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Sea of Changes in New York Governor's Tax Proposals

by Timothy P. Noonan

Every year around this time, New York's governor proposes an executive budget outlining various proposals for raising revenue and balancing the budget. And every year a wide variety of new provisions are proposed, most of which are of little consequence to the everyday New York tax practitioner. But there are always some items of interest for practitioners, and this year there are several provisions that are particularly noteworthy. This article will review some of those more interesting and relevant provisions.

Part G: Tax Stamp on Illegal Drugs

This provision calls for exactly what it says: to "improve the enforcement and tracking of illegal drug trafficking by requiring all marijuana and controlled substances to have a tax stamp."[1] Persons selling those controlled substances are required to purchase tax stamps and affix them to packages of marijuana or other controlled substances that they sell in order to show that the tax has been fully paid.

Perhaps you are asking yourself: "What is the governor smoking?" A person engaged in the selling of illegal drugs probably is not that concerned about making sure appropriate taxes are paid. More practically, if you engage in that business activity, imagine yourself going to the Department of Taxation and Finance and applying for that license! The bill contains a strict secrecy requirement, preserving the confidentiality of any information obtained from "dealers," a term that takes on new meaning when thought of in this context. And interestingly, Democratic Gov. Eliot Spitzer's memorandum in support of the proposal says 29 other states have similar provisions. Presumably the measure would allow the state to bring additional charges against sellers of illegal drugs. But whether the tax department will see any actual tax revenue, particularly on a sale of stamps, is another matter. The governor thinks so -- the budget estimates the proposal will eventually increase revenue $17 million annually.

Part L: Sales Tax Collection by Exempt Organizations

Under current law, exempt organizations are not required to collect sales tax on sales of taxable products or services unless those sales take place from a shop or store, defined as any place or establishment where goods are sold or displayed with some degree of regularity, frequency, or continuity.[2] As correctly noted in the governor's memorandum in support, over time that shop or store exemption has become antiquated because many exempt organizations no longer have to use a shop or store to sell items with any degree of regularity -- they can do so over the Internet. The new provision would amend the tax law to require exempt organizations to collect sales tax on remote sales of tangible personal property and some services. But how broadly defined the term "remote" will be could be an issue. Under the proposal, it applies to sales by telephone, mail order, Internet, *or otherwise*. Does that mean all sales by exempt organizations are now taxable? It does not appear that is the intent, but the "or otherwise" language is confusing and I hope it will be clarified.

Part P: Change to the 548-Day Rule

The proposal to change the 548-day rule is somewhat obscure. Under New York's residency rules, a taxpayer qualifies as a resident of New York if the taxpayer is domiciled in New York. There are, however, a few exceptions whereby New York domiciliaries can still be taxed as nonresidents. One of those circumstances involves the so-called 548-day rule.[3] Under that rule, a New York domiciliary can be taxed as a nonresident if he meets some requirements regarding the amount of time spent in out-of-state and out-of-country locations over a 548-day period. One of those tests concerns time spent in New York by the taxpayer's spouse or minor children. The taxpayer's spouse or minor children cannot reside *at the taxpayer's permanent place of abode* in New York for more than 90 days. In other words, the spouse and minor children are allowed to spend more than 90 days in New York; they just cannot spend more than 90 days at the permanent place of abode. The governor's proposal is designed to take away that purported loophole because according to the memorandum in support, "taxpayers have exploited the plain language of the law by having their spouses and minor

children avoid using their permanent place of abode in New York, and instead do such things as stay with relatives in New York or temporarily rent a hotel room."[4]

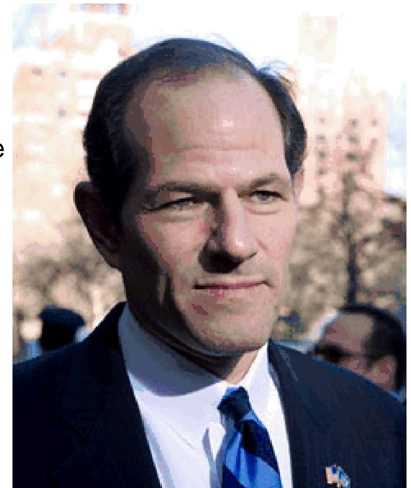
In my experience, few taxpayers know about the 548-day rule, much less find themselves in the position to exploit it. But whatever the case, apparently someone in the tax department or in the governor's office feels that this is an area of exploitation, and this change is designed to correct it.

Part T: New Sourcing Rules

The new sourcing rules are labeled as another loophole closer. Under current law, nonresidents are not taxed on the sale of an interest in a limited liability company or partnership. According to the memorandum in support, nonresidents "escape taxation" by placing New York real property in an entity and then selling the interest in the entity. The purpose of the bill, according to the memorandum in support, "would prevent nonresidents from using this loophole to avoid paying New York personal income tax on the sale of real property located in New York." There is, however, a threshold: The entity's New York real property must exceed or equal 50 percent of the entity's assets.

That provision potentially could be subject to constitutional attack. A question arises regarding whether a tax on the sale of an intangible by a nonresident violates constitutional rules against extraterritorial taxation. Moreover, if indeed the creation of the entity was simply a loophole designed by nonresidents to avoid payment of tax, presumably the tax department could attack it on "sham transaction" or other similar grounds. Do we really need a constitutionally suspect change in the law to address that situation?

Part X: New Sales Tax Nexus Rules



The governor's new sales tax nexus rule is the resurrection of the "Grinch tax" that created much angst late last year. To recap: in early November, the tax department issued a technical services bureau memorandum that was designed to simply "clarify" the department's policy regarding nexus for some out-of-state vendors.[5] The TSB-M was aimed at Internet retailers who paid commissions to in-state companies to include online links to the Internet retailer's Web site. Those affected could come forward and start collecting by December 2007 without penalty for past noncompliance. Shortly after its issuance, the supposed new tax espoused in TSB-M-07(6)8 was widely maligned in mainstream media.[6] The new policy was dubbed the Grinch tax or the "Amazon tax" based on a belief that a new tax was being imposed on those doing Christmas shopping at amazon.com or other Internet Web sites.[7] Whatever the case, just a few days after its issuance, the TSB-M was pulled, and the governor's office indicated that it was not the right time to make that change in New York tax policy.[8]

That was then, this is now. Sorry Cindy Lou Who, but the Grinch is back! Part X of the governor's fiscal 2008-2009 budget proposes a change in the law that is very much like the policy espoused in the November 2007 TSB-M. Like the TSB-M, the proposed bill also provides a limited amnesty for the specified businesses covered by the bill that allows them to come forward and register by June 1, 2008, and also provides for relief from any taxes, penalties, or interests existing before June 1, 2008.

Like other proposals in the governor's budget, that one may also raise constitutional questions. Of course, everyone knows of the physical presence standard espoused in *Quill* and accepted by the New York Court of Appeals in *Orvis*.[9] Does amazon.com have physical presence simply because the law firm of Hodgson Russ advertises for it on its Web site? Or perhaps that can be looked at another way: What if amazon.com pays Hodgson Russ $1,000 to provide a link to the amazon.com Web site on its own Web site? Under this bill, that would constitute nexus for amazon.com. Now suppose amazon.com paid *The New York Times* $1,000 to advertise the amazon.com Web site in its paper and provided a toll-free number with the ad. Nexus? Most people would say no. Is there a constitutionally significant distinction between those two situations?

Part Y: New Economic Nexus Standard

And speaking of constitutionally suspect proposals . . .

New York is following the lead of other states in imposing some form of "economic nexus" standard, but in the proposed new economic nexus standard it is limiting the proposal to cover only some banking corporations involved in the credit card business. Under that proposal, banks that exceed very minimal revenue or customer thresholds (only 1,000 customers in New York is one of the tests) would be subject to tax under article 32 regardless of whether they have any physical presence in New York. That is a huge change in existing law as well as policy. Apparently the governor and the tax department believe that physical presence -- up to this point the standard for the imposition of New York taxes -- is not required for bank taxes. As most practitioners are aware, whether so-called economic nexus is allowed under the negative commerce clause has been one of the more widely debated and covered issues in state and local tax circles. New York is now joining in on the fun.

Part Z: New Voluntarily Disclosure Program

The proposal for a new voluntary disclosure program may be the most interesting to everyday tax practitioners. It contains provisions purportedly designed to "increase voluntary compliance with the tax law" and, in that way, is consistent with the general change in the administration's policy toward tax enforcement, particularly regarding instances of fraud and suspected criminal activity. Two aspects of that proposal are worth noting.

First, section A of the bill provides a statutory structure for a new voluntary disclosure program. As most practitioners know, the current voluntary disclosure program is not set forth under a statute. It is a policy of the tax department, and a good and useful one at that. Delinquent taxpayers can voluntarily approach the tax department and obtain limited look back for filing returns, along with the abatement of penalties and protection from criminal prosecution. That program has, by all accounts, been successful in the past in getting delinquent taxpayers into compliance. It also allows taxpayers with potentially questionable responsibility for tax to come forward in a reasonable fashion to resolve those liabilities.

The new proposal, however, may all but eliminate the voluntary disclosure program. Notably, it would require taxpayers to disclose and pay taxes and interest for *all years* to be accepted into the program**.** Presumably few taxpayers will now be able to come forward under that regime, particularly those facing years of often unintentional noncompliance. The rationale for the proposal appears consistent with the new mindset among many in New York tax enforcement circles that all noncompliant taxpayers are scofflaws who have intentionally avoided their tax responsibilities for years without fear of the consequences. But those in everyday practice know that is not the case, particularly for those taxpayers interested in making voluntary disclosures. Those taxpayers often may have uncertain liability because of potential nexus issues or taxability questions. Or they may simply have not been aware of their responsibilities for one reason or another. The current voluntary disclosure program allows them to come forward in a reasonable fashion.

Presumably the governor or the tax department believes that criminals who intentionally avoid their tax responsibilities should not be given the benefit of a limited look back. There will be no argument on that point here. And indeed, perhaps the tax department is correct in thinking that there are many taxpayers out there whose level of noncompliance rises to the willful and fraudulent level. But those criminals who have intentionally shirked their obligations for years aren't the ones looking for voluntary disclosures -- that's why they are criminals! It would be a shame if the tax department's voluntary disclosure program -- which has benefited both the state and its taxpayers for years -- is rendered nonexistent because of some bad apples who wouldn't have ever used the current program anyway.

The other notable aspect, particularly for tax practitioners, relates to fraud penalties. When fraud penalties are imposed, the bill provides that taxpayers will not be afforded the opportunity to proceed to the conciliation conference level. The rationale, apparently, is that allegations that serious require more immediate attention and resolution. But it seems a little unfair to limit the appeal rights for some taxpayers, especially those facing such serious allegations. You would think that taxpayers facing these serious allegations should be given every chance to pursue all possible appeal rights.

Part EE: Closing Other So-Called Loopholes

Finally, Part EE proposes to close two loopholes purportedly used by taxpayers to reduce or avoid sales taxes. One so-called loophole involves the commercial aircraft exemption in section 1115(a)(21) of the Tax Law. Currently, no tax is due on the purchase of an aircraft to be used in the provision of air transportation services, even if those services are provided to wholly owned affiliated companies. The acceptance of that structure has long been advocated in a series of consistent advisory opinions.[10] This bill proposes to eliminate that loophole by removing the exemption when affiliated entities are present. The other change relates to the "new resident" use tax exemption in Tax Law section 1118(2). According to the memorandum in support, New York residents are able to form new corporations or LLCs to purchase items out of state and bring them into the state free from use taxes. Again, like the new sourcing provisions discussed in Part T above, it

would seem that the tax department could attack those transactions via sham transaction principles or by other business-purpose-type attacks.

Conclusion

As you can see, the governor is doing all he can to keep tax practitioners on their toes. But none of those proposals are yet the law of the land, so stay tuned for further details.

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FOOTNOTES

[1] *See* 2008-09 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support (hereafter referred to as the memorandum in support).

[2] Tax Law section 1116(b)(1); 20 NYCRR section 529.7(i)(2).

[3] Tax Law section 605(b).

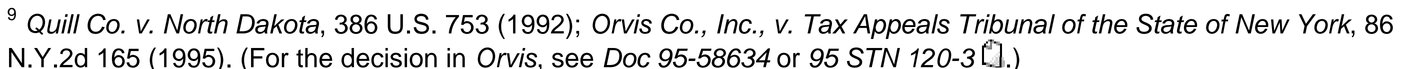
[4] Memorandum in support.

[5] *See* TSB-M-07(6)S, *Doc 2008-1753* [**PDF**].

[6] "The Grinch and the Gov," *The New York Sun*, Nov. 16, 2007; "Spitzer's Christmas Tax Surprise Aims to Collect Levies on Sales Over Internet;" *The New York Sun*, Nov. 14, 2007; "The Tax Man Grabbeth," *New York Post*, Nov. 19, 2007.

[7] *Id.*

[8] *See* TSB-M-07(6.1)S, Notice of Withdrawal of TSB-M-07(6)S; *see also* "Spitzer Abandons Amazon Tax," *The New York Sun*, Nov. 15, 2007.

[9] *Quill Co. v. North Dakota*, 386 U.S. 753 (1992); *Orvis Co., Inc., v. Tax Appeals Tribunal of the State of New York*, 86 N.Y.2d 165 (1995). (For the decision in *Orvis*, see *Doc 95-58634* or *95 STN 120-3* .)

[10] *See, e.g., Cleveland Browns Transportation LLC*, TSB-A-06(8)S; *Standard & Poors Securities Evaluations, Inc.*, TSB-A-05(15)S; *LYLIFE LLC*, TSB-A-05(38)S; *Ernst & Young*, TSB-A-05(13)S; *CB Applications*, TSB-A-00(6)S; *Ernst & Young, LLP*, TSB-A-02(47)S; *The Gap Inc.*, TSB-A-00(3)S; *Verizon Corporation Services Group, Inc.*, TSBA-05(16)S.