New York State Bar Association

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NYSBA

August 25, 1999

The Honorable Arthur J. Roth
Commissioner
New York State Department of Taxation and Finance
W.A. Harriman Campus, Building 9
Albany, NY 12227

Re: Commuter Tax Repeal

Dear Commissioner Roth:

As you know, the recent repeal of part of the New York City Nonresident Earnings Tax (the "Commuter Tax") has given rise to a variety of legal challenges, as well as certain administrative issues concerning the application of the tax. We do not have any comment on the legal issues that are currently in litigation. We are however concerned that the outcome of this litigation could affect large numbers of New York taxpayers, and create considerable confusion for the 1999, and possibly 2000, filing seasons. Moreover, as a practical matter it is likely that the amounts involved for any one taxpayer will be rather small, making it particularly burdensome for the affected individuals to ascertain the proper application of the amendments to the Commuter Tax.

For these reasons, we believe it is incumbent upon the Department to plan for the different possible outcomes of the current litigation, and develop and disseminate simple instructions that will implement the ultimate judicial determination. As discussed below, if the resolution of the questions in litigation differs from the Department's current interpretation, there will be hundreds of thousands of individual taxpayers who either are owed refunds, or owe additional tax. These individuals will need to be apprised of their rights and responsibilities. The best way to do that, and to achieve the proper filings, is for the Department to take the initiative to contact the affected individuals, provide them with guidance enabling them to compute their correct income tax liabilities, and ensure that any refunds or deficiencies are processed in the most efficient and fair manner.

In our view the current situation is without precedent, involving as it does the taxation of a great number of individuals under legislation that has been held to be unconstitutional. While we understand the State's right and obligation to defend the 1999 legislation, we also believe that, should the State not ultimately prevail in its litigating positions, it will bear a particular obligation to notify the affected individuals, and facilitate their compliance with the law. That responsibility, in turn, will fall to your Department, and for that reason we are writing to convey to you our proposal for a mechanism that will ensure the efficient administration of corrections in individuals' income tax filings, should that become necessary. Because we are now at the point in time where your Department is preparing the 1999 forms, and preparing for the 1999 filing season, we believe it is helpful to offer our suggestions now, rather than waiting for the outcome of the pending litigation.

Background. For several decades New York City imposed a tax on wages and self-employment income earned in the City by individuals who did not reside in the City. This tax ("the "Commuter Tax") is currently imposed at 0.45% of wages and 0.65% of self-employment income. In May of this year the New York Legislature enacted, and Governor Pataki signed, legislation repealing the New York City Commuter Tax as applied to individuals residing in New York State. (S.5594--B, amending Tax Law Article 30 and General City Law Article 2-E (the "May legislation".) The May legislation amended the Commuter Tax by redefining a "nonresident" of New York City to include only persons who also are nonresidents of New York State.

The May legislation had an effective date of July 1, 1999. From that date, therefore, the statutory structure of the taxation of individuals earning income within New York City is as follows:

(a) Individuals residing in New York City pay State income tax and City resident income tax;

(b) Individuals residing outside the City but within the State pay State income tax; and

(c) Individuals residing outside New York State pay State income tax and the Commuter Tax.

The May legislation provided that, should it be finally determined that the continued imposition of the Commuter Tax only on nonresidents of New York State is unconstitutional, then the Commuter Tax will be fully repealed, also effective July 1, 1999. (S.5594--B, section 9, subsection 2.) From the inception of the partial repeal of the Commuter Tax significant doubts had been raised as to the constitutionality of imposing a higher rate of income tax on individuals who reside out-of-state; section 9 of the bill addressed that possible infirmity by clearly spelling out that the consequence of such a determination would be the full repeal of the Commuter Tax.

Shortly after the enactment of the partial repeal legislation, a number of lawsuits were filed challenging the continued application of the Commuter Tax to individuals resident in New Jersey, Connecticut, and other states. Members of our Executive Committee are involved in that litigation, as are the States of New Jersey and Connecticut, which filed suits challenging the taxation of their residents. These "nonresident suits" generally allege that the May legislation violated the Privileges and Immunities Clause, the Equal Protection Clause, the Due Process Clause, and the Commerce Clause of the United States Constitution, as well as comparable provisions of the New York State Constitution, by discriminating against nonresidents of New York and subjecting them to a higher rate of tax. In a decision rendered on June 28, 1999, Justice Barry A. Cozier of the New York Supreme Court agreed with the plaintiffs in the nonresident suits, and held that the Commuter Tax as amended was unconstitutional. That decision is currently on appeal to the Appellate Division, First Department, with oral argument scheduled for the week of September 7, 1999. We understand that it is possible the Appellate Division's decision will eventually be further appealed to the Court of Appeals.

The nonresident suits assert that the State is barred from imposing the Commuter Tax on nonresidents. However, New York City also has challenged the partial repeal of the Commuter Tax, asserting that the repeal legislation was enacted in violation of the State Constitution, specifically the Home Rule provisions. The City suit asserts that the enactment of the May legislation was invalid, and the partial repeal therefore is without effect. Under the City's position, the Commuter Tax continues to apply to all persons working and not residing in the City, whether resident in New York State or in other States. In the June 28 decision it was held that the enactment of the May legislation did not violate the Home Rule provisions. The Supreme Court

therefore held that the May legislation was effective, and had the effect of repealing the Commuter Tax in its entirety. The City has appealed this decision, and its case is consolidated with the State's appeal of the Supreme Court's decision in the nonresident suits.

Following the enactment of the May legislation, and again after the Supreme Court decision in June, the Department of Taxation and Finance issued "Important Notices" informing employers of their withholding responsibilities. In its June 1, 1999 Notice, the Department advised employers to cease withholding Commuter Tax from commuters residing in New York State effective July 1, and provided an exemption certificate State residents could use to claim exemption from the Commuter Tax. In addition, the Department advised employers to continue withholding Commuter Tax from individuals who worked in the City and lived out-of-state. In its June 30 Notice the Department advised that, while its appeal of the Supreme Court ruling is pending, and in light of the Court's failure to enjoin collection of the tax, employers should continue to withhold Commuter Tax from nonresident commuters.

In accordance with the Department's instructions, therefore, after July 1, 1999, commuters residing in New York State would no longer have had Commuter Tax withheld from their wages, while commuters residing out-of-state would have continued to have the tax withheld. Assuming that self-employed individuals follow this same procedure with their September 15 and subsequent estimated tax payments, those commuters resident in the State will not include Commuter Tax in their estimated tax payments, while out-of-state commuters will.

The current withholding regime is consistent with the terms of the May legislation, and conforms to the State's litigating positions. If the State prevails in the current litigation this regime produces the correct result -- collection of Commuter Tax only from nonresident commuters. However, if the State loses either aspect of the lawsuits currently pending, the current withholding/estimated tax regime will result either in overcollection of income tax from nonresidents, or in undercollection of tax from residents. Either of those possible outcomes would affect the tax filings of hundreds of thousands of individual New York taxpayers, requiring refunds of over-withheld tax to nonresidents or, alternatively, requiring additional tax payments from under-withheld residents. The administrative morass engendered by either of these

possible situations could well be considerable. For that reason, we are writing to encourage the Department to develop contingency plans, and to suggest procedures that will facilitate proper tax filings should the ultimate outcome of the litigation not uphold the State's current positions.

Current Considerations. As discussed above, there are three possible outcomes:

(a) The State may prevail on all points, in which case the filings and withholdings made in accordance with the Department's instructions will be correct.

(b) The State may lose the City's lawsuit, in which case New York residents would continue to owe Commuter Tax and would, if the State's announced procedures had been followed, be under-withheld.

(c) The State may prevail over the City but lose the nonresident suits (as it did in June), in which case nonresidents would have overpaid their 1999, and possibly 2000, New York income tax.

In scenario (b) New York residents will owe additional tax. In scenario (c) nonresidents will be owed refunds. As a matter of tax administration, should either scenario (b) or (c) come to pass, we believe it is critical that the affected individuals be provided with accurate information promptly, to facilitate the resolution of their 1999 tax obligations with their 1999 tax returns if at all possible. Furthermore, if individuals are underwithheld as a result of scenario (b), clearly they should not be subject to penalties. Finally, if individuals are entitled to refunds as a result of scenario (c), the mechanisms for computing and claiming such refunds should be as clear and simple as possible. These three basic views underlie the proposal set forth below. Before addressing that proposal, however, it is useful to review the considerations that have shaped it.

First, we recognize that it is unlikely the Department will take any further action to change withholding, or to advise individual taxpayers of potential over- or under-withholding, prior to the final resolution of the pending lawsuits. We understand that the very large number of individuals affected by the current

uncertainties, as well as the cumbersome nature of effecting wholesale changes to payroll and withholding programming throughout the State, weigh in favor of retaining the current regime until there is a final resolution of the various challenges to the May legislation.

Second, at this point it appears possible that a final judicial resolution of the issues raised by the May legislation could be achieved prior to the end of this calendar year. Judicial consideration of the challenges to the May legislation has proceeded quite rapidly thus far, no doubt reflecting the significance of the issue to the City and the three States involved in the litigation. Certainly it would be helpful to achieve a resolution of the litigation prior to the end of the year, or even by the end of January, 2000 (when most individuals receive their W-2's, and are therefore able to file their 1999 tax returns). This would enable informed individuals to file their 1999 returns in conformity with the ultimate resolution of the open issues, and would mitigate the extent to which individuals might later need to claim refunds, or the State might later need to pursue collections. If there is a resolution of the pending litigation in time to be reflected in 1999 tax returns, then any underpayment of Commuter Tax could be reported and paid with the 1999 IT-201's and NYC-203's filed by New York residents, and any overpayment of Commuter Tax likewise could be reported and claimed with nonresidents' filings of their 1999 IT-203's and NYC-203's. Coordinating the resolution of the Commuter Tax challenges with the 1999 filing season would eliminate a great deal of confusion and paperwork, because taxpayers would be able to combine the proper reporting of their Commuter Tax obligations with the tax returns they otherwise are required to file to report their (much larger) New York State income taxes.

However, neither you nor we control the pace of the ongoing litigation. Therefore, while we may agree that it would be easier to accommodate a resolution that is achieved prior to the 1999 filing season, we also must recognize that this may not come to pass. Accordingly, it is necessary to consider the possibility that individuals will file their 1999 tax returns in accordance with the current interpretations announced by the Department, but may thereafter have to amend their filings either to pay additional tax, or to claim a refund. It also is possible, particularly if the Appellate Division and/or the Court of Appeals affirms Justice Cozier's decision but a further appeal remains pending, that nonresidents may file 1999 tax returns claiming that the Commuter Tax does not apply to period after June 30. Such filers may not pay the disputed Commuter

Tax at all, or may claim refunds based in whole or in part on an asserted overpayment of Commuter Tax.

A third consideration that affects our proposal is the mechanics of computing an individual's Commuter Tax liability should the current reporting regime prove to be inconsistent with the final outcome of the pending litigation. The most complicating element here is the fact that the May legislation repealed the Commuter Tax as of the middle of a tax year (July 1, 1999). Because of this mid-year effective date, a nonresident commuter for whom the Commuter Tax continued to be withheld after July 1, 1999, may not be able to ascertain from his or her W-2 the amount of Commuter Tax that is attributable to the period after July 1. By the same token, the Department may not be able to ascertain from the W-2 or K-1 of a New York resident the amount of post-June 30 income that is attributable to New York City earnings. Whatever the outcome of the current lawsuits, some group of people will need to know the allocation of their New York City earnings before and after June 30. However, the current reporting regime does not clearly advise employers and partnerships of the need to preserve this information for all classes of commuters.[1]

Proposal. We believe it is imperative that the Department develop a contingency plan now that addresses the possible alternative outcomes of the pending Commuter Tax litigation. The large numbers of affected New York employers, the even larger numbers of affected individual taxpayers, the unattractive genesis of the confusion (which we do not attribute to the Department), and basic issues of fairness, all require that the Department proceed proactively to anticipate possible outcomes, and to facilitate proper tax compliance at the least possible cost.

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[1] Partnerships with resident commuters may "rule off their books" at June 30, or otherwise prorate partnership income to enable their resident commuter partners to implement the June 30 cut-off of the Commuter Tax in accordance with the Department's announcements; this kind of accounting convention should also serve to inform the nonresident commuters of their post-June 30 share of the partnership's 1999 income. Outside of these situations, however, employers whose payroll accounting followed the Department's Notices, and for whom the income allocations for one employee will not necessarily affect the allocations of any other, may have no reason to record the pre- and post-June 30 allocation of 1999 income.

As soon as there is a final judicial determination of the challenges to the partial Commuter Tax repeal, the Department should immediately notify the affected taxpayers of that outcome. Obviously this will include the New York employers who received copies of the Department's two prior Notices. In addition, the Department will need to notify the affected taxpayers of the ultimate outcome, and of any resulting change in their Commuter Tax obligations. The Department is in the best position to identify the recipients of these mailings; what is important is that the Department act as promptly as possible to provide accurate information to the affected individuals, bearing in mind that each of the City, the State of New Jersey, and the State of Connecticut will also likely be motivated to provide a description of the determination to their residents and taxpayers.

Along with notification of the particulars of the judicial determination, the State should also provide the proper form for reporting Commuter Tax liability, consistent with the ultimate outcome of the Commuter Tax litigation. While it seems possible to design the NYC 203 Nonresident Earnings Tax Return Form to cover all three possible outcomes, that may result in a rather confusing set of instructions, If the Department chooses to disseminate, with the mailings of the 1999 tax return forms, a Form NYC 203 that reflects only the State's current interpretations of the May legislation, and if the ultimate judicial determinations differ from those interpretations, we believe it will be necessary to mail Revised Forms NYC 203 to affected taxpayers.

We recommend that, as part of the current process of designing the 1999 tax returns, the Department either develop a Form NYC 203 that clearly covers all three possible outcomes of the litigation, or design two additional alternative Forms for possible future mailing should that be necessary. One alternative Form would enable New York residents to report their Commuter Tax liability for the full calendar year, should the May legislation be held to have been invalidly enacted. Another alternative Form NYC 203 would enable nonresident commuters to report their Commuter Tax liability through only June 30, 1999, should they prevail in the nonresident suits.

Because it is possible that the ultimate determination of the Commuter Tax litigation may not occur until after individual commuters have filed their 1999 tax returns, we also believe that the alternative revised Forms NYC 203 should be designed to function on a stand-alone basis as either supplemental tax returns, or claims for refund. Thus, taxpayers could use the

form not only to compute the correct amount of Commuter Tax due, based on the ultimate outcome of the litigation, but also to report and pay underpaid tax, or claim refunds of overpaid tax. This would obviate the need for separate filings of additional tax return forms, and simplify corrected compliance with the Commuter Tax.

In addition to the foregoing taxpayer-directed information, the Department also should take the initiative to communicate with employers and partnerships now (as they have already twice done), to alert them to the fact that their employees and partners have a need to obtain information as to the amount of their New York City earnings for periods before and after July 1, 1999. While that information is still current it probably can easily be captured and preserved. Employers will be asked to provide these breakdowns for some group of taxpayers whatever the outcome of the current lawsuits,[2] and they may be more receptive to those requests if they understand why the information is being requested at some later time, and if they have been notified on a contemporaneous basis of the importance of preserving these records.

Finally, underpayments of tax generally incur interest, and can give rise to penalties. If the City successfully challenges the partial repeal of the Commuter Tax (scenario (b)), the Department may wish to consider its authority to abate such interest or penalty. Alternatively, the Department may wish to seek legislation that abates interest and penalty on underpayments of Commuter Tax, where the underpayment resulted from compliance with the Department's interpretation of the May legislation. We would support your efforts to abate penalties in this scenario, as we believe the imposition of penalties in this context would be highly inappropriate. Even if the Department ultimately prevails (scenario (a)), it may be appropriate to abate penalties where taxpayers acted in reliance on a favorable (but later reversed) decision of the Appellate Division or the Court of Appeals; at this stage in the proceedings, however, we have not formed an opinion on that question. Finally it may be appropriate to absolve individuals of interest charges, if they promptly respond to notification of an underpayment of Commuter Tax, although at this point this question also may be premature.

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[2] Even if the State's interpretation prevails, it appears that resident commuters will need to know their January - June wages/self-employment income to complete the NYC-203.

Conclusion. We understand that there are more than 700,000 individuals covered by the Commuter Tax. There are also a very large number of New York employers affected by the outcome of the litigation. While the administrative maze resulting from the May legislation is not the creation of the Department, it is nonetheless incumbent on the Department to be prepared to respond to the judicial resolution of the Commuter Tax issues in a manner that treats taxpayers fairly. We do not think it is sufficient simply to announce that affected taxpayers owe tax, or are entitled to claim refunds. We believe our proposal, or some similar initiative, is the appropriate response for New York State to make. As always, the Tax Section would be happy to work with the Department in bringing this matter to a conclusion.

Very truly yours,

Harold R. Handler
Chair

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