2014 CLOSELY HELD AND FLOW-THROUGH ENTITIES CONFERENCE

NEW YORK TAX UPDATE

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This year's budget bill provides for some major changes to the corporate and estate tax scheme, as well as some tweaks to the income and sales taxes. Here are the highlights:

I. NEW BUDGET - ESTATE TAX

A. **Tax Rate** – Generally unchanged. Still maximum of 16%.

B. **Exclusion Amount**.

The budget bill gradually increases the estate tax exclusion for a decedent's gross estate until 2019, when it is expected to equal the federal exclusion.

Deaths On or After	Exclusion	Full Phase Out
April 1, 2014	2,062,500	2,165,625
April 1, 2015	3,125,000	3,281,250
April 1, 2016	4,187,500	4,396,875
April 1, 2017	5,250,000	5,512,500
January 1, 2019	Federal Amount	Federal Amount Plus 5%

Portability: None.

Warning. The estate tax exclusion phases out as a taxable estate increases from 100% to 105% of that year's exclusion amount. As a result, the phase out can exceed 100% of the estate additional value! And the tax savings by a gift can exceed the gift's value!

1. Example: D dies on September 1, 2014 with a taxable estate of $2,165,625 and owes a tax of $112,050, even though the estate only exceeded the exclusion amount by $103,125. This represents a marginal tax rate of 109% by 2017. This marginal rate can exceed 170%!

C. **Gifts** - While not technically a gift tax, all gifts made by a decedent within 3 years of death will be added back to the gross estate. Gifts made while the decedent was not a resident are excluded from this rule applies to gifts made after March 31, 2014 and is scheduled to sunset on January 1, 2019.

D. **Generation-Skipping Tax** – Eliminated.

1. Generation Skipping Tax no longer applies to any distributions or terminations made after March 31, 2014. Form ET-500, Generation Skipping Transfer Tax Return for Distributions, and Form ET-501 Generation Skipping Transfer Tax Return for Terminations, must be filed for any taxable distributions and terminations made January 1, 2014, through March 31, 2014. To be taxable for New York State purposes, the distribution or termination must have occurred at the same time as, and as a result of, the death of an individual. These returns must be filed on or after January 1, 2015, but not later than April 15, 2015. *See* TSM-M-14(1)M.

E. **QTIP Election** - Must follow federal (unless no federal return required).

F. **Trusts** - Effective for income earned after January 1, 2014 and paid after June 1, 2014, income tax is imposed on the New York beneficiary of a previously exempt resident trust on any accumulated income that is distributed to the beneficiary. Income accumulated before the beneficiary became a New York resident is excluded. If a trust is set up as an incomplete gift to an intentionally defective grantor trust (usually set up in Delaware or Nevada), the trust's income is taxable to the New York grantor. Special credits are available to insure that there is no double taxation. Note: New York City follows these rules. *See* TSB-M-14(3)I.

II. NEW BUDGET - INCOME TAX

A. **Service award programs for volunteer firefighters and ambulance workers** - Taxpayer must have attained the age of 59 ½ and the award must not be paid out as a lump sum distribution. This exception also applies to New York City and takes effect for taxable years beginning on or after January 1, 2014.

B. **Late Filed STAR Exemptions** - The Commissioner now has discretion to grant a taxpayer the ability to file a late STAR exemption form as long as it is filed no later than one year after the original deadline and the taxpayer provides an explanation as to why failure occurred.

C. **NYC Real Property Circuit Breaker** - Now available to qualified taxpayers with household gross income of under $200,000. Must be owner-occupied residential property. Property taxes must exceed 4-6% of household’s gross income (depending on gross income). Maximum credit is $500 and applies to the 2014 and 2015 tax years. Can also apply to renters.

D. **Non New York City Real Property Freeze Credit** - Applies to STAR recipients for the next two years. There will be a credit on the personal income tax return for homeowners whose primary residence is located in a jurisdiction with a “freeze compliant budget.”

E. Certain noncustodial parents can qualify for the earned income credit. Claimants must have a child support order in effect and be current.

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F. **MCTMT** - Filing date moved to April 15. Same with quarterly estimates.

G. **Add-On Minimum Tax** - Repealed for New York State and New York City.

H. **E-Returns** – For E filings for returns filed after January 1, 2014, the tax preparer must keep a copy of the taxpayer signature authorization form (TR-579-IT).

III. NEW BUDGET - CORPORATE TAX CHANGES

A. Corporate tax reform was signed into law as a part of the 2014-2015 New York State budget bill on March 31, 2014. Most changes are effective January 1, 2015. Most significant corporate tax changes since 1987. These changes apply to New York State but not New York City, unless noted.

B. **Structural Changes:** Article 32 (Bank Franchise Tax) eliminated and merged into Article 9A (Corporate Franchise Tax).

1. Pre-2015 law: Banking and financial institutions were subject to tax under Article 32. Banks and financial institutions were taxed on the highest of 2 amounts: (1) basic tax on entire net income (ENI); or (2) alternative minimum tax (paid on the highest of three tax bases: taxable assets, alternative ENI, and fixed dollar minimum tax capital and fixed dollar minimum tax. Banks and financial institutions used 3-factor (payroll, receipts, deposits) apportionment, received a deduction of 25% interest income attributable to federal/NY obligations, and exclusion of income/expenses from International Banking Facilities. A separate Bank Tax was seen as unnecessary following Gramm-Leach-Blilely. The banks paid a disproportionately large share of corporate taxes under the old rules.

2. 2015 law: Article 9-A is streamlined. Primary features:

a. Economic nexus

b. Modified tax base: Tax is now computed on highest of three bases: (1) Business Income, (2) Capital; and (3) Fixed dollar minimum tax. The separate tax on subsidiary capital has been eliminated.

c. Classification of income

d. Apportionment

e. Combined reporting

f. Tax attributes (NOLs and credits)

C. **Nexus**

1. Pre-2015 law:

a. Physical presence required with very limited exceptions:

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b. Economic nexus for credit card companies

c. Non-affiliated fulfillment services exception.

2. 2015 law:

a. Economic nexus rules apply without physical presence.

b. Tax now applies to all out-of-state corporations with $1 million or more New York receipts (using customer sourcing). Is this constitutional?

c. Credit card companies are doing business if they have over 1,000 customers or contracts with over 1,000 merchants in New York.

d. For combined reporting group, the threshold is met by aggregating all members of the group with $10,000+ New York receipts. Nexus threshold is met if the aggregate New York receipts are at least $1 million or more.

e. Does not override Public Law 86-272.

f. Repeals the exception for inventory held in a fulfillment house. Now those out-of-state businesses will be subject to tax.

g. Corporate partners: corporations that are partners in a partnership doing business in New York are subject to tax.

-- Pre-2015 law: Current regulations limit corporate partner nexus to: (1) general partners in a partnership doing business in the state; and (2) limited partners in a partnership doing business in the state, (except portfolio investment partnerships) if ten conditions are satisfied. Ownership of more than a 1% limited partnership with basis greater than $1 million.

-- 2015 law: Expanded regulatory authority. The New York State Department of Taxation and Finance is granted authority by statute to adopt regulations that subject a corporation to tax if it is a partner of any type in a partnership doing business in New York (or that has economic nexus with New York). Subject to challenge, in particular with respect to economic nexus.

h. Alien Corporations.

-- Pre-2015 law: Subject to tax on worldwide income if nexus in New York.

-- 2015 law: Not subject to Article 9-A if: (i) not deemed domestic under IRC (e.g., "stapled stock" entities; or has no effectively connected income (ECI). If subject to tax, base includes ECI only. Cannot be part of combined reporting group if not subject to Article 9-A.

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D. New Rates, Caps and Brackets

ENTIRE NET INCOME (ENI) BASE/BUSINESS INCOME BASE

Type of business	Tax Year 2014	Tax Year 2015	Tax Year 2016	Tax Year 2017	Tax Year 2018 and Thereafter
Qualified New York Manufacturers[1]	0.0%	0.0%	0.0%	0.0%	0.0%
Qualified Emerging Technology Companies (QETCs)	5.9%	5.7%	5.5%	5.5%	4.875%
Small Businesses[2]	6.5%	6.5%	6.5%	6.5%	6.5%
Remaining Taxpayers	7.1%	7.1%	6.5%	6.5%	6.5%

[1]Includes eligible qualified New York manufacturers
[2]For the 2014 and 2015 tax years, current law graduated rates apply to small businesses with income over $290,000 but below $390,000. **A flat 6.5% rate applies to tax years beginning on or after January 1, 2016.**

Fixed Dollar Minimum Tax (FDM)

- **Qualified New York manufacturer C corporations and QETCs:**

New York Receipts	TAX YEAR 2014	TAX YEAR 2015	TAX YEAR 2016	TAX YEAR 2017	TAX YEAR 2018 AND THEREAFTER
Not more than $100,000	**$23**	**$22**	**$21**	**$21**	**$19**
$100,001 - $250,000	**$68**	**$66**	**$63**	**$63**	**$56**
$250,001 - $500,000	**$159**	**$$153**	**$148**	**$148**	**$131**
$500,001 - $1,000,000	**$454**	**$439**	**$423**	**$423**	**$375**
$1,000,001 - $5,000,000	**$1,362**	**$1,316**	**$1,269**	**$1,269**	**$1,125**
$5,000,001 - $25,000,000	**$3,178**	**$3,070**	**$2,961**	**$2,961**	**$2,625**
Over $25 million	**$4,500**	**$4,385**	**$4,230**	**$4,230**	**$3,750**

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- **Remaining C corporation taxpayers are subject to the following:**

New York Receipts	Tax Year 2014	Tax Year 2015 and Thereafter
Not more than $100,000	$25	$25
$100,001 - $250,000	$75	$75
$250,001 - $500,000	$175	$175
$500,001 - $1,000,000	$500	$500
$1,000,001 - $5,000,000	$1,500	$1,500
$5,000,001 - $25,000,000	$3,500	$3,500
$25,000,001 - $50,000,000	$5,000	$5,000
$$50,000,001 - $100,000,000	$5,000	$10,000
$100,000,001 - $250,000,000	$5,000	$20,000
$250,000,001 - $500,000,000	$5,000	$50,000
$500,000,001 - $1,000,000,000	$5,000	$100,000
Over $1 billion	$5,000	$200,000

Notes: The fixed dollar minimum amounts are unchanged for S corporations.

Capital Tax: The following represents the schedule for the tax rate on capital:

Type of Business	Tax Year 2014	Tax Year 2015	Tax Year 2016	Tax Year 2017	Tax Year 2018	Tax Year 2019	Tax Year 2020	Tax Year 2021 and Thereafter
Qualified New York Manufacturers & QETCs	0.136%	0.015%	0.106%	.085%	.056%	.038%	.019%	0%
Cooperative Housing Corporations	0.04%	0.04%	0.04%	0.04%	0.04%	0.04%	.025%	0%
Remaining Taxpayers	0.15%	0.15%	0.125%	.1%	.075%	0.05%	.025%	0%

- For tax year 2014, the tax is capped at $350,000 for qualified New York manufacturers including QETCs, and $1 million for all other taxpayers.
- For tax years beginning on or after January 1, 2015, the tax is capped at $350,000 for qualified New York manufacturers and QETCs, and $5 million for all other taxpayers.
- Small business taxpayers are exempt from the capital base tax in their first two years.

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E. New Bases for Corporate Tax

1. Pre 2015 law:

a. *Article 9-A:*

Three categories of capital and income: subsidiary, investment and business. Taxpayer could elect to treat cash as investment or business income. Apportioned investment income using issuer's allocation percentages.

Corporations calculate entire net income from federal taxable income (or worldwide income) with modifications. (For non – U.S. corporations, ENI is limited to federal taxable income.).

Separate apportionment of business income and investment income.

Exclusion of income, gains and losses from subsidiary capital, and must add back interest and other expenses attributable to subsidiary capital and attribute income/expenses to investment income.

b. *Article 32:* Includes worldwide income (for non-U.S. corporations, limited to effectively connected income), excludes 17% of interest from subsidiary capital, 60% of dividends from subsidiary capital, and 22 ½% percent of interest on NYS or federal obligations, and no interest expense attribution.

2. 2015 law:

All corporations will compare the taxes on business income, business capital and the fixed dollar minimum tax, and pay the largest one. The alternative minimum tax and the tax on subsidiary capital have been repealed (as well as the exclusion for 100% of income, gains and losses from subsidiary capital.). The capital stock base remains but phased out by 2021. There are three categories of income: (1) Business Income, (2) Investment Income and (3) Other Exempt Income. Only Business Income is subject to tax. (Thus, Business income is now the primary tax base.) The MTA surcharge survives but with a simplified calculation.

Tax = Rate x BAP x (ENI – investment income – other exempt income)

a. *Business income* -Start with entire net income minus investment income and exempt income.

The starting point for ENI is a corporation's federal taxable income. No add back of foreign taxes paid.

For a taxable alien (non-U.S.) corporation, the starting point for ENI is effectively connected income, now harmonizing their federal and state tax base. Must add back treaty benefits.

Use business allocation percentage (receipts only).

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b. *Investment Income* – Not subject to tax.

Now a much narrower category. Investment income represents investments in stock of a corporation (not unitary entities) held over 6 months and not sold in the ordinary course of business.

Presumption that a taxpayer is not unitary with a corporation in which it owns (directly or indirectly) less than 20% of the voting stock.

This will generally cover dividends and capital gains.

Income from investment income no longer includes bonds, other corporate securities or cash. These are all now business income. (Corporate debt equity instruments, government debt instruments and qualifying corporate debt instruments constitute business capital, not investment capital.)

No election to treat cash as investment income.

Exception: Income or gain from other securities/debt obligations that cannot be constitutionally apportioned to New York" under the U.S. Constitution is classified as exempt investment income.

c. *Exempt Income* – Not subject to tax. This generally represents subpart F income from unitary corporations and dividends from unitary corporations not included in a combined group (businesses taxable under Article 9 and 33).

Exempt CFC income is income included in federal taxable income under IRC § 951(a), received from a corporation conducting a unitary business with the taxpayer, but that is not included in the Article 9-A unitary combined group.

Exempt unitary corporation dividends are dividends from stock of a unitary corporation that is not included in the Article 9-A unitary combined return (e.g., dividends from an Article 9 or Article 33 corporation).

d. *Allocation of interest expenses*. For investment income and other exempt income, taxpayers need to quantify the interest incurred directly and indirectly or use a 40% reduction as a safe harbor. If you make the safe harbor election, it must apply to both categories, not just one. The good news is that all non-interest expenses can now be used to reduce business income (attribution is no longer required). If the interest expense attribution amount exceeds investment income and other exempt income, the excess interest expense must be added back to ENI.

New 40% election: If the taxpayer elects to reduce its investment and other exempt income by 40% (in lieu of computing actual interest expense), the 40% becomes business income - - the election increases business income by the dollar amount of the 40% reduction.

e. *Expense deductions.*

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Pre-2015 law: expenses allocated to business, investment or subsidiary income.

2015 law: No deduction for interest or other expenses attributable to non-taxable income (i.e., investment and other exempt income). Election to reduce non-taxable income by 40% (thereby increasing taxable income) in lieu of attributing expenses.

f. *Business Capital* - Represents all assets less investment capital. It now includes subsidiary capital.

F. Apportionment

1. Still single sales factor. Now applies to banks and financial institutions.

2. Sourcing.

a. Pre 2015 law:

Article 9-A: New York receipts are generally: (1) sales of tangible personal property shipped or delivered to the taxpayer's customers in New York; (2) sales of services to the extent the services were performed in New York; (3) property situated, and royalties from the use or patents or copyrights, within New York, and (4) other business receipts to the extent "earned" in New York.

Article 32: ENI is apportioned using a three factor formula consisting of a: deposits factor; payroll factor, and receipts factor. The three factors are averaged, with the deposits and receipts factor double weighted. Same formula generally applies in apportioning the Article 32 gross assets base.

b. 2015 law: Market based sourcing for all receipts.

The rules do not change for sales of tangible property (sourced to the location of the customer) and data/information delivered on-line (location of customer's access). The new law expands the categories of receipts for which sourcing is specifically addressed and provides guidance on how to apply the sourcing rules.

Digital products and receipts from "other services and other business receipts:" More specific framework/process for determining source because hierarchies determine where to assign particular receipts. A taxpayer is required to exercise due diligence under each method before rejecting it and moving to the next method in the hierarchy. The hierarchy for sourcing digital products is as follows: (1) location of primary use; (2) location where product is received by the customer; (3) prior year's apportionment factor for the digital product; (4) current year's apportionment factor for other digital products that can be sourced using the hierarchy.

Services, however, will now be sourced to the location where the services are delivered, not where the services were performed. If the delivery or access point is

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unknown, the customer's billing address/zip code can be used. Last year's apportionment factor can be used as a last resort.

May elect to apportion 8% of all QFI income in lieu of sourcing.

Alternative apportionment: The Commissioner of the New York State Department of Taxation and Finance has discretion to apply alternative methods "to effect a fair and proper apportionment of the business income and capital reasonably attributed to the state" when the standard statutory scheme "does not result in a proper reflection of the taxpayer's business income or capital within the state." The party seeking alternative apportionment bears the burden of proof.

Here's an overview of the rules:

Market-Based Sourcing

Type of Income	**Old Rule**	**New Rule**
Sales of TPP	"Ship to" address	Customer's location
Services	Where are services performed	**Hierarchy:** 1) Location where services delivered 2) Customer's billing address 3) Zip code 4) Last year's **apportionment** schedule
Online sales of data, software, or information	Where customer accesses property/information	**Hierarchy:** 1) Locations of access 2) Customer's billing address 3) Customer's zip code 4) Last year's **apportionment** schedule

G. Net Operating Losses –

1. Pre 2015 law: Computation based on federal NOLS. The computation of NOLS is pre-apportionment. Resulted in "double tracking" of NOLs.

2. 2015 law: Will now be computed without reference to federal NOLs. Corporations are permitted two types of NOLs: (1) a net operating loss deduction (for post-2014 NOLs), and (2) a "prior NOL conversion subtraction" (for pre-2015 NOLs).

a. *NOLs incurred beginning on or after 2015*

Post apportionment computation.

3 year carry back (but not before 2015)

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20- year carry forward.

The NOL will equal the current year's business loss for the tax year multiplied by the business allocation percentage for that year.

It will not include any losses incurred in years beginning before January 1, 2015 (replaced with the "prior NOL conversion subtraction" PNOCCS) or when the taxpayer was not a New York taxpayer.

Removes the existing limitation on NOL deductions based on the "amount allowed for federal income tax purposes"

Eliminates the requirement that the NOL deduction originate in the same source year as the federal NOL deduction for that year

Conforms the NOL carry forward period to the 20-year federal carry forward period.

Unabsorbed NOLs generated in tax years beginning before January 1, 2015 cannot be carried forward. Instead, unabsorbed NOL carry forward amounts existing on the last day of the taxpayer's base year – its last taxable year ending before 1/1/2015- are converted into a "prior NOL conversion subtraction" (PNOCCS).

b. *PNOCCS – all unabsorbed NOLs incurred before 2015*

There will be a new prior net operating loss conversion subtraction (PNOCCS).-A company's net operating loss will be computed on the last day of 2014 and multiplied by the base year apportionment and divided by 6.5% (or 5.7% for manufacturers) to equal the total PNOCCS for the future.

PNOCCS Subtraction Pool = [(2014 BAP) x (2014 tax rate) x (unabsorbed NOLs)]/6.5

Taxpayers can claim one-tenth a year for up to the next 20 years or use one-half in 2015 and one-half in 2016.

The conversion subtraction must be applied before claiming the regular NOL deduction for the tax year.

The PNOCCS cannot reduce the tax on business income lower than either of the tax on business capital or the fixed dollar minimum.

H. MTA Surcharge - Base is current year New York State tax before credits. $1 million in-district receipts threshold. Still uses 3 factor formula and the 2015 rate is increased to 25.6% (to be adjusted annually).

I. Credits: Nearly all of the existing tax credits under Article 9-A and Article 32 remain in effect under the new law.

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1. Effective in 2014, the new law introduces a real property tax credit for "qualified New York manufacturers" equal to 20% of the real property taxes paid on New York property that is principally used in manufacturing.

2. No repeal of the ITC for the financial services industry.

3. No requirement that tax credits be claimed only on the taxpayer's originally filed return.

J. Combined Reporting.

1. Pre 2015 law: Article 9-A. Combined report is required if:

a. Corporations are engaged in a unitary business;

b. Corporations meet 80% or more common ownership test (measured by voting power or capital stock); and,

c. "Substantial intercorporate transactions" exist among the corporations (regardless of the transfer price for those intercorporate transactions).

d. Combination is permitted or required if unitary business and common ownership tests are met and separate filing would result in "distortion."

2. 2015 law: Combined report required if the corporations:

a. Are engaged in a unitary business; and,

b. More than 50% of the common ownership test is met (measured by voting power of capital stock).

c. Observations:

Unitary water's edge combined reporting. The beginning of unitary business audits?

Ownership test reduced to 50% of the voting power.

Still requires a unitary business.

Say goodbye to substantial intercorporate transactions. Distortion and substantial inter-corporate transactions are no longer required.

Affiliated group election. Taxpayers can make an election to combine if they meet the 50% test, regardless of whether those corporations are conducting a unitary group. The election must be made on the original return and is irrevocable for 7 years and includes any new members. The election is automatically renewed for another 7 years unless affirmatively revoked. If the election is revoked, there is a 3 year waiting period.

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Corporations that may be included in the combined report: general domestic corporations, certain alien corporations, combinable captive insurance companies, captive REITS, and captive RICs.

Certain corporations may not be included in a combined report (even if commonly owned group election is made): a corporation that is taxable (or would be taxable if subject to tax) under Article 9 or Article 33, a REIT or RIC that is not a captive REIT or RIC, a New York S Corporation; and an alien corporation that is not treated as a domestic corporation under the Internal Revenue Code and that has no effectively connected income for the taxable year.

If a corporation is subject to tax solely as a result of its ownership of a limited partnership interest in a limited partnership that meets the new (or old) nexus standards and none of its related corporations are subject to tax under Article 9-A, the corporation is not required to file a combined report with those related corporations.

3. Computation of tax: Tax on a combined report will the highest of the: (1) tax on the combined business income base, (2) tax on the combined capital base, or (3) fixed dollar minimum tax for the designated agent of the combined group. Plus, fixed dollar minimum tax for each member of the combined group (other than the designated agent) that is a New York taxpayer.

4. All New York taxpayers will be jointly and severally liable for the tax due on the combined report.

5. Capital base: Is the portion of the combined capital of the combined group that is apportioned to New York. In computing combined capital, all intercorporate stockholdings, intercorporate bills, intercorporate notes receivable and payable, intercorporate accounts receivable and payable, and other intercorporate indebtedness are eliminated.

6. Business income base: Is the portion of the combined business income of the combined group that is apportioned to New York, reduced by any net operating loss deductions for the group. All intercorporate dividends must be eliminated and all other intercorporate transactions are deferred in a manner similar to § 1502 of the Internal Revenue Code.

7. The new law continues the "Finnigan" approach by including the receipts, net income, net gains and other items of all combined group members regardless of whether the individual members are New York taxpayers.

IV. NEW BUDGET - OTHER STUFF

A. There is also a new refundable income tax credit for qualified manufacturers equal to 20% of the real property taxes paid.

B. Extension of real property and sales tax benefits to businesses, landlords and tenants in lower Manhattan for the next 2 years.

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C. Enhancement to Youth Works Tax Credit. This enhancement provides an additional $1,000 tax credit for each youth retained in full-time status for one more year and an additional $500 for each youth retained in part-time status for one more year. It also lowers the part-time hourly threshold from 20 hours to 10 hours for full-time high school students.

D. New credits for musical and theater productions in upstate New York as well as film credits to add Albany and Schenectady Counties to those counties where additional credit based on wages can be earned.

E. Workers With Disabilities Tax Credit – Effective January 1, 2015, there will be a nonrefundable credit equal to 15% of qualified wages for qualified full-time employees (maximum* $5,000 per employee) and 10% of the qualified wages for qualified part-time employees (maximum $2,500 per employee). Unused credits can be carried forward for 3 years. Full-time employment is defined as working at least 30 hours per week. This credit is available for qualified wages paid after January 15. In order to participate, taxpayer must apply to the Department of Labor by November 30 of the prior year to become a qualified employer.

* A qualified individual is a developmentally disabled individual who is receiving rehabilitation services.

F. Taxpayers convicted of bribing public officials, defrauding the government or similar convictions will forfeit their eligibility for tax credits.

G. The sales tax exemption for food or beverages sold from a vending machine has been increased to $1.50 (was $.75 or less) effective date June 1, 2014. TSB-M-14(7)S

H. Family Tax Relief Credit – This $350/family credit for taxpayers with AGI of between $40,000 and $300,000 will still be prepaid in 2014, but will become a credit on the taxpayer's personal income tax return in 2015 and 2016.

V. 2014 COMPLIANCE INITIATIVES AND ISSUES

A. New York voluntary disclosure and compliance program. In an attempt to bolster tax compliance, recent legislation created a statutory framework for voluntary disclosure, where taxpayers can voluntarily approach the Tax Department to report past delinquencies and obtain a certain degree of amnesty. Eligible taxpayers who file a disclosure statement and execute a Voluntary Disclosure and Compliance Agreement with the Tax Department will avoid incurring any civil penalties and will not be subject to any criminal proceedings. Taxpayers will not be able to enter such an agreement if: 1) they are currently under audit or a party to a criminal investigation; 2) the Department has already identified the disclosed deficiency; or 3) the taxpayer is disclosing participation in a tax avoidance transaction that is a federal or New York State reportable or "listed" transaction.

This program is also available to taxpayers who disclose a delinquent tax liability that was deliberately or fraudulently evaded. An automated process is available at http://www.tax.state.ny.us/e-services/vold/program_info.htm. *See* TSB-M-08(6)I, (11)C, (6)M, (4)R and (10)S. Over $31 million collected in the first year of the program!

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B. Old Assessments/New Statute of Limitations Rule. Tax Department has initial burden to prove proper mailing of original statutory notice. *See Taczanowski* (ALJ May 21, 2009, aff'd. TAT January 28, 2010). However, the Tax Law was amended to limit the Tax Department's ability to collect on old warrants. The new section states that a tax liability is not enforceable and every tax liability is extinguished after 20 years from the date a warrant first could have been filed by the Commissioner of Tax, regardless of whether a warrant is actually filed. Warrants can be filed the day after the last day for payment as specified in a Notice and Demand provided there is no right to a hearing with respect to such Notice and Demand. Where there is a right to a hearing, the first date a warrant can be filed is the date that opportunity for a hearing or review has been exhausted. Moreover, unlike the previous law, a payment or other acknowledgement of the liability does not revive or restart the 20 year limitation period. *See* Tax Law § 174-b.

This provision applies to all taxes administered by the Tax Department, including any special assessments, fees, interest, additions to tax, penalties, and other impositions that are administered by the Commissioner of Tax. This provision takes effect immediately and applies to all past debts currently in collection. *See* TSB-M-11(10)I.

C. New Offer In Compromise Program - The Tax Law was amended to expand the eligibility of taxpayers to participate in the Tax Department's Offer In Compromise Program. Under the amendments, the amount payable through an offer in compromise is an amount that reasonably reflects collection potential or is otherwise justified by proofs offered by the taxpayer. See TSB-M-11(9)I and TSB-M-11(14)S. Under the new law, eligibility to participate in the Offer In Compromise Program has been expanded to include individual taxpayers who can prove that collection in full of any liability administered by the Tax Department will cause the taxpayer undue economic hardship.

D. New Whistleblower Law. The new law amends New York's false claims act to expressly authorize private citizen whistleblowers, subject to some oversight by the Attorney General, to bring on behalf of the State treble damage false claims lawsuits against high-end taxpayers who have engaged in tax fraud or knowingly filed false tax returns. To encourage whistleblowers to come forward, the law offers potentially huge rewards for successful whistleblowers and further includes strong protective measures to insulate whistleblowers from retaliation. *See* Noonan and Comiskey, *Calling all Whistleblowers: New York Wants You!*, State Tax Notes (January 2011).

On April 19, 2012, New York's Attorney General announced that he is suing Sprint-Nextel for allegedly knowingly and deliberately failing to pay more than $100 million in sales taxes that it owes to New York. He is seeking more than $300 million in damages. Sprint has filed a motion to dismiss, which was recently denied.

E. Enforcement of Tax Law § 632-a? 2007 Legislation that attempted to shut down PSCs. Effective for tax years beginning on or after January 1, 2007, if the Commissioner determines that a personal service corporation or an S corporation has been formed or used to avoid or evade tax, the income, deductions, losses, etc. can be reallocated between the corporation and its shareholder-owners. This new discretion should only be exercised if substantially all of the services of a personal service corporation are performed on behalf of another New York business.

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More questions than answers about whether (or how) this will even be applied. Focus has been on large professional services firms.

F. Attorney's fees are possible for egregious behavior - Jack W. Hunt & Associates vs. NYS Department of Taxation and Finance. __NYS 3d__ (2011).

G. The End of the LLC Responsible Officer Issue? The LLC member issue is still out there. New York Tax Law § 1133(a) imposes personal liability for a business' unpaid sales and use taxes upon any person who is required to collect and pay over the tax. In turn, New York Tax Law § 1131(1) defines the phrase "persons required to collect tax" to include, "any member of a partnership or limited liability company." The broad language of Tax Law § 1131(1) forms the statutory basis for the Tax Department's position. If an individual or entity is a partner of a partnership, they may be assessed for the full amount of any sales and use taxes, penalties, and interest that New York considers as being owed by the partnership, regardless of the individual's or entity's status as a limited partner or the partner's duties vis-à-vis the partnership. Similarly, the veil of limited liability that cloaks LLC members for other purposes is, regarding sales and use taxes, nonexistent according to the Department's reading of Tax Law § 1131(1). Thus, according to the Tax Department, **every member of the LLC is subject to absolute and unlimited "per se" liability.** *See Noonan, The Continuing Saga of Unlimited Liability Companies in New York,* State Tax Notes, April 2010 (included in materials).

Legislation to resolve this issue has been proposed. That's a good thing, since the Tribunal in *Matter of Santo* (December 2010) has upheld the law and imposed "per se" liability on a passive LLC member.

<u>BUT</u>: New York has issued special settlement guidance, effective March 9, 2011. Under the new rules, limited partners may qualify for special relief if they can demonstrate that they were not under a "duty to act" concerning the businesses' tax obligations. Additionally, the LLC member must have less than a 50% share of the profits and losses of the LLC. If they qualify, no penalty will be imposed on LLC members, and the liability of the eligible LLC member will be limited to an amount determined by multiplying the business's liability for sales taxes and interest by that person's percentage of ownership interest in the business, or the person's percentage share of profits and losses of the business, whichever is higher. This special relief does not apply to any general partners of a partnership nor to any partner of a limited liability partnership. *See* TSB-M-11(6)S.

H. Don't Forget about Sourcing Rules for Flow-Thru Entities Selling Real Property! Under legislation enacted in 2009, the phrase "real property located in this state" as defined in Tax Law section 631 is redefined to include interests in a partnership, limited liability company, 21S corporation, or closely held C corporation (that is, with 100 or fewer shareholders) owning real property located in New York state if the value of the real property exceeds 50 percent of the value of all of the assets in the entity. There is a two-year lookback rule to avoid taxpayers' "stuffing" assets into an existing entity before a sale. For sales of entity interests occurring on and after May 7, 2009, any gain recognized on the sale of an interest in that an entity will be allocated among the assets in the entity, and the amount allocated to New York real property will be treated as New York-source income.

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I. Criminal Enforcement Continues. June 29, 2012 Press Release announces indictment of nonresident taxpayer (resident of Colorado) for failing to allocate New York source income to New York. See http://www.tax.ny.gov/press/rel/2012/wolf062912.htm.

J. New York Administrative Appeal Update:

1. Bureau of Conciliation and Mediation Services

-- Intermediate appeal forum
-- 7,000 cases filed annually
-- Agreement reached in 75% of cases
-- 67% of cases resolved within 6 months

2. Division of Tax Appeals

-- Formal appeal before Administrative Law Judge
-- 11-month backlog (from time of filing petition until time judge is assigned)
-- Judges have a docket capped at 24 cases
-- State attorneys starting to take a more active role prior to judicial assignment

VI. NEW YORK STATE TAXATION OF S CORPORATIONS

A. Taxation of Entity

- Each S corporation pays a fixed-dollar minimum tax in New York State as follows:

New York Receipts	Tax
X < $100,000	$25
$100,000 < X < $250,000	$50
$250,000 < X < $500,000	$175
$500,000 < X < $1,000,000	$300
$1,000,000 < X < $5,000,000	$1,000
$5,000,000 < X < $25,000,000	$3,000
X > $25,000,000	$4,500

- No built-in gains tax. However, there is no basis step-up either. TSB-A-11(1)I.

- LIFO recapture tax under Code Sec. 1363(d) may apply.

B. Taxation of Resident Individual Owners

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- Resident owners are taxed on federal taxable income with state modifications.

C. Taxation of Non-Resident Individual Owners

1. Allocation and Apportionment

Use Article 9-A rules to determine source of income. Single-factor, receipts-only apportionment.

S Corporations have the obligation to withhold and remit estimated taxes on behalf of nonresident owners who will have a tax liability to New York form flow-through items of at least $300. Waivers are available. Tax Law 658(c)(4); TSB-M-04(1)I; Form IT-2658.

2. Special Situations

a. Sale of stock with 338(h)(10) election: Gain on deemed asset sale is taxed to extent of apportionment to New York. Deemed liquidation (sale of shares) is disregarded. Tax Law Sec. 632(a)(2).

b. Sale of assets for a distributed installment note (Code Sec. 453(h)(1)(a)): Gain recognized by shareholders as payment are received are sourced to New York based on corporation's pre-sale business allocation percentage. Tax Law Sec. 632(a)(2).

c. Sale of stock where more than 50% of the corporation's assets are New York real estate. Gain may be treated as arising from New York real property to the extent that the corporation's assets are New York real property. Tax Law Sec. 631(b)(1)(A)(1).

D. Baum Case and Anti-Baum Legislation.

1. The Decision: *Matter of Gabriel and Frances Baum* (TAT, Feb. 12, 2009) confirmed that when a nonresident sells shares in an S corporation, the gain or loss on the sale is not considered New York "source" income subject to tax. This is true, according to the Tax Appeals Tribunal, even if the parties elected under I.R.C. § 338(h)(10) to have the transaction treated for *federal* tax purposes as a deemed sale of the S corporation's assets, followed by a deemed liquidation of the proceeds in exchange for the shareholders' stock. The Tribunal found that New York's tax law did allow recognition of the "fictitious" transactions triggered by the federal election and that the substance of the transaction remained the sale of *stock*—which does not constitute New York source income for a nonresident.

2. The Legislation: Claiming *Baum* had "erroneously overturned longstanding policy" of the Tax Department, the Legislature responded in 2009 by enacting legislation to reverse the Tribunal's ruling. The new statute declares that nonresidents who sell S corporation stock under a 338(h)(10) election are bound by the election and thus are treated as realizing gain or loss from the sale of the corporation's assets (a taxable transaction to the extent assets are located in New York).

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3. The Constitutional Problem: The new statute not only applies prospectively, but is *retroactive* to tax years beginning Jan. 1, 2007. New York auditors are brandishing the retroactivity provision to assess nonresidents on long-closed transactions. This likely runs afoul of constitutional due process, particularly for taxpayers induced to structure their transactions based on the law as it previously existed. *See* Timothy P. Noonan and Joshua K. Lawrence, "Noonan's Notes on Tax Practice—No Repose on 338(h)(10) Elections: New York's Retroactive 'Correction,'" *State Tax Notes,* April 16, 2012.

E. *Burton v. New York State Dept. of Taxation & Fin.* (978 NYS2d 653, 2014 NY Slip Op 24004 [Sup Ct, Albany County 2014])

- Case involving the sale of S corporation stock by nonresident shareholders pursuant to an IRC § 338(h)(10) election.
- Taxpayers sold their stock in 2007. At the time, Tax Law § 632(a)(2) prohibited this income from being treated as New York source income to a nonresident, as the Tribunal held in *Baum.*[1]
- Section 632(a)(2) was retroactively amended in 2010 to "undo" the Tribunal's decision in *Baum,* and the amendment was made effective to years beginning on or after January 1, 2007.[2]
- Taxpayers argued the amendment violated Article 16, section 3, of the N.Y. Constitution which prohibits New York from taxing the sale of a nonresident's intangible personal property, and that the Department's reliance on the amendment was unconstitutional.
- Notably, the taxpayers withdrew the argument that the retroactive enforcement of the law was unconstitutional, at oral argument.
- Court rejected the taxpayers' argument and held that since the transaction was treated as an "asset sale" per the federal election, taxing the gain "did not run afoul of the constitutional prohibition against taxing a nonresident's intangible personal property."

F. *Caprio v. New York State Dept. of Taxation & Fin.* (37 Misc 3d 964 [Sup. Ct. N.Y. County 2012], *rev'd* 2014 N.Y. Slip Op 02399 [1st Dep't April 8, 2014])

- This case was initially heard in N.Y. County Supreme court. The plaintiffs, the Caprios, challenged the retroactive application of the 2010 amendment to Tax Law § 632(a)(2) that dealt with nonresident S corporation shareholders who received installment obligations in exchange for their S corporation stock under I.R.C. § 453(h)(1)(A). The Caprios argued that the retroactive

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1 *Matter of Baum*, Tax Appeals Tribunal, February 12, 2009.

2 L. 2010, ch. 312, pt. B, § 1.

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application of the amendment violated their New York and federal due process rights.

- The 2010 amendment to Tax Law § 632(a)(2) that dealt with I.R.C. § 453(h)(1)(A) specifically targeted and intended to overturn a 2009 New York ALJ determination, *Matter of Mintz*. Under I.R.C. § 453(h)(1)(A), an S corporation shareholder who exchanges S corporation stock for installment obligations (in a liquidation to which I.R.C. § 331 applies) received by the S corporation in a sale or exchange, is treated as receiving payment for the sale of stock upon receipt of the installment payments. The 2010 amendment, however, requires nonresident shareholders who receive such distributions of installment obligations to source the gain recognized on the payments according to the S corporation's business allocation percentage.

- The Caprios, who were nonresidents of New York, sold their S corporation stock in 2007. The Caprios and the buyers both made I.R.C. § 338(h)(10) elections, and the Caprios also received a liquidating distribution of installment obligations in exchange for their S corporation stock under I.R.C. § 453(h)(1)(A).

- In 2012 the Supreme Court determined that the retroactive application of the 2010 amendment to Tax Law § 632(a)(2) did not violate the Caprios' due process rights. The Caprios appealed the Supreme Court's decision, however, and it was recently overturned by the Appellate Division, First Department.

- The First Department applied a 3-factor test (which was reaffirmed in *James Square*) to determine that the retroactive application of the 2010 amendment to Tax Law § 632(a)(2) violated the Caprios' due process rights. The First Department found that (1) the Caprios reasonably relied on the existing law in 2007 to structure their transaction, and had no forewarning of the change made by the 2010 amendment, and (2) that the length of the period of retroactivity (3.5 years) was excessive, and that the 2010 amendment was not curative, and finally (3) that the public purpose for the retroactive application of the 2010 amendment asserted by the Tax Department was not convincing.

G. Hybrid Corporations (Federal S/NYS C)

1. Taxation of Entity—Hybrids are taxed like regular C corporations under Article 9-A. Income is tri-furcated into income from subsidiary, investment and business capital. Income from subsidiary capital is exempt. Income from investment capital is apportioned to New York under the generally-favorable investment allocation percentage. Income from business capital is apportioned to New York under the business allocation percentage (single factor receipts only).

2. 2007 New Rules—Effective for tax years beginning on or after January 1, 2007, hybrid S corporations are no longer allowed if the S corporation's investment income for the current year exceeds 50% of its federal adjusted gross income. Because shareholders may

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not know whether a mandatory S election will be required until the end of the S corporation's tax year, estimated tax rules are relaxed for affected S corporation shareholders.

3. The ***Siegel*** Case (ALJ, August 2011). For years before 2007, taxpayer transfers shares to hybrid S corporation, set up also to do future consulting, and has hybrid sell the shares. ALJ holds that this was done for tax avoidance purposes and can be disregarded. Case in on appeal.

VII. PARTNERSHIPS/LLCS (I.E. WHICH HAVE NOT "CHECKED THE BOX")

A. Taxation of Entity

Partnerships:

If the New York source gross income is:	The fee is:
exactly $1,000,000	$500
more than $1,000,000 but not over $5,000,000	$1,500
more than $5,000,000 but not over $25,000,000	$3,000
more than $25,000,000	$4,500

LLCs/LLPs (same as S Corporations):

If the New York source gross income is:	The fee is:
not more than $100,000	$25
more than $100,000 but not over $250,000	$50
more than $250,000 but not over $500,000	$175
more than $500,000 but not over $1,000,000	$500
more than $1,000,000 but not over $5,000,000	$1,500
more than $5,000,000 but not over $25,000,000	$3,000
more than $25,000,000	$4,500

B. Taxation of Resident Individual Owners: Resident owners are taxed on modified federal taxable income.

C. Taxation of Nonresident Individual Owners: Nonresident owners are taxed (in effect) only on New York source income.

- Allocation and Apportionment—Partners use a *different apportionment approach* than S corporation shareholders. The formula is three-factor (property, payroll, gross income), and, by regulation (a regulation which is likely fundamentally unsound), gross income is attributed to New York by *originating office* (not by destination or customer location).

- Special rule for real and tangible property—Gains and losses from the ownership of real and tangible property are allocated (and not apportioned) to the location of the state where the property is located. Tax Law Sec. 631(b)(1)(A). This also

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applies to real estate operated as a business (e.g. a hotel). *Linde* (TAT May 24, 2012).

Withholding requirement—Same as with S corporation shareholders.... Tax Law 658(c)(4); TSB-M-04(1)I; Form IT-2658.

D. Olsheim - ***Matter of Olsheim*** (Tax Appeals Tribunal,April 10, 2014)

- Issue was whether a capital loss from the disposition of a partnership interest is allocable to NYS by a nonresident. Taxpayer was a member of an LLC which was taxed as a partnership.

- Taxpayer inherited his LLC interest from his father in 2004, at which time he received a step-up in basis equal to the fair market value of his LLC interest (*i.e.*, his "outside basis"). His "inside basis" (*i.e*., his *pro rata* share of the LLC's adjusted basis in the LLC's assets), by contrast, was not automatically stepped-up. The LLC declined to affirmatively elect to equalize his inside basis so his outside basis exceeded his inside basis.

- In 2005, the LLC sold its only asset (a NYC office building) and dissolved. At that time, the taxpayer's outside basis exceeded his inside basis so the dissolution caused him to realize a loss on his LLC interest equal to the difference between his outside and inside bases. On his 2005 nonresident return, he allocated this loss to NYS, offsetting his gain from the sale of the building and after an audit, the Department issued him an assessment. Relying on TSB-M-92(1)I, the Department posited that while his income from the building sale was New York source income, the loss sustained from the disposition of his LLC interest was not. Thus, the entire gain was NYS source income which could not be offset by the loss from his LLC interest.

- The Tribunal affirmed the ALJ determination which sustained the assessment. The ALJ rejected the taxpayer's argument that the TSB-M was contrary to the definition of "New York source income of a nonresident individual" under Tax Law § 631(a)(1) and was also contrary to the 2009 amendment to Tax Law § 631(b)(1)(A)(1), under which a partnership interest is included as an ownership interest in New York real or tangible personal property.

E. Taxation of Corporate Owners: Corporate owners generally take into account the partnership tax attributes on an *aggregate* basis. Thus, the Department treats items of income, gain, loss and deduction and tax attributes as being passed through to corporate owners pro rata. Both the Department and taxpayers struggle as to the breadth of this approach.

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VIII. NYC TAXATION OF S CORPORATIONS

A. Taxation at the Entity Level

1. NYC taxes corporations that make an S election as if they were regular C corporations for purposes of the General Corporation Tax ("GCT") and Bank Tax.

- o This also means that a qualified subchapter S subsidiary (QSub) must file a separate GCT return in NYC if it has nexus. (*Finance Memorandum 99-3*)
- o If the QSub and its parent satisfy the requirements for combined reporting, then they may be required or permitted to file together on a combined report.
- o Whereas a QSub's income & losses would appear on the parent's income tax return for federal and New York purposes since it is treated as a disregarded entity, that is not the case in New York City unless it will file on a combined return

2. The fact that a corporation loses its S corporation status for federal purposes has no effect on its NYC filing. *New York City Finance Letter Ruling* 97-4703 (07/28/1997).

3. Since 2009, NYC has been phasing in its single factor allocation method for business income, using a phase-in over 10 years. Prior to 2009, an equal-weighted 3-factor formula was used. After 2017, only a sales factor will be used. Until 2011, manufacturers could elect to use a 3 factor formula with double-weighted sales. After 2011, manufacturers began using the same allocation methodology as other NYC taxpayers. Below is the phase-in for the next several years:

- 2012: 60% receipts, 20% property, 20% payroll
- 2013: 67% receipts, 16.5% property, 16.5% payroll
- 2014: 73% receipts, 13.5% property, 13.5% payroll

B. Taxation of Resident Individuals

- A NYC resident pays NYC tax on the same income stream from an S corporation twice – at the entity level and on the flow-through income on the individual's personal income tax return. *See Matter of Gael de Brousse,* ALJ Decision DTA No. 816052 (08/06/98).

  - o Despite the concern regarding double taxation, S corporations account for approximately 1/3 of GCT revenues according to NYC calculations, making it unlikely that NYC's treatment of S corporations will change anytime soon

C. Taxation of Nonresident Individuals

- Since nonresidents are not subject to personal income tax in New York City, they do not have to report any flow-through income or distributions from an S corporation to the City.

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D. 338(h)(10) elections

- Where an acquisition is treated as an asset sale for federal purposes under a 338(h)(10), the shareholders do not realize any gain recognized from the stock sale. Instead, the target corporation recognizes gain on a deemed asset sale and the gain flows through to its shareholders, who then get to increase their basis in the shares. Then, the shareholders are deemed to have sold their shares in exchange for the proceeds from the deemed asset sale. The target ends up with a stepped up basis in the assets and the sellers, with a single level of tax.
- So, how does this work in NYC, which doesn't recognize the S election? The regulations (19 RCNY 11-27(j)) tell us that a 338(h)(10) election will not be recognized for purposes of computing the GCT. So, there is no deemed asset sale and no stepped up basis for the purchaser. The acquisition of the S corporation is treated as a stock sale and the purchaser does not acquire a stepped up basis. Thus, the target now has two different bases in the assets – one for NYS and federal purposes, and one for NYC purposes.
- But keep in mind that the NYC resident shareholder of the target corporation determines his or her city taxable income starting with federal AGI. So, for NYS/NYC personal income tax purposes, the shareholder pays tax on gain from the deemed asset sale under 338(h)(10).

IX. NYC UNINCORPORATED BUSINESS TAX (UBT)

A. Entity-Level Taxation

1. The UBT is imposed on any individual or unincorporated entity (including a partnership, LLC, fiduciary, or corporation in liquidation) engaged in any trade, business, profession, or occupation wholly or partly carried on within New York City. A partnership includes any entity treated as a partnership for federal income tax purposes.

2. An individual or other unincorporated entity is not subject to the UBT if it only engages in activities (trade or the purchase, holding, or sale of property) for its own account. The exemption applies if the individual or entity is "primarily engaged" (90% of the gross value of its assets) in trading or investing activities for its own account.

3. Beginning in 2009, taxpayers with unincorporated business income of $95,000 or less are not required to file a UBT return.

4. If the UBT is $3400 or less, the business is permitted a credit for 100% of the tax.

5. The credit is phased out for liabilities between $3400 and $5400:

- For tax amounts between $3400 and $5400, the credit is computed as follows: (UBT amount) x (($5400 – UBT amount)/$2000). If the UBT exceeds $5400, no credit is allowed.

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6. Like the GCT, beginning in 2009, NYC is transitioning to a single sales factor allocation method over 10 years.

B. Taxation of Resident Individuals

1. NYC resident individuals who are sole proprietors, LLC members (including SMLLCs), or partners in an unincorporated entity subject to the UBT can take a credit on their personal income tax return for UBT taxes paid.

2. If your NYC taxable income is $42,000 or less, you can claim a credit of 100% of the UBT paid.

3. If your taxable income is over $142,000, you can claim a credit of 23% of UBT paid.

4. For NYC taxable incomes between $42,000 and $142,000 the amount of credit is determined by formula.

C. Taxation of Nonresident Individuals

1. For UBT purposes, a nonresident individual's UBT liability does not differ from that of a resident.

2. A New York State nonresident individual cannot take a credit for UBT paid, even if that individual files a nonresident return in New York.

D. Tiered Partnerships

UBT Paid Credit for Corporate Partners:

1. Corporate members or partners of an unincorporated entity are eligible for a credit against their NYC GCT liability if the corporation is required to include its distributive share of the income, gain, loss, deductions and/or guaranteed payments from the partnership in the corporation's tax base.

2. If the corporation determines its GCT liability based on ENI, the UBT credit paid is the lesser of the following:

- (UBT tax + credits allowable to the unincorporated business under NYC Admin. Code §11-503(j)) x (total of the corporate partner's distributive share of income, gain, loss, deductions and guaranteed payments / net distributive share of all partners for whom their individual share is greater than zero) x 4/8.85. OR
- The amount of allocated net income on the corporation's GCT return (Schedule A, line 1) x 4/8.85.

3. If the corporation determines its GCT liability using the alternative tax base (ENI plus certain salaries or other compensation), the UBT paid credit is determined using the lesser of the following:

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- (UBT tax + credits allowable to the unincorporated business under NYC Admin. Code §11-503(j)) x (total of the corporate partner's distributive share of income, gain, loss, deductions and guaranteed payments / net distributive share of all partners for whom their individual share is greater than zero) multiplied by 0.3319; OR
- The alternative tax amount if the amount is greater than zero.

4. Corporate partners or members can only take the UBT paid credit in a year that it has a GCT liability. It is permitted to carry forward credits not taken for 7 years.

UBT Paid Credit for Upper-tier Partners or LLC Members:

1. Partners or LLC members who are subject to the UBT and include in the partnership's business income their distributive share of income, gain, loss and deductions from a lower tier partnership or LLC may claim a credit for UBT tax paid. The credit equals the lesser of the following:

- UBT paid by the distributing partnership plus the credits taken by the distributing partnership on its own return multiplied by the partners distributive share percentage or the partner's UBT liability before any business tax credits (whichever is lesser); OR
- The UBT computed on the partner's share of income without any UBT paid credit for lower tier partnerships so long as the amount exceeds zero.

2. Excess credits can be carried forward for 7 years, but if a partner is itself a partnership, the carryforward is allowed only if at least one partner's interest in the unincorporated business's income and deductions is at least 80%.

Other Issues:

1. A corporate limited partner can be deemed to have nexus in NYC by virtue of a passive interest in an entity that is doing business in the City. But so long as there is no unitary business and no "flow of values" between the corporation's passive interest and its active business, the corporation should be permitted to use separate accounting to allocate its income. In *Matter of Just Born*, TAT (E) 93-456 (GC) (1998), the taxpayer had a PA confectionary business, whose income was not subject to tax in NYC based on Public Law 86-272. But it also had a passive partnership interest in a NYC partnership whose losses offset the corporation's income for federal purposes. The Tribunal held that the taxpayer could apply a discretionary adjustment and separately allocate the income from the confectionary business and the partnership, resulting in no New York City tax liability, stressing that but for the passive partnership interest, the corporate would not be subject to the GCT. The Commissioner of Finance requested that the Tribunal vacate the portion of its decision that the income from the confectionary business was protected by PL 86-272, but the Tribunal denied the motion.

E. Special Situations

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1. Independent contractors—unless they meet the "safe harbor" requirements for an individual to be classified as an employee—are subject to UBT. *See Statement of Audit Procedure* UBT-2009-1rev (Feb. 12, 2009) for a list of safe harbor requirements for real estate sales people and associate brokers.

2. In *Matter of Murphy & O'Connell*, TAT(E)06-18UB (07/26/2011), the NYC Tribunal reaffirmed its prior rulings that contributions to a pension plan on behalf of partners are not deductible by the partnership because they are payments to partners for services. The Tribunal did agree that the taxpayer should receive interest on its refund of payment for penalties that the Department had subsequently withdrawn. For some reason, the taxpayer then appealed to the First Department, which upheld the Tribunal's ruling.

3. Earlier this year, there was a big uproar over the announcement that NYC intended to disallow certain expense deductions by hedge fund or private equity fund managers. Typically, the management company (usually some type of partnership) would receive the management fees for the fund and those fees would be subject to UBT. A separate partnership receiving a carried interest or incentive allocation fee would not be subject to the UBT, since it was trading on its own account. The management company would also deduct all of the management expenses for the fund. The new NYC policy would disallow the deduction of a portion of the expense deductions as attributable to the non-taxable partnership.

- It's not clear that the Department of Finance intends to follow through on this policy change or how it would be administered – would there be a set methodology to disallow expenses or would it be discretionary?

4. It appears from our experience that NYC Finance is using information shared from the IRS on filers with significant Schedule C income on their 1040 who also have a NYC address to inquire whether they have a UBT filing requirement. NYC has been sending out letters from the Office of the Sheriff asking for the taxpayer to either file a UBT return or provide an explanation as to why no UBT returns were filed.

X. HOT RESIDENCY ISSUES

A. Statutory Residence – the Gaied Case!

1. ***Matter of Gaied v. New York State Tax Appeals Trib.*** (___ NY3d ___, 2014 NY Slip Op 1101 [2014])

- New York State's high court holds that in order to treat a person as a statutory resident, there must be some basis to conclude that the taxpayer had a dwelling in New York that "was utilized as the taxpayer's residence."

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- The Court observed that the legislative history of the PPA statute (which was previously examined by the Court in *Tamagni*) as well as the Department's own regulations support the view that maintaining a PPA in New York requires that "the taxpayer must, himself, have a residential interest in the property."

- In particular, the Court noted that the statutory residence provision in the law "fulfils the significant function of taxing individuals who are 'really and [for] all intents and purposes . . . residents of the state.'" This legislative history, according to the Court, illustrates that the law was designed to "prevent tax evasion by New York *residents*" (emphasis in original).

- Thus, the Court held that there was no rational basis for the Tax Appeals Tribunal's interpretation that "a taxpayer need not reside in the dwelling but only maintain it."

2. New Audit Guidelines, issued June 2014, say that New York's policy does not need to change in light of the *Gaied* decision! Factors to determine PPA still include: (i) physical attributes (is unit suitable for year-round living and not a mere camp or cottage?); and the taxpayer's "relationship" to the dwelling, including:

- Does taxpayer have property rights?

- Does taxpayer "maintain" with money, furniture, food, payment of expenses?

- What is relationship to co-habitants?

- Look at independent statements (mail, voting, car, phone, etc.)

- Does taxpayer keep stuff there?

- Does taxpayer has access (a key)?

3. **Statutory Residency – Day Count**

a. ***Matter of Zanetti*** (Tax Appeals Tribunal, February 13, 2014)

- Statutory residence case focused on what constitutes a "day" for purposes of the 183-day requirement of the statutory residence test.

- Outcome hinged on whether 26 days in 2005 counted towards the 183-day requirement. The taxpayer, a Florida resident, owned a residence in Long Island and either arrived in or departed from New York on each of these 26

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days via private jet. The ALJ, citing *Matter of Leach v. Chu*,[3] concluded that these were New York days, thereby rendering him a statutory resident.

- Tribunal affirmed, relying on *Leach*. It rejected the taxpayer's argument that the 26 travel days weren't New York days pursuant to General Construction Law § 19's definition of "day" as a 24-hour period or the definition of a "day" in the revised Black's Law Dictionary.

b. And double tax on statutory residents is still ok. ***Noto v. New York State Dept. of Taxation & Fin.*** (2014 NY Slip Op 30578[U] [Sup. Ct. Suffolk County 2014])

B. Domicile

1. Blatant Plug – In 2014, CCH published the newest version of the *New York Residency and Allocation Audit Handbook*.

2. Guidelines – New version issued in June 2014. The 2012 residency audit guidelines limit domicile review to five primary factors. They are: housing, business ties, "near and dear", time and family ties (limited to immediate family). Although these factors are not binding on ALJs, most judges focus on them. Secondary factors (e.g. licenses, voting, automobile registration, wills, social clubs, etc.) are no longer critical. *See* Noonan and Klein, *The Nuts and Bolts of a Residency Audit*. State Tax Notes (December 2008). New guidelines include rules for foreign domicile and a review of the availability of credits for taxes paid to other jurisdictions.

3. "Leave and Land" Domicile is established by physical presence coupled with an intent to establish a permanent home. *Ingle* (TAT December 1, 2011)

4. A taxpayer's existing domicile continues until a new one is acquired, but the law does not require ownership of a home at the new location. A taxpayer can move, live with family or friends, or rent a new home in the new location and still not be considered to have changed domicile. *See Jeter*, (ALJ November 8, 2007). Domicile is not predicated on a real estate closing if the taxpayer has already "moved" to the new location. *Reichstetter* (ALJ October 31, 2002).

5. The mere ownership of a New York apartment does not create domicile. TSB-A-11(8)I.

6. Special Exceptions for Domiciliaries:

a. *30-Day Rule* - Tax Law § 605(b)(1)(A)(i) – Domiciliaries who (1) maintain a permanent place of abode outside New York during the year, (2) do not maintain a permanent place of abode in New York during the year, and (3) spend no more than 30 days in New York during the year.

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[3] 150 AD2d 842 (3d Dept 1989), *lv dismissed* 74 NY2d 839 (1989) (upholding regulation interpreting a day as "presence within New York State for any part of a calendar day").

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b. *Foreign Country Rule* – Tax Law § 605(b)(1)(A)(ii) – For taxpayers who are outside the United States for 450 out of 548 days and where neither the taxpayer nor his spouse or minor children spend over 90 days in New York during the 548-day period. Note that any consecutive 548-day period is allowed, but that special ratios apply to any short-year periods.

i. A "minor" is a person who has not attained the age of 18 years. TSB-A-12(5)I.

ii. If the taxpayer is legally separated, the spouse and minor children's New York time is irrelevant (unless the taxpayer has custody). TSB-A-12(3)I. *See also* TSB-A-12(3.1)I (April 11, 2013).

iii. Note that the day count rules ("any part of a day") apply here as well. TSB-A-11(3)S.

iv. A foreign citizen who is a statutory resident must pay tax on all federal adjusted gross income from Form 1040NR. TSB-A-10(7)I.

7. Recent domicile cases:

a. *Eileen Taylor* (TAT December 8, 2011). A move to a foreign country, even coupled with giving up a New York home, will be strictly scrutinized. It is very difficult to demonstrate a change of domicile to a foreign country. The Tribunal did not believe that the taxpayer abandoned her New York domicile when the taxpayer had a series of one-year (renewable) contracts with her employer. It also didn't help that the taxpayer received a housing stipend during her stay in London.

b. *Cooke* (ALJ November 15, 2012). Taxpayer was able to establish domicile in Hamptons in spite of spending just as much time in New York City as on Long Island. The taxpayer's minor children attended elementary and high school New York City prior to the years at issue but had completed school by the time the audit was opened. The real key to this case was persuasive testimony from the taxpayer and family members about the location of their "true" home.

c. *Terranova* (TAT September 20, 2012). Taxpayer was unable to show a change of domicile to Florida when he continued to be intimately involved in a New York business and there was very little evidence the taxpayer actually spent much time in his Florida home. It didn't help that the taxpayer's minor daughter was still finishing high school in New York and the taxpayer shared joint custody with his ex-wife.

d. *Byck* (ALJ October 25, 2012). It is practically impossible to prove a change of domicile without any testimony from the taxpayer. How else do you demonstrate intent?

8. Be careful what address you use on tax returns or when protesting a case to the Division of Tax Appeals. *Rothenberg* (TAT January 15, 2004). A New York home address on a Form 1040 creates a presumption that the taxpayer is a New York domiciliary. *Marcinek* (TAT August 13, 2009).

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C. Empire Zones and S Corps

1. ***Matter of Batty and Pennefeather*** (Division of Tax Appeals, April 4, 2013)

- ALJ determined that resident owners of flow-through entities are entitled to a tax reduction credit (the "TRC") based on the tax paid to New York on all income that flowed-through to them to them from the entity.
- Department had unsuccessfully argued that the TRC was available only for the portion of their income that would have been deemed to have been "New York source income" had they been taxed as nonresidents.
- Department did not appeal the ALJ's determination – but is not acquiescing to it either.

2. ***Matter of Henson and Hamel*** (Division of Tax Appeals, April 10, 2014)

- Issue was the same as *Batty*, i.e., whether a resident shareholders of a New York S corporation are entitled to the TRC based on the tax paid to New York on all income that flowed-through to the shareholder from the corporation. The ALJ cancelled the assessment based on the same rationale as was outlined in *Batty.*

3. New Legislation proposed to reverse this, though not clear whether it would be retroactive. Work on the street is that Tax Department is giving up.

D. The Accrual Rule

1. Change of Residence - Recent rules revise the New York (State and City) tax treatment of taxpayers who change their residence. The new provisions require:

a. application of the accrual rules to statutory residents;

b. proportionate accruing to an individual's resident period for income or loss from partnerships and S corporations; and

c. Allowance of a taxpayer's (or if the Tax Department requires) election to determine gain or loss for a partnership or S corporation to reflect the actual date of gain or loss. *See* Important Notices N-05-2, 3 & 4.

2. The accrual rule can apply to a taxpayer who moves into New York, but there is no accrual until the transaction is "closed". *Michaels* (ALJ April 2, 2012). This may allow New York City residents to move out of the City before the closing, sell their New York City home and avoid all New York City taxes.

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