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NEW YORK GOVERNOR PROPOSES IMPORTANT TAX CHANGES

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In December, accelerating the usual state budget process somewhat, New York Governor Paterson released his budget proposals for the 2009–10 fiscal year (the "Budget Bill" or "Bill"), and on January 15, he released various technical amendments to the December proposals. Reflecting the need to balance a budget that has been severely wounded by the recent fiscal crisis against the governor's stated desire to avoid raising business income taxes, the Budget Bill presents an interesting amalgam of sales tax base broadeners and tax increases on wealthy individuals—in particular, nonresident hedge fund managers—without much tinkering with the corporate taxes. While many things may change between now and the ultimate enactment of legislation, scheduled as usual for April 1, the proposals made to date merit review.

SALES TAX

Affiliate Nexus. The Budget Bill would treat remote sellers as having nexus to New York based on the New York activities of their "affiliates." The Budget Bill creates two basic triggers requiring remote sellers to collect and remit sales tax:

- The remote seller uses the same trademarks, service names, or trade names as are used by a vendor in New York; or
- An affiliate engages in activities in New York that benefit the remote seller, in its development or maintenance of a market in the state, to the extent such activities are constitutionally sufficient to support nexus.

Digital Products. The Budget Bill extends the sales tax to "digital products," defined to include property and services delivered electronically into New York (provided the services are of a type otherwise subject to sales tax under current law). Certain exceptions apply for television programming and non-prewritten software.

The Bill includes rules for determining whether a digital product is delivered in New York. Vendors are to source sales based first on the location of the equipment from which the digital product is accessed by the customer or, failing that, based on the billing address, or if neither the equipment's location nor the billing address is known, by the street address of the user, provided that the use of that address is not in "bad faith." For certain sales of prewritten software, the Bill also provides that the purchaser may provide a multiple points of use certificate, on which the vendor may rely.

Bad Debts on Factored Credit Card Receivables. New York's tax law currently includes a provision allowing for the refund of sales tax where private label credit card receivables factored to third parties become uncollectible. Reasoning that even if the consumer never pays for the purchased goods, the vendor has collected at least part of the sales price from its lender, the Bill proposes to repeal this relief provision. As explained in the memorandum in support of this proposal, "The State is not a party to the terms of this lending agreement, and it should not be subsidizing the lending practices of the private label credit card issuers."

Base Broadeners. The Bill proposes a wide variety of additions to the sales tax base, including cable and satellite TV and radio services, haircuts, clothing (with some tax holiday weeks), and credit reports delivered orally. Among the high-ticket items targeted by the Bill, the state again attempts to capture tax on various transactions involving vessels, airplanes, and vehicles. The Bill also proposes an additional 5 percent sales tax on "luxury products," which is a revenue raiser resembling the 1990s-era federal excise tax on luxury goods.

The Bill also includes a rather odd provision imposing sales tax on the discounts afforded under store coupons. While billed as an attempt to treat store coupons in the same manner as manufacturers' coupons, the proposal raises obvious questions about the difference between a store coupon and other forms of discount or price reduction a retailer might offer.

Narrowed Capital Improvements Exemption. While sales tax is always imposed on the materials used in making capital improvements to real property, the tax does not apply to the labor component of such improvements. Contractors thus pay tax on their purchases of the materials, but the property owner does not pay any sales tax to its contractor on "capital improvements" to real property.

The Bill would significantly narrow this exemption. As proposed, the exemption would be available only for new construction, the construction of an addition, or the "total reconstruction" of existing real property.

Expanded Bulk Sales Exposure. Like many states, New York has a bulk sale rule under which a purchaser of a business or business assets may be held liable for the seller's unpaid sales taxes. To avoid this liability, the purchaser must provide advance notice of the sale to the state and withhold out of the purchase price the unpaid sales taxes identified by the Department of Taxation and Finance.

The Budget Bill expands this successor liability to make purchasers liable for penalty and interest, as well as the underlying unpaid tax.

CORPORATE INCOME TAX

Sourcing Income From Digital Products. For purposes of apportioning corporate income, the Bill sets forth new rules for the sourcing of receipts derived from digital products. These generally mirror the definition and sourcing rules for digital products proposed under the sales tax.

Insurance Companies. The Bill proposes a general overhaul of the state's tax on insurance companies, designed to bring New York into closer conformity with the structure of insurance taxes in other states.

The Bill also attacks the perceived loophole of "overcapitalized captive insurance companies." These companies would lose their classification as insurance companies and instead be required to file on a combined basis with their corporate parents.

Credit Reform. The Bill would repeal various "underutilized" credits and enact reforms to the Qualified Empire Zone Enterprise ("QEZE") program. In place of these incentives, the Bill places a new emphasis on credits for research activities and emerging technologies.

PERSONAL INCOME TAX

Hedge Fund Managers. The Budget Bill would recharacterize certain income earned by nonresident partners as New York source income fully taxable by New York. While apparently designed to impose New York tax on income earned by hedge fund managers from "carried interests," this provision is both extremely complex and very poorly written. In its essence, the proposal attempts to recharacterize the distributive share of partnership income of a partner who serves various management or advisory roles as income derived from New York sources and therefore fully taxable in New York; in its details, the provision is nearly impenetrable.

Perhaps the biggest concern underlying this proposal is the potential disconnect between New York's characterization of such partnership income as New York source and the disparate characterization of the same income by the partner's home state, which may well continue to treat it as a distributive share of income from intangibles. That mismatch in character quite possibly could lead to double taxation of managers' income from carried interests.

Disallowance of Itemized Deductions. Instead of directly raising personal income tax rates, the Bill raises revenue by disallowing itemized deductions for individuals with adjusted gross income exceeding $1 million. This "millionaire's" tax spares the charitable deduction but otherwise would disallow deductions for home mortgage and investment interest, local property and income taxes, and other expenses allowed federally as itemized deductions.

FIRPTA Comes to New York. While nonresidents selling a direct interest in New York real property are subject to tax on that New York source income, the sale of stock or a partnership interest currently is classified as income from an intangible and not taxable in New York. The Bill would change that, by treating sales of interests in LLCs and other entities classified as partnerships, in S corporations, and in certain C corporations as producing New York source income. This new sourcing rule would apply where the value of the real estate is 50 percent or more of the entity's total asset value, the latter being measured by reference to assets held at least two years, to avoid "stuffing." Oddly, once the provision is triggered, the gain on sale is allocated to New York based on the relative values of the entity's assets, not the relative amounts of built-in gain.

VOLUNTARY DISCLOSURE AND COMPLIANCE

New York has been promoting its new Voluntary Disclosure Program as offering increased protections to taxpayers who voluntarily report their noncompliance and step forward to pay their unpaid New York State taxes. The Budget Bill now makes clear what may be the case in any event: New York will share information regarding voluntary disclosures with the IRS and other taxing authorities.

The Bill also includes a new "whistleblower" provision, authorizing the state to pay awards to persons who report information that leads to the detection of substantial underpayments or to criminal prosecution for tax crimes.

NEW YORK CITY CHIMES IN

In his State of the City Address delivered January 15, Mayor Bloomberg spoke of changes to the city's tax laws that could have potentially significant consequences for corporate taxpayers. Stating that "[i]t's time to align our tax laws with those in other states, close loopholes, and end unnecessary tax burdens that can stifle the creation of new jobs," the mayor mentioned reforming the unincorporated business tax, as well as changing "tax policies that discourage local job creation"—quite possibly signaling a move to single-factor, receipts-based apportionment.

AND DON'T FORGET THE FEDS!

With a new President and Congress and an economy in crisis, changes to the federal tax laws are in the wind as well. Jones Day's tax lawyers are following these developments and will alert you to important federal changes, and to their state and local tax side effects as well.

WAIT! THERE'S MORE

The foregoing provides an overview of proposals that are likely to be of broad interest. There are other, more narrowly targeted provisions in New York State's Budget Bill, as well as various technical changes to the tax law, and the federal and city changes are still being developed. The application of any of these proposals to specific situations requires analysis of the specific statutory language and, of course, the relevant facts. If you have any questions or would like further information on these proposals, please let us know.

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