

2008-2009 NEW YORK STATE BUDGET

State & Local Tax Alert
June 9, 2008

On April 23, Governor David A. Paterson signed New York State's 2008-2009 budget bill into law. Despite the swift and chaotic departure of former Governor Eliot Spitzer, the State Legislature managed to adopt a budget package that preserves a number of Governor Spitzer's revenue-generating proposals and so-called "loophole closers." The initiatives were designed to bridge a projected \$4.4 billion-dollar shortfall in state revenues without directly raising taxes.

Some of the major changes to the revenue laws approved by the Legislature and Governor Paterson are highlighted below.

BUSINESS-RELATED TAXES AND FEES

"Economic Nexus" for Banks With Credit Card Customers in New York

The budget bill substantially changes the state's tax policy by imposing a new "economic presence" standard for taxing banking corporations that issue credit cards to New York residents. The amendment to Article 32 of the tax law will treat certain banks with credit card operations as "taxpayers" for the purposes of imposing corporate taxes, regardless of whether they have a physical presence in New York. Under the new rules, a bank can be deemed to be "doing business" in New York—and thus having nexus with the state—based merely on the number of credit card customers or the level of receipts from credit card transactions in New York. Effective for tax years beginning on or after January 1, 2008, a bank will be considered to be "doing business" in New York and subject to Article 32 taxes if it:

- has issued credit cards to 1,000 or more customers with New York mailing addresses during a tax year
- has 1,000 or more merchant customers within New York to whom it has issued reimbursements for credit card transactions
- has receipts of \$1 million or more from cardholders with New York mailing addresses or
- has receipts of \$1 million or more during a tax year from merchant customers in New York arising from credit card transactions.

The term "credit card" is broadly defined and includes bank, credit, travel, and entertainment cards.

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2008-2009 NEW YORK STATE BUDGET

Reduction of Capital Base Rate and Elimination of Cap on Liability

The budget legislation reduces the capital base rate for corporate franchise taxpayers required to compute their liability based on business and investment capital rather than on net income. At the same time, the budget raises the current \$1 million dollar cap on capital-base liability for non-manufacturers to \$10 million. For tax years beginning on or after January 1, 2008, the capital-base rate is reduced from .00178 to .0015 percent. Despite the beneficial lower rate, certain companies, such as financial services companies reeling from their recent downturn in profits, could be affected significantly by the much higher ceiling on capital-base liability.

Manufacturers will not be affected by the elimination of the \$1 million cap and will still enjoy a \$350,000 ceiling on capital-base liability. However, the legislation also amends the definition of manufacturer. Under the new rules, qualified energy technology companies will be considered manufacturers. In order for other taxpayers to qualify as manufacturers, the taxpayers must have manufacturing property in New York with a federal adjusted basis of at least \$1 million, or have all of their real and personal property located within New York.

Disallowance of the Federal Deduction for “Qualifying Production Activities Income”

Effective for tax years beginning on or after January 1, 2008, New York taxpayers who claim a deduction under I.R.C. § 199 for Qualifying Production Activities Income (QPAI) will have to add back such deductions when calculating their net income for New York. This applies to all types of taxpayers, including personal income tax filers, general corporations, insurance and financial corporations, and businesses and individuals subject to New York City taxes. Eighteen other states have passed similar measures decoupling themselves from the federal deduction, which allows qualifying businesses to deduct a percentage of federal income if engaged in domestic production activities. Disallowing the flow-through of the deduction is expected to result in \$56 million of additional revenue in 2009.

Mandatory First Installment

Effective for tax years beginning on or after January 1, 2009, most corporate taxpayers with a prior year tax liability in excess of \$100,000 must calculate the mandatory first installment payment of franchise tax and MTA surcharge using 30 percent (instead of 25 percent) of the prior year's liability. Taxpayers who owed between \$1,000 and \$100,000 will continue to use the 25 percent amount.

LLCs, LLPs, and S and C Corporations: Fees and Taxes

Effective for tax years beginning on or after January 1, 2008, flow-through entities will be subject to a new, uniform fee and tax structure at the entity level. Significantly, LLCs (including those that are disregarded entities for federal tax purposes) and LLPs will no longer pay a set annual fee based on the number of members. Instead, LLCs and LLPs will pay a fee based on their gross income derived from New York sources. The fee will range from \$25 for an entity with less than \$100,000 of New York income to \$4,500 for those with \$25 million or more. The measure also replaces the fixed-dollar minimum tax on S corporations and C corporations with a similar fee based on gross income. Under the new rules, LLCs, LLPs, and S and C corporations will be subject to the following rate structure:

NY Gross Income or Receipts

LLC/LLP Fee*

2008-2009 NEW YORK STATE BUDGET

S Corp — fixed dollar minimum

C Corp — fixed dollar minimum

Under \$100,000

\$25

\$25

\$25

\$100,001 to \$250,000

\$50

\$50

\$50

\$250,001 to \$500,000

\$175

\$175

\$175

\$500,001 to \$1,000,000

\$500

\$500

\$500

\$1,000,001 to \$5,000,000

\$1,500

\$1,500

\$1,500



2008-2009 NEW YORK STATE BUDGET

\$5,000,0001 to \$25,000,000

\$3,000

\$3,000

\$3,000

Over \$25,000,000

\$4,500

\$4,500

\$4,500

*Single-member LLCs will pay \$25/year.

Note that foreign corporations with a total tax liability (including the MTA surcharge) of under \$300 must raise their liability to \$300 to satisfy the maintenance fee requirement.

Modified Combined-Reporting Rules for REITs and RICs

The budget legislation also tightens the combined reporting rules for real estate investment trusts (REITs) and regulated investment companies (RICs) to prevent corporations—particularly banking corporations—from using “captive” REITs and RICs to avoid taxable income. The measure establishes a 50 percent stock ownership threshold for defining a captive REIT or RIC and requires all captive REITs and RICs to file a combined return with the closest corporation that directly or indirectly owns or controls them. This is true whether the REIT or RIC is owned by a banking corporation subject to Article 32 taxes, an insurance corporation subject to Article 33, or a general business corporation under Article 9-A. The legislation is intended to further tighten the rules already adopted in last year’s budget legislation, which required combined reporting, but left what the governor and legislators considered lingering loopholes. In addition to requiring combined reporting, the legislation eliminates dividend-deduction rules that allowed banking and insurance corporations to accumulate and distribute dividends from out-of-state REITs and RICs without paying tax at the parent level.

Empire State Film-Production Credit

The budget legislation boosts the percentage of film-production costs eligible for the Empire State film-production credit from 10 percent to 30 percent and extends the program for an additional two years. The maximum aggregate credit that can be awarded under the program was also raised from \$60 million to \$110 million over a six-year period.

Moratorium on Brownfield Cleanup Program Applications

Effective immediately, the budget legislation imposes a 90-day moratorium on new project applications in the state’s Brownfield Cleanup Program. Broader reforms, such as capping the tax credits available under the program and giving the State Department of Environmental Conservation the power to reject credits where a site was likely to be redeveloped without them, were proposed in the executive budget, but not adopted.

2008-2009 NEW YORK STATE BUDGET

Investment Tax Credit Extension

The termination date for the investment tax credit for financial services companies has been extended from October 1, 2008 to October 1, 2011.

MTA Surcharges

Currently, general business corporations, banks, insurance corporations, and certain other taxpayers pay a business tax surcharge if they do business in the Metropolitan Commuter Transportation District (MTC). The surcharge, which is imposed at 17 percent of the business's franchise tax, had been scheduled to sunset after 2009. The budget bill extends the surcharges for four more years, setting a new sunset date of December 31, 2013.

SALES TAXES

The “Amazon Tax” — Nexus for Internet Retailers and Other “Remote” Sellers

The budget bill introduces what has become commonly known as the “Amazon Tax” (or the “Grinch Tax” as it was dubbed when first debuted by Governor Spitzer in time for the 2007 holiday shopping season). Aimed predominantly at out-of-state Internet retailers, the sales tax amendment will require certain “remote” retailers to begin collecting sales tax on sales to New Yorkers that formerly would have been exempt based on the seller's lack of nexus with the State. The amendment creates a rebuttable presumption that an Internet or other retailer with no other physical connection with New York is soliciting business in New York through a representative or contractor if it compensates New York residents for referrals to its Web site.

For example, if a New York author maintains a website to promote her book and on it she offers a link to an Internet bookseller for copies of her books, the link could subject the Internet bookseller to New York sales tax liability if the author gets a commission for sales made using the link. However, the presumption of in-state nexus will not apply where the seller's gross receipts from such commission arrangements are \$10,000 or less during the preceding four quarters. For further guidance, see TSB M 08(3)S. Note that Amazon.com is challenging this new law. See *Amazon.com, LLC v. New York State Department of Taxation and Finance*. (S. Ct. NY County #08601247)

Sales by Nonprofit Organizations

The budget legislation imposes new limits on sales tax exemptions available to nonprofit and other exempt entities. Such exempt organizations had previously been required to collect sales tax only if they sold items out of a physical store they operated. The new legislation will expand the sales tax liability for exempt organizations to include:

- sales of property made by such an organization on a regular basis via the Internet, telephone, mail-order, or other remote means;
- rentals or leases of tangible personal property (where the tax exempt organization is the rentor/lessor), and
- sales of utilities and services to real property.

These new rules become effective September 1, 2008.

2008-2009 NEW YORK STATE BUDGET

Vendor Registration

Beginning November 1, 2008, the budget bill directs the Commissioner of Taxation and Finance to institute a sales tax vendor re-registration. The law imposes a \$50 fee on sales tax vendor registrations for all re-registering vendors, excluding those that remit sales tax on an annual basis. New registrations will continue to be free. The program is intended to update taxpayer information, delete obsolete registrants, and “collect new data to support the administration of the sales tax.” The re-registration program is expected to be completed by March 31, 2012.

MISCELLANEOUS PROVISIONS

Voluntary Disclosure

In an attempt to bolster tax compliance, the budget legislation creates a statutory framework for voluntary disclosure, that allows taxpayers to voluntarily approach the Tax Department to report past delinquencies and to 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.

Prior to the budget bill, the Tax Department allowed voluntary disclosure by way of policy, but had no statutory framework under which to administer it.

Voluntary Compliance Initiative (VCI)

New York is also reopening the 2005 through 2006 VCI, effective November 1, 2008, - January 31, 2009. The VCI covers tax avoidance transactions for years beginning before January 1, 2005. For listed or reportable transactions, the penalty is reduced by 50 percent. For all other tax avoidance transactions, 100 percent of the penalties will be abated.

Middle-Class STAR Rebates

The budget package includes changes to the middle-class STAR property tax relief program, a significant one of which is a delay in the planned 17 percent increase in the basic middle-class STAR benefit by one year, which is expected to save the state \$169 million. The legislation also increases from 5 percent to 10 percent the maximum potential reduction in property owners’ STAR rebates based on changes to their equalized assessments.

Increased Excise Tax on Cigarettes

The budget bill raises the state’s tax on a pack of cigarettes from \$1.50 to \$2.75 per pack, effective June 3, 2008. This \$2.75 State excise tax is in addition to New York City’s own \$1.50 per-pack tax, making the tax on cigarettes in New York City the highest in the nation. The bill also adds a new “snuff” tax of \$.96 per ounce on all smokeless tobacco products. The tax hike is expected to raise an additional \$250 million a year, more than any other single revenue measure adopted in the budget bill.

2008-2009 NEW YORK STATE BUDGET

Tax Credit for Taxicabs and Livery Services

The State extended for two more years the tax credit available to taxicab and livery companies that upgrade their vehicles to make them accessible to people with disabilities.

Mandatory Electronic Filing

The budget bill authorizes the commissioner to mandate electronic filing for certain taxpayers and preparers. Beginning with the 2008 tax year, taxpayers who do not utilize a tax preparer and who prepare their return using tax software (either their own or software hosted the Tax Department) may be required to file that return electronically. This will not apply to individual personal income tax return filers. As for professional tax preparers, a preparer who completed more than 100 returns during the 2007 calendar year or thereafter and who subsequently prepares one or more returns authorized to be e-filed using tax software, then for the current year and each succeeding year, the preparer will be required to file all tax documents electronically. Clients will still have the ability to elect not to e-file.

PROPOSALS NOT ADOPTED

Although the 2008-2009 budget legislation preserved a number of Governor Spitzer's revenue-generating initiatives, the legislation is also significant for the proposals not adopted from the ex-governor's original plan. They include the following:

- **A stamp tax on illegal drugs:** The legislature rejected Governor Spitzer's proposal to impose a tax on marijuana and controlled substances possessed by a dealer.
- **Taxing nonresidents on gains from the sale of partnership interests involving real estate:** The former Governor's plan had proposed including gains from the sale of a nonresident's partnership or similar entity interest in the nonresident's New York source income if the gain related to the transfer of real property located in New York.
- **Treating for-profit health maintenance organizations as insurance corporations for the purposes of the Article 33 premiums tax.**

Note that New York State and New York City still recognize like-kind exchanges under IRC § 1031. This is currently under review.