

New York Governor's Tax Proposals for Fiscal 2010: A Compelling Array of Possible Changes

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According to New York Gov. David A. Paterson (D), "the state of our state is perilous." With this gloomy perspective of New York's fiscal health in mind, Paterson presented his annual executive budget more than a month early. Not surprisingly, the governor's budget included a potentially record-breaking number of new revenue-raising provisions.¹ Even though it remains to be seen which of those provisions make it into law, it is worthwhile to review some of the most noteworthy proposals, given their potential significance for New York tax practitioners.

New Sales Tax Measures

As an alternative to increasing tax rates, Paterson has proposed an array of new sales tax measures. Many involve taxing services that were not subject to New York sales tax. Not only does that plan have economic significance for consumers, but it also subjects a much larger number of businesses to the requirements of collecting sales tax on their products and services. Those include personal services such as beauty, massage, and nails; services received at gyms, Turkish baths, and saunas; credit rating and reporting services; all noncommuter transportation services; any sports or amusement charges at a "place of amusement," including movie and other types of theater; and television and radio services received via cable and satellite (parts Q, V, NN, and OO). Also, the executive budget applies sales tax to the value of all discount coupons, whereas previously only manufacturer's coupons were included in the total receipt subject to tax (Part S). If the measures to tax those services pass, it is likely that there will be a much larger number of sales tax audits in the service industry.

The budget proposal imposes sales tax on all digital products (Part CC). Under the current tax law, downloaded products and information delivered in digital format are not subject to tax.² The proposed changes would create a broad definition of taxable digital products and services to include all information delivered, provided, furnished, or accessed via wire, cable, fiber optics, laser, microwave, or other means. The new provisions would apply sales tax to popular digital products such as MP3 files, ring tones, and downloaded movies and games. The sale of digital products would be sourced to the location where the digital product is accessed, bringing New York in line with other states that tax digital information.

Also, although more significant for consumers than tax practitioners, the governor is seeking to apply an 18 percent sin tax to all sugary beverages, including nondiet soft drinks and juices consisting of less than 70 percent juice (Part HH). On the other end of the economic spectrum, the executive budget would create a luxury tax (Part RR) -- similar to the federal excise tax no longer in effect -- of an additional 5 percent on the sale of motor vehicles priced to the extent the sale price exceeds \$60,000. The 5 percent luxury tax would also apply to yachts (to the extent the sale price exceeds \$200,000), aircraft (\$500,000), and jewelry (\$20,000).

Another sales tax measure seeks to close an existing loophole that permits businesses to purchase an aircraft or other vessel without paying sales or use tax (Part AA). Under existing law, a New York business can avoid the tax by having an out-of-state affiliate purchase the aircraft or vessel. The proposal changes the definition of commercial aircraft³ to say that an aircraft used primarily to transport the purchaser's personnel or those of an affiliated entity does not qualify for the sales tax exemption on the purchase of the aircraft. Previously, in a long line of advisory opinions, that type of exemption had been blessed by the department.⁴ The governor's proposal would make a similar change in the use tax exemption for tangible personal property purchased out of state by a nonresident. In its new form, the exemption would exclude aircraft, vessels, and motor vehicles purchased by a nonresident business entity for use in New York primarily to carry individuals employed or otherwise associated with the purchaser. The exclusion from the "new resident" use tax exemption (that is, a nonresident who purchases property out of state and then brings it into New York for use) would apply when any of the transported employees or associates are New York residents at the time of the property's

purchase or if they are employed by or associated with a New York resident affiliate of the purchaser at the time of purchase.

Finally, in the category of narrowing sales tax exemptions, Paterson's proposed budget narrows the capital improvement exemption (Part PP). The measure adds to the definition of a capital improvement under Tax Law section 1101(b)(9) and thus limits the exemption from sales tax for services rendered in conjunction with a capital improvement. Currently, a capital improvement is defined as an addition or alteration to real property that substantially adds to its value, becomes a permanent fixture of the property, and is intended to become a permanent installation. The new version would require that for an addition or alteration to constitute a capital improvement under the tax law, it must be new construction, a new addition, or a total reconstruction. The capital improvement issue is a big one in sales tax audits, so that change would have a big effect on day-to-day sales tax audits for future years.

Overall, these changes, if enacted, would give New York possibly one of the broadest sales taxes in the nation. When you add that New York's state and local sales tax rates are among the nation's highest, you can see why sales tax will continue to be an active area for New York tax practitioners.

Affiliate Nexus Provision (Part FF)

Once again, New York is seeking to expand the state's nexus provisions. First there was economic nexus to impose corporate franchise tax requirements on out-of-state banks with in-state credit card customers.⁵ Then there was the "Amazon tax" for out-of-state retailers that had links on in-state retailers' Web sites.⁶ Now Paterson has added even more expansive affiliate nexus provisions to require out-of-state Internet or catalog retailers to collect New York sales tax if the company has a parent or affiliate company with brick-and-mortar stores in New York. In other words, the new measure targets retailers that separate their Internet and catalog operations from actual retail stores in New York to avoid nexus with the state on Internet and mail-order sales. However, even an out-of-state company without retail stores in New York might be subject to affiliate nexus if it has a New York affiliate that "engages in activity in the state that inure to the benefit of the seller" and if the affiliate has New York nexus.

Apparently, someone in the governor's office must be aware of the potential for constitutional challenges to the new provision. The Memorandum in Support of the Proposed Budget⁷ notes that the U.S. Supreme Court has yet to address the constitutionality of affiliate nexus. However, New York has decided to follow those states that have stretched the requirement of physical presence for sales tax nexus until the Supreme Court decides to weigh in on the matter.

Change to the 548-Day Residency Rule (Part A)

Around this time last year, when I reviewed Gov. Eliot Spitzer's proposed executive budget for 2008-2009,⁸ I discussed a provision seeking to change the 548-day residency rule. Apparently, that change never made it into the final budget bill; however, Paterson's office considers it important enough to revisit the issue in this year's proposed budget.

Under current law, a taxpayer domiciled in New York is not taxed as a resident, if, within any consecutive 548-day period, the taxpayer is present in a foreign country for at least 450 days; the taxpayer is not present in New York for more than 90 days; and the taxpayer's spouse and minor children do not reside at the taxpayer's permanent place of abode in New York for more than 90 days. Apparently, the Department of Taxation and Finance considers the last part of that test to be a substantial loophole in the law, allowing a taxpayer's spouse and children to gallivant around New York while staying somewhere other than the taxpayer's permanent place of abode. The new measure, like the one proposed the previous year, would change that language and require that the taxpayer's spouse and minor children not be present anywhere in New York for more than 90 days for the taxpayer to avoid being taxed as a resident.

Gains from the Sale of New York Property (Part H)

The governor's proposal on gains from the sale of New York property seeks to close a perceived loophole in the law, and is another repeat from last year's budget proposal. Under the current tax law, New York treats the sale of an interest in a partnership as a nontaxable sale of an intangible asset. Thus, if a nonresident seeks to avoid real estate taxes on the sale of New York real property, the nonresident can place the property in a partnership and sell the interest in the partnership -- a nontaxable sale of an intangible. The new law would close that loophole by imposing a tax on gains from

the sale of interests in partnerships and other entities when the gains are attributable to the ownership of real property in New York.

New Rules for Hedge Fund Income (Part N)

The proposed measure on hedge fund income would recategorize as New York-source income any income received for investment management services by a nonresident partner of an investment partnership (such as a hedge fund) doing business in New York. Under Tax Law section 631(b)(1)(B), a nonresident partner of a hedge fund or private equity partnership who receives income as a percentage of realized capital gains does not pay either New York or federal income tax on the income. The governor's proposal would change that on the state level, ostensibly to "equalize the treatment of non-residents and resident partners."⁹ Thus, the compensation that a nonresident partner receives for providing a "substantial quantity" of investment services for a partnership doing business in New York would now be characterized as taxable New York-source income.

Elimination of Itemized Deductions for Wealthy Individuals (Part M)

The current tax law limits the amount of itemized deductions taken by an individual with income over \$525,000 to 50 percent of the value of the individual's deductions.¹⁰ The proposed measure would eliminate the ability of individuals with an adjusted gross income over \$1 million to claim itemized deductions, other than for charitable contributions.

Changes to the Empire Zone Program (Part K)

Paterson has proposed significant changes to the Empire Zone program. The proposed measure would start by requiring all Qualified Empire Zone Enterprises (QEZEs) to recertify and then would later raise the bar for certification. To remain eligible for the program's benefits, the business would have to demonstrate a 20-1 ratio of in-zone wages, benefits, and investments versus zone credits claimed and used over three years. New applicants for QEZE certification would be limited to manufacturing and financial service enterprises and extraordinary projects and they must also meet the 20-1 cost-benefit ratio. Also, the budget effectively eliminates the authority to designate any new empire zones. The budget also introduces new compliance measures for the program, most significantly by repealing the sales and use tax exemptions for QEZEs and replacing them with corresponding credits or refunds to allow the tax department to monitor the use of sales tax benefits.

New Compliance Measures (Part SS)

As a corollary to the new revenue measures, Paterson has also recommended several new compliance measures to enhance the ability of the Department of Taxation and Finance to monitor, audit, and collect from taxpayers. According to the budget, the governor's office is hoping that the new compliance measures would preserve and increase revenue by \$321 million annually. Many of those compliance measures involve the disclosure and sharing of taxpayer information with various government authorities. For example, the voluntary disclosure program would allow the tax department to share information about a participant's tax returns with the IRS and other taxing authorities (Subpart L). That could likely create another disincentive for taxpayers to participate in the program.¹¹ New York would also be able to share taxpayer information in order to enter into agreements with the IRS and other states to offset tax and nontax payments, such as refunds, against tax and nontax debts (Part E). In other words, if a New York resident owed income taxes to New York but was about to receive a refund from the IRS, New York could enter into an agreement with the IRS so that the refund would be applied to the individual's New York tax liability.

Quite a few of the new compliance measures relate to sales tax collection and reporting -- not surprising, given the number of new sales tax provisions the governor is proposing. One proposal requires banks and other financial institutions to report annually the gross amount of bank settlements and deposits into accounts of registered sales tax vendors (Subpart A). Similarly, another proposal would require some third parties, including auto insurers, franchisers, and wholesalers, who transact business with New York sales tax vendors to file informational returns (Subpart N). In the realm of sales tax audits, Paterson is proposing to allow auditors to use generally accepted statistical sampling techniques to reduce the audit time (Subpart B). Currently, taxpayers have the right to insist that their records be used to determine their sales tax liability so long as their records are adequate. The resort to external indices or statistical sampling is generally permitted only if the taxpayer's records are inadequate.¹² That new proposal would allow the use of statistical sampling even if the taxpayer maintained adequate records. At the same time, the budget would increase

the penalties on persons required to keep sales tax records for either failing to keep those records or make them available to the tax department (Subpart C).

There is an increase in interest and penalty rates for nonpayment and fraud. And a few other proposed compliance measures are worth mentioning. First, the budget creates a new whistle-blower statute that would allow the tax commissioner to pay for information leading to a determination of a substantial underpayment of tax or to a criminal prosecution for violation of the tax law (Subpart G). On collection issues, Subpart I permits the tax department to serve a tax levy on a bank branch within New York state, even if the taxpayer's accounts are held in an out-of-state branch of that bank. And, as mentioned above, there are new provisions imposing penalties for the failure to provide information to the tax department on audit -- obviously something practitioners need to watch for.

Conclusion

Those are just the highlights of Paterson's proposed executive budget. And, of course, it remains to be seen how many of those proposals will make it into the final budget legislation. But given New York's financial situation and the pressures not to raise tax rates, it is likely that we will see many of those "revenue-enhancing measures" in the new tax law. Practitioners better be ready for the changes.

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FOOTNOTES

1 See State of New York, 2009-2010 Executive Budget, Amendments to Article VII (Dec. 16, 2008).

2 See, e.g., *Spiritual Compass LLC*, TSB- A-07(16)S (Feb. 22, 2007) (stating that "charges for music, audio recordings, or artwork delivered electronically for download on customers' computers or other devices are not sales of tangible personal property and are thus not subject to sales tax").

3 See Tax Law section 1101(b)(17).

4 See *Cleveland Browns Transportation LLC*, TSB-A-06(8)S; *Standard & Poor's Securities Evaluations, Inc.*, TSB-A-05(15)S; *NYLIFE LLC*, TSB-A-05(38)S; and *Ernst & Young*, TSB-A-05(13)S and TSB A 04(2)S.

5 Tax Law section 1462(f)(2)(v).

6 See Tax Law section 1101(b)(8)(vi).

7 2009-2010 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support [hereinafter referred to as the Memorandum in Support].

8 Timothy P. Noonan, "Sea of Changes in New York Governor's Tax Proposals," *State Tax Notes*, Feb. 18, 2008, p. 555, *Doc 2008-2919* [PDF], or *2008 STT 34-26* .

9 Memorandum in Support, Part N.

10 Tax Law section 615(f).

11 Timothy P. Noonan and Joseph N. Endres, "Identifying and Resolving a New York Tax Problem Just Got Tougher," *State Tax Notes*, Sept. 29, 2008, p. 899, *Doc 2008-19756* [PDF], or *2008 STT 190-3* .

12 See *Marine Midland Bank*, Tax Appeals Tribunal (May 1993).