

## **New Budget Brings New Tax Provisions in New York**

**by Timothy P. Noonan and Mario T. Caito**

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Timothy P. Noonan



Mario T. Caito

Timothy P. Noonan is a partner in the Buffalo and New York City offices of Hodgson Russ LLP, and Mario T. Caito is an associate with the firm.

In this installment of Noonan's Notes, the authors discuss New York budget highlights, as well as successes and failures in a range of New York tax proposals.

Next year, we'll have to make sure we don't plan to cover New York's budget highlights in the April installment of Noonan's Notes. For the second year in a row, the budget was late, meaning that our loyal readers (or our one reader) were forced to wait a few more weeks than normal for this column. But after many weeks of debate, New York Gov. Kathy Hochul (D) and the New York State Legislature finally got it done, more than a month past the April 1 deadline. So — also a month past our deadline — here's our review of what passed and what didn't pass (with sincere apologies to the *Tax Notes* crew).

## Top Highlights

### Commuter Tax 'Clarification'

We have all sorts of special taxes in New York, some with goofy names. The Metropolitan Commuter Transportation Mobility Tax (MCTMT) is one of them. It functions somewhat like a payroll tax on employers in the Metropolitan Commuter Transportation District<sup>1</sup> and applies to self-employed individuals, including partners in partnerships.

The first change involves some rate creep. The budget almost doubles the top MCTMT rate from 0.34 percent to 0.6 percent for employers engaging in business in the counties of Bronx, Kings, New York, Queens, and Richmond (the New York City counties) with a quarterly payroll over \$437,500.<sup>2</sup> For self-employed taxpayers with earnings sourced to the New York City counties, the MCTMT rate increases from 0.34 percent to 0.47 percent in the 2023 tax year and to 0.6 percent for the 2024 tax year.<sup>3</sup>

The other change is a sneaky one and very well might be a source of future litigation. The tax on partners and other self-employed individuals is tied, per the statute, to "net earnings from self-employment," as the term is defined in IRC section 1402. And as relevant here, that section exempts amounts earned by limited partners from "net earnings from self-employment," except for guaranteed payments for services provided to a partnership. This therefore means that some "limited partners" are not subject to self-employment taxes on their share of a partnership's

<sup>1</sup>This includes these New York counties: Bronx, Kings, Queens, Richmond, Rockland, Nassau, Suffolk, Orange, Putnam, Dutchess, and Westchester.

<sup>2</sup>N.Y. Tax Law section 801(a)(1)(B) (as revised).

<sup>3</sup>N.Y. Tax Law section 801(a)(2)(B) (as revised).

ordinary income, regardless of their partnership role in practice.

The IRS does not like this provision all that much, and for years there have been efforts to eliminate or narrow the limited partner exclusion,<sup>4</sup> in some cases with success, at least as applied to partners in state law limited liability partnerships and limited liability companies.<sup>5</sup> But the IRS has not been able to extend that rationale to state law limited partnerships, and efforts to change the law have also failed.

It turns out that the New York tax department doesn't like the limited partner exclusion either, and for the past few years it has tried to enforce the MCTMT on state law limited partners, with a focus on hedge fund managers and private equity companies that earn a share of their management company income through a limited partnership structure. But rather than wait out the IRS on this issue — the IRS is fighting this issue in tax court cases — the Legislature, presumably at the tax department's suggestion, is taking matters into its own hands. Specifically, the budget amends the definition of net earnings from self-employment to *clarify* the treatment of limited partners who are actively engaged in the operations of a partnership within the Metropolitan Commuter Transportation District and establish that only “true” limited partners are exempt from MCTMT liability. The amendment language states that “an individual shall not be considered a limited partner if the individual, directly or indirectly, takes part in the control, or participates in the management or operations of the partnership such that the individual is not a passive investor, regardless of the individual's title or characterization in a partnership or operating agreement.”<sup>6</sup>

On a going-forward basis, this change is within the purview of the Legislature. If it wants

to change the MCTMT definitions and add another tax to the already heavy burden placed on New Yorkers, have at it! But to style this as a “clarification” is another matter. Before this change, the limited partner exception was baked into the existing statute; the fact that the IRS and the department didn't like it shouldn't allow them to use a “clarification” to change it. And labeling the provision as a “clarification” is often a tell-tale sign that the tax department might attempt to apply these rule changes retroactively, which is an unsettling reality for taxpayers who thought they were correctly navigating New York's tax system over recent years. Whether it is constitutional to apply a law retroactively is a topic for a different day, but if the department chooses to apply the provision retroactively, it is likely to be challenged as a violation of due process in future cases, since the provision is a change in preexisting law.

### Appeals From the Tax Appeals Tribunal

Another provision of interest to our readers is one that empowers the tax department to appeal some Tax Appeals Tribunal decisions. Since the creation of the Division of Tax Appeals in 1987, the department has not had a right to seek judicial review of Tax Appeals Tribunal decisions, while taxpayers have. And in our view, why should it? The division is part of the tax department; the idea that an administrative agency could essentially appeal final decisions within its own agency seems a bit silly. Also, giving the tax department another bite at the apple would lengthen an appeals system that in recent years has grown slower and slower, with some appeals lasting four years or more.

Despite this, for the past several years, the department has sought this appeal right. And for many years, it never made the final cut in adopted budgets — until now. Under the budget, the department now has the right to seek judicial review of tribunal decisions.<sup>7</sup> But the department does not have this right *carte blanche* — it is allowed judicial review only when its appeal would be “premised on interpretation of the state or federal constitution, international law, federal law, the law of other states, or other legal matters

<sup>4</sup> Prop. reg. section 1.1402(a)-2; Joint Committee on Taxation, “Options to Improve Tax Compliance and Reform Tax Expenditures,” JCS-2-05, at n.219 (2005); Joint Committee on Taxation, “Additional Options to Improve Tax Compliance,” at n.72 (2006); Department of the Treasury, “General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals,” at 65 (2021).

<sup>5</sup> *Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136 T.C. 137 (2011); *Castigliola v. Commissioner*, T.C. Memo. 2017-62 (2017); see also *Riether v. United States*, 919 F. Supp. 2d 1140 (D.N.M. 2012); *Hardy v. Commissioner*, T.C. Memo. 2017-16.

<sup>6</sup> N.Y. Tax Law section 800(e) (as revised).

<sup>7</sup> N.Y. Tax Law section 2016 (as revised).

that are beyond the purview of the state legislature.” So if a case deals only with the interpretation or application of state tax law, the department has no appeal rights. Plus, if the tax department seeks judicial review, interest and penalties stop accruing until the appeal is over.

Sorry to be negative again, but we don’t like this change either! The appeals process (while we think it works better than in most other states) is already long and expensive. This will just make it worse, particularly in the cases that are the most complex (constitutional cases, cases involving federal tax law, and so forth). Plus, we can envision new disputes about when these appeals are permitted, such as determining if cases involve “legal matters that are beyond the purview of the state legislature.” And, the tribunal functions as a body within the executive branch. Its commissioners are appointed by the governor. If the executive branch and the tax department don’t like its decisions, they can remedy that with new commissioners! Giving the executive branch the right to basically sue itself creates a wrinkle in a tax appeals process that has otherwise worked pretty well over the past 40 years.

### Other Stuff

#### Passthrough Fixes

The budget provides a necessary change to New York state’s passthrough entity tax (PTET) and New York City’s PTET. It amends the definitions of passthrough entity taxable income and city passthrough entity taxable income in N.Y. Tax Law sections 860(h) and 867(b) to correct an unintended circular mathematical computation of these values. Before the fix, in calculating passthrough entity taxable income, the tax base for the PTET, a taxpayer was required to deduct PTETs paid, thus decreasing the basis for the very PTET being deducted. That structure, of course, doesn’t make much sense. So, the budget fixed this issue, now requiring taxpayers in the computation of their passthrough entity

taxable income to not deduct any PTETs paid or any substantially similar taxes paid to other jurisdictions.<sup>8</sup>

Further, the budget amends the definition of city taxpayer to include city resident trusts and estates,<sup>9</sup> allowing S corporations and partnerships with city resident trusts and estates owners to participate in the New York City PTET. Lastly, regarding the PTET, the budget clarifies that participation elections must be made “on or before” the due date of the first estimated payment and that elections are irrevocable “after” the due date.<sup>10</sup>

Here at Noonan’s Notes World Headquarters, we also don’t like that the annual PTET election date is so early in the tax year, and compared with some states, it is a full year earlier. Pegging the election date to March 15 every year not only causes many taxpayers to accidentally miss the deadline, but also means that new businesses formed after March 15 will have to wait a year to get the benefits. As this tax is intended to benefit New Yorkers and is revenue neutral to the state, we’re hopeful that at some point soon these election deadlines will be revisited.

#### Disaster Relief

The commissioner’s ability to provide relief to taxpayers affected by disasters is expanded in the budget on two occasions. The commissioner may now abate interest that accrues due to a taxpayer’s inability to meet a tax deadline because of a president- or governor-declared disaster emergency, regardless of whether the filing deadline is extended.<sup>11</sup> Before the budget, if a filing deadline was not extended, the tax department could abate only penalties in this situation, but not interest. Relatedly, the budget now empowers the commissioner to abate the penalty for a corporation’s underpayment of estimated tax “to the extent the commissioner determines that by reason of casualty, disaster or other unusual circumstances the imposition of such addition to tax would be against equity and

<sup>8</sup> N.Y. Tax Law sections 860(h), 867(b) (as revised).

<sup>9</sup> N.Y. Tax Law section 867(e) (as revised).

<sup>10</sup> N.Y. Tax Law sections 861(c), 868(c) (as revised).

<sup>11</sup> N.Y. Tax Law section 171(28) (as revised).

good conscience.”<sup>12</sup> Notably, the commissioner already had this power with personal income tax filers.

### Fuel Taxes

The budget closes an interesting loophole regarding the taxation on the distribution of motor fuel and diesel. Important to understand here is that as temperatures get warmer, fuel expands, and — although we are no scientists — this is the reasoning for this amendment. Before this change, however, fuel distributors could purchase less fuel than they later sold because of fuel’s ability to expand in warm temperatures. They could then collect tax from consumers on the extra sold fuel, while only remitting tax to the tax department on the lesser amount of fuel the distributors originally purchased. Now, the budget requires distributors of motor fuel and diesel to collect, report, and remit taxes to the tax department on the sale of any gallon of fuel, including additional gallons resulting from temperature fluctuations.<sup>13</sup>

### False Claims Act

The budget amends the New York False Claims Act (NYFCA) to permit actions in cases when the taxpayer didn’t actually even make a claim — that is, cases involving unfiled tax returns.<sup>14</sup> Before the budget, if an individual did not file a tax return, there was, therefore, no “claim[], record[], or statement[]” on which liability under the NYFCA could be premised. The budget addresses this issue, opening the door for a nonfiler to be liable under the NYFCA. This expansion of the NYFCA takes effect immediately and is applicable in any pending case to tax obligations knowingly concealed or knowingly avoided on or after the effective date. For actions filed after the effective date, the updated act applies only to tax obligations knowingly concealed or avoided on or after May 1, 2020.

<sup>12</sup> N.Y. Tax Law section 1085(e-1) (as enacted).

<sup>13</sup> N.Y. Tax Law sections 285-a(4), -b(5), 308(j), 1102(g) (as enacted).

<sup>14</sup> N.Y. Finance Law section 189(4) (as revised).

### Rates

The budget extends various tax rates. It extends the 7.25 percent business income tax rate for corporate taxpayers with a business income base over \$5 million. Also, the budget delays the scheduled phaseout to 0 percent of the 0.1875 percent capital base tax. These rates were scheduled to depart at the end of 2023 and are now extended through 2026.<sup>15</sup> Moreover, the budget extends reduced rates for conveyances to real estate investment trusts under the New York state real estate transfer tax and the New York City real property transfer tax until September 1, 2026.<sup>16</sup>

### Cigarette Taxes

New York continues to bolster its taxation on the tobacco industry. The budget increases the existing excise and use tax rates on cigarettes by \$1, from \$4.35 to \$5.35 per pack of 20 cigarettes,<sup>17</sup> presumably in a direct effort to reduce smoking in the state (at least the smoking of cigarettes . . . this administration has been friendly to marijuana smokers!).

### Film Credits

The budget modifies several credits. In the media sector, it extends the availability of the New York City musical and theatrical production tax credit through tax year 2025 and establishes a \$350,000 maximum credit amount for each “qualified New York city musical and theatrical production in a level two qualified New York city production facility.”<sup>18</sup> Relatedly, the budget amends the film production tax credit, primarily by increasing the credit rate to 30 percent, increasing the annual credit cap to \$700 million, extending the program’s duration to 2034, and allowing an additional credit for non-wage production costs.<sup>19</sup>

<sup>15</sup> N.Y. Tax Law section 210(1)(a), (b)(1)(i) (as revised).

<sup>16</sup> N.Y. Tax Law sections 1201(b)(xi)(2), 1402(b)(2)(B) (as revised).

<sup>17</sup> N.Y. Tax Law sections 471(1), 471-a (as revised).

<sup>18</sup> N.Y. Tax Law section 24-c(a)(2), (c) (as revised). The budget defines a level two qualified New York City production facility to be a facility in Manhattan that meets certain amenity and income specifications. N.Y. Tax Law section 24-c(b)(3)(ii) (as revised).

<sup>19</sup> N.Y. Tax Law section 24(a), (b)(2), (e)(4) (as revised).

## Other Credits

Finally, the budget creates or expands several different tax credits:

- It creates the Child Care Creation and Expansion Tax Credit Program Act for businesses creating or expanding their child care capacity for the children of their employees, and it allows businesses that meet the eligibility requirements to claim a credit through tax year 2025 equal to 20 percent of the costs of creating or expanding their child care program's available infant and toddler seats, capped at 25 seats.<sup>20</sup>
- It allows New York City to adopt a biotechnology credit, beginning in tax year 2023, and limits the credit to New York City's general corporation tax and unincorporated business tax,<sup>21</sup> while Hochul's original budget proposal allowed the credit to also be claimed under the banking corporation tax.
- It amends the investment tax credit to make it refundable for eligible farmers through tax year 2027.<sup>22</sup>
- It expands the time frame in which the brownfield tax credit can be claimed for some projects, based on the location of the project and when the taxpayer purchased the project site.<sup>23</sup>
- It repeals a provision of the corporate franchise tax that allowed for the transfer of unused ITCs in qualified transactions (that is, IRC section 351 and 355 reorganizations).<sup>24</sup>
- It lengthens the application deadline for the COVID-19 Capital Costs Tax Credit Program by six months.<sup>25</sup>
- It extends the availability of the rehabilitation of historic properties tax credit and the empire state commercial production tax credit by five years.<sup>26</sup>

- And, for good measure, it extends the availability of the No. 6 heating oil conversion tax credit by six months.<sup>27</sup>

## What Didn't Pass?

Hochul's original budget proposal included an amendment that would require all federal S corporations to be automatically treated as S corporations for New York tax purposes, unless the corporation was a qualified New York manufacturer under Tax Law section 210 and elected New York City corporation status on its tax return.<sup>28</sup> This change has been proposed in the past and, yet again, did not make it.

The Senate's and Assembly's respective budget proposals included increased New York personal income tax rates, including a 10.8 percent tax rate for income levels between \$5 million and \$25 million and an 11.4 percent tax rate for income levels over \$25 million.<sup>29</sup> But Hochul was vocally opposed to these increased rates, presumably viewing them as likely to accelerate the relocation of wealthy taxpayers from New York to states with friendlier tax climates. Ultimately, the governor's logic prevailed, resulting in no adjustments to personal income tax rates in the budget.

Lastly, the Assembly's budget proposal included a new sales tax on digital products. The proposal, if adopted, would have imposed a 4 percent sales tax on digital products, including some popular streaming services, apps, games, music, podcasts, and audiobooks.<sup>30</sup> Concerns were raised over the proposal's constitutionality and its conformity with the Internet Tax Freedom Act, and, ultimately, it was omitted from the budget. ■

<sup>20</sup> N.Y. Soc. Serv. Law sections 394-b, -d (as enacted).

<sup>21</sup> N.Y. Tax Law section 1201-a(d)(1) (as revised).

<sup>22</sup> N.Y. Tax Law section 210-B(1)(d) (as revised).

<sup>23</sup> N.Y. Tax Law section 21(a)(2), (a)(3)(i), (b)(2) (as revised).

<sup>24</sup> Tax Law section 210-B(1)(e) (as revised).

<sup>25</sup> N.Y. Econ. Dev. Law section 484(4) (as revised).

<sup>26</sup> N.Y. Tax Law sections 28(a)(1), 606(oo)(1)(A) (as revised).

<sup>27</sup> N.Y. Tax Law section 47(a)(1) (as revised).

<sup>28</sup> N.Y. S.4009/A.3009, Part CC.

<sup>29</sup> N.Y. S.4009-B, Part LL; A.3009-B, Part DD.

<sup>30</sup> N.Y. A.3009-B, Part EE.