Legislature went to great lengths in 1986 to create the DTA as an independent unit within the Department of Taxation and Finance. The 1986 budget legislation also established and defined the role of the Bureau of Conciliation and Mediation Services, which was given the power to conduct conciliation conferences, similar to pretrial mediation but with greater settlement authority. Overall, the 1986 legislation was the result of many years of deliberations, and reflected nationwide trends to separate state tax adjudicatory and administrative functions.⁵

As we've said in this space in the past, over the 30 years that the DTA has been in operation, this appeals system has worked well, with knowledgeable, professional, independent administrative law judges and tribunal members rendering high-quality decisions in a timely manner, and subject to an effective appeals

process.⁶ Unlike some other administrative agencies, where there may be inadequate separation, the DTA runs in an independent and evenhanded manner. And this system usually received high marks from independent sources for its impartiality, effectiveness, and transparency.⁷

After the executive budget was submitted, the Assembly introduced a single-purpose bill that would create a new Division of Central Administrative Hearings.⁸ This bill is markedly different from the executive budget's bare-bones proposal. For instance, the Assembly's bill exempts certain agencies and divisions, including the DTA, from the consolidation. It also addresses more substantive issues relevant to this new body's operations, functions, and powers.

We sincerely hope this budget provision gets left at the curb. The timing would also be especially unfortunate for the authors of this article, since we just penned a long series of articles last year on the state's tax appeals process.⁹

⁶See N.Y. Tax Law section 2004 (requiring the majority of the tax appeals tribunal's commissioners to be knowledgeable and skillful in matters of taxation); and N.Y. Tax Law section 2010(2).

⁷See Douglas L. Lindholm, Ferdinand S. Hogroian, and Frederick J. Nicely, "The Best and Worst of State Tax Administration, COST Scorecard on Tax Appeals & Procedural Requirements" (Dec. 2016). New York's ranking this year was lower than usual, "largely attributable to passage of retroactive tax legislation several times," which is hardly the fault of the DTA (*Id.* at 3). Indeed, we handled one of these retroactivity cases last year, and it was fairly clear from the tribunal's decision that it felt constrained by an overly expansive application of retroactivity provisions put in place by the Legislature. See *Matter of Luizza*, DTA No. 824932 (N.Y. Tax App. Trib. 2016).

⁸See Assembly Bill A. 02041.

⁹See Noonan and Doolittle, "Litigating a New York Tax Case, Volume 1: The Audit Process," *State Tax Notes*, Feb. 29, 2016, p. 637; Noonan and Doolittle, "Litigating a New York Tax Case, Volume 2," *State Tax Notes*, Mar. 14, 2016, p. 797; Noonan and Doolittle, "Litigating a New York Tax Case, Volume 3: The Administrative Appeals Process," *State Tax Notes*, May 9, 2016, p. 427; and Noonan and Doolittle, "Litigating a New York Tax Case, Volume 4: Tax Litigation in the New York Courts," *State Tax Notes*, June 13, 2016, p. 863.

⁴*Id.*, at 29.

⁵N.Y. Tax Law Article 40 (as added by L. 1986, ch. 282); N.Y. Tax Law section 170(3-a) (as added by L. 1986, ch. 283); see *New York State Society of Enrolled Agents v. New York State Division of Tax Appeals*, 161 A.D.2d 1 (2d Dep't. 1990); *New York State Department of Taxation and Finance v. Tax Appeals Tribunal*, 151 Misc.2d 326 (Sup. Court, Albany County 1991).

Treat Disregarded Entities as Single Taxpayer

Here we go again. A few years ago, after the state lost in *Baum*,¹⁰ the Legislature enacted legislation to reverse that result, and to do so on a retroactive basis.¹¹ The legislation survived, barely, after the court of appeals' decision in *Caprio*.¹² And it looks like lawmakers are at it again. Here, the governor proposed enacting a new Tax Law section 43 to clarify that a single-member limited liability company (SMLLC) that is disregarded for federal income tax purposes must also be disregarded for New York state personal income tax purposes.¹³ Not only that, if the taxpayer is the sole member of multiple LLCs, this provision would treat the sole member and all such LLCs as a single entity. This proposal is intended to reverse the recent tax appeals tribunal decision in *Matter of Weber*, which held that two disregarded SMLLCs owned by the taxpayer should be treated as distinct entities, separate from each other and separate from Weber, for purposes of determining her eligibility for the Empire Zone wage tax credit derived from the activities of the disregarded SMLLCs.¹⁴

Again, this provision would take effect immediately and apply to all tax years for which the statute of limitations for seeking a refund or assessing additional tax is still open. This isn't going to help New York's Council On State Taxation grade next year.

Eliminating Tax Planning Opportunities

The budget bill seeks to close two perceived loopholes, one for income tax and one for sales tax.

IRC Section 1060 Sale by Nonresident Partners

Normally, the sale of a partnership interest is treated as the sale of an intangible, nontaxable to a nonresident. A few years ago, the law was

amended to partially tax the sale of an interest in a partnership or other entity to the extent that more than 50 percent of the entity's assets consisted of New York real property.¹⁵ A few years after that, the Legislature clarified that the sale of stock under IRC section 338(h)(10) should be treated as a sale of assets to a New York nonresident.¹⁶ The proposed provision would achieve the same result for nonresident partners when the partnership sells its assets and then makes an election under IRC section 1060 election to treat the transaction as a sale of an intangible partnership interest.¹⁷ If enacted, the new provision would characterize the transaction for the seller and buyer consistently as a sale of assets.

Sales Tax Planning Opportunity for Related Entities

The bill would eliminate the ability of related entities to purchase tangible personal property (TPP) or services exempt from sales tax under the resale exemption.¹⁸ That would be accomplished by amending the definition of retail sale to include any transfer of TPP to some entities when the property would be resold to a related person or entity, including:

- sales to SMLLCs or subsidiaries that are disregarded for federal income tax purposes, for resale to a member or owner;
- sales to a partnership for resale to one or more partners; and
- sales to a trustee for resale to a trust beneficiary.

The governor and the tax department have tried to pass a similar provision in the past. To us, it never seemed necessary. Sales tax is a form-over-substance tax, and more often than not, taxpayers end up getting burned by the form of

¹⁰*Matter of Baum*, DTA Nos. 820837 and 820838 (N.Y. Tax App. Trib. 2009).

¹¹N.Y. Tax Law section 632(a)(2).

¹²*Caprio v. NYS Department of Taxation & Finance*, 25 N.Y.3d 744 (2015), *rearg. denied* 26 N.Y.3d 955 (2015).

¹³Revenue Bill, Part Q.

¹⁴*Matter of Weber*, DTA No. 825857 (N.Y. Tax App. Trib. 2016).

¹⁵See N.Y. Tax Law section 631(b)(1)(A)(1). This provision may be unconstitutional (see Noonan and Lawrence, "Could Ohio's Latest Due Process Case Spell Trouble for New York?" *State Tax Notes*, July 11, 2016, p. 117).

¹⁶See N.Y. Tax Law section 632(a)(2) (as amended by L. 2010, ch. 57).

¹⁷Revenue Bill, Part AA.

¹⁸Revenue Bill, Part AA.

the transaction, particularly when dealing with transactions between affiliated entities. If the tax department believes that some taxpayers are abusing this, it presumably has the power to use the alter ego or sham transaction doctrines to shut them down.

S Corporation Conformity

New York has always required that federal S corporations make a separate election to be treated as S corporations for New York tax purposes. If no election was made, the entity is a hybrid S corporation, taxed as a C corporation for New York tax purposes. Ten years ago, after perceived abuse of this provision in some instances, a law was passed to mandate S corporation status for, among other things, corporations whose income was more than 50 percent investment income.¹⁹ The definition of investment income under that law, however, was pretty broad.²⁰ And since that law was passed, there have been continued disputes about how that language has been interpreted and applied. The proposed fix would get rid of hybrids altogether. The budget bill proposes to require all federal S corporations that are subject to tax in New York, or that have qualified subchapter S subsidiaries subject to tax in New York, to be treated as S corporations for New York state tax purposes.²¹ This provision would take effect immediately and apply to tax years beginning on or after January 1, 2018.

Provisions That Target the Top Tax Bracket

The budget bill contains two provisions that target higher income taxpayers.

¹⁹N.Y. Tax Law section 660(i) (as added by L. 2007, ch. 60).

²⁰N.Y. Tax Law section 660(i)(3) defines investment income as "the sum of an eligible S corporation's gross income from interest, dividends, royalties, annuities, rents and gains derived from dealings in property, including the corporation's share of such items from a partnership, estate or trust, to the extent such items would be includable in federal gross income for the taxable year." See Noonan and Doyle, "New York Budget Increases Taxes by \$300 Million," *State Tax Notes*, May 7, 2007, p. 423.

²¹Revenue Bill, Part Y.

Extend Personal Income Tax Top Bracket

Currently, the top personal income tax bracket (8.82 percent) is scheduled to expire for tax years beginning after 2017. The bill proposes extending the top tax bracket under the personal income tax law for three years to 2020.²² That is not a shocker. We expected this rate provision to be extended.

Make the Limitation of Charitable Contribution Deduction Permanent

The bill would make permanent the current charitable deduction limitation applicable to higher income taxpayers.²³ Currently, the New York state itemized charitable tax deduction is limited to 50 percent of the federal deduction for individuals with AGI between \$1 million and \$10 million, and 25 percent of the federal deduction for individuals with AGI over \$10 million. However, those limitations are scheduled to expire at the end of 2017, when all taxpayers with AGI more than \$1 million would be subject to a 50 percent limitation.

Reform the Investment Tax Credit

The bill would amend the investment tax credit (ITC) statutes²⁴ by identifying some uses of property for which the ITC would not be allowed.²⁵ Under this proposal, the ITC would not be allowed for TPP and other tangible property principally used by the taxpayer in producing or distributing electricity, natural gas, steam, or water delivered through pipes and mains; or creating, producing or reproducing, in any medium, a film, visual or audio recording, or commercial, or in duplication, for purposes of broadcast in any medium, of a master of a film, visual or audio recording, or commercial. The limitation relating to films, recordings, and commercials applies to costs incurred outside New York. These changes would become immediately effective and would apply to tax years beginning on or after January 1, 2018.

²²Revenue Bill, Part R.

²³Revenue Bill, Part S.

²⁴N.Y. Tax Law sections 210-B and 606.

²⁵Revenue Bill, Part P.

Other Tax Credits

Aside from the ITC, the budget contains provisions that would establish new credits and amend or extend existing credits, as described below:

- **Film Credits.** The Empire State Film Production Tax Credit and Empire State Film Post-Production Tax Credit would be extended for three years, through 2022.²⁶
- **Life Science Credits.** The benefits of the Excelsior Jobs Program Act would be extended to life sciences companies, which would be defined as a corporation, partnership, limited partnership, or other entity engaged in “the fields of biotechnology, pharmaceuticals, biomedical technologies, life systems technologies, health informatics, health robotics and biomedical devices.”²⁷
- **Workforce Training Credit.** The bill would also amend the Employee Training Incentive Credit Program to encourage companies to include incumbent worker training as part of their expansion and retention projects, and expand the credit to include training for employees working in life sciences.²⁸
- **Youth Jobs Program Tax Credit.** The Urban Youth Jobs Program Tax Credit, which would be renamed the New York Youth Jobs Program Tax Credit, would be extended for an additional five years to 2022.²⁹ The bill would also amend Labor Law section 25-a to authorize additional allocations of \$50 million per year in tax credits for the additional five-year period.
- **Alternative Fuels and Electric Vehicle.** The Alternative Fuels and Electric Vehicle Recharging Property Credit would be extended for five years, through tax years beginning in 2022.³⁰

- **Child and Dependent Care Credit.** The refundable Child and Dependent Care tax credit (CDCC) under Tax Law section 606(c) would increase for taxpayers with New York AGI between \$50,000 and \$150,000. The stated purpose of this provision is to “target middle income working families who are finding it increasingly difficult to afford quality child care.”³¹ The amount of the CDCC for these taxpayers would range from between 100 percent to 60 percent.³²

Conclusion

As is the case every year, we expect some of these provisions to make it and others to be left to the side. We should be hearing news over the next few weeks about how this shakes out. For practitioners, of course, we'll be paying particularly close attention to the administrative hearing consolidation proposal. We'll update everyone after the dust settles. ■

²⁶Revenue Bill, Part M.

²⁷Revenue Bill, Part K.

²⁸Revenue Bill, Part L.

²⁹Revenue Bill, Part N.

³⁰Revenue Bill, Part O.

³¹ELFA Statement in Support, *supra* note 3, at 22.

³²Revenue Bill, Part T.