March 4, 2019

The Honorable Andrew M. Cuomo
Governor of New York State
NYS State Capitol Building
Albany, NY 12224

Re: Report No. 1413 – Comments on 2019-2020 New York State Executive Budget

Dear Governor Cuomo:

I am submitting herewith for your consideration materials developed by the New York State Bar Association’s Tax Section, relating to the above-referenced issue.

Thank you for your attention to this matter.

Sincerely,

Ronald F. Kennedy

cc:

Michael Schmidt
Acting Commissioner
New York State Department of Taxation and Finance
W.A. Harriman Campus
Albany, NY 12227

Nonie Manion
Executive Deputy Commissioner
New York State Department of Taxation and Finance
W.A. Harriman Campus
Albany, NY 12227
Eric Mostert  
Chief Fiscal Officer  
New York State Department of Taxation and Finance  
W.A. Harriman Campus  
Albany, NY 12227

Amanda Hiller  
Deputy Commissioner, Counsel  
New York State Department of Taxation and Finance  
W.A. Harriman Campus  
Albany, NY 12227

Christopher Curtis  
State Treasurer  
New York State Department of Taxation and Finance  
W.A. Harriman Campus  
Albany, NY 12227

Scott Palladino  
Deputy Commissioner, Tax Policy Analysis  
New York State Department of Taxation and Finance  
W.A. Harriman Campus  
Albany, NY 12227

Deborah Liebman  
Deputy Counsel  
New York State Department of Taxation and Finance  
W.A. Harriman Campus  
Albany, NY 12227

Liz Krueger  
Chair, Finance Committee  
New York State Senate  
NYS State Capitol Building  
Albany, NY 12247

Helene E. Weinstein  
Chair, Ways and Means Committee  
New York State Assembly  
923 Legislative Office Building  
Albany, NY 12248
Ronald F. Kennedy  
Director of Governmental Relations  
New York State Bar Association  
One Elk Street  
Albany, NY 12207

Re:  Report No. 1413 – Comments on 2019-2020 New York State Executive Budget

Dear Mr. Kennedy:

I am pleased to submit this Report of the Tax Section of the New York State Bar Association commenting on the 2019-2020 New York State Executive Budget.

The Report focuses on certain technical, administrative and conceptual issues raised by selected provisions of the Budget Bill with reference to the New York Tax Law and the New York City Administrative Code and identifies aspects we think should be clarified or reconsidered prior to adoption by the Legislature.
We appreciate consideration of our Report. If there are any questions or comments, we will be glad to discuss and assist in any way.

Respectfully submitted,

[Signature]

Deborah L. Paul
Chair

Enclosure
New York State Bar Association
Tax Section
Comments on 2019-2020 New York State Executive Budget

Introduction

This report on selected tax provisions of the 2019-2020 New York State Executive Budget (the “Budget Bill”) was prepared by the Tax Section of the New York State Bar Association. It focuses on certain technical, administrative and conceptual issues raised by selected provisions of the Budget Bill with reference to the New York Tax Law (the “Tax Law”) and the New York City Administrative Code (the “Code”) and identifies aspects we think should be clarified or reconsidered prior to adoption by the Legislature.

This report offers comments and recommendations on the following parts of the Budget Bill:

- Part C: Provide a Sourcing Rule for Global Intangible Low-Taxed Income (“GILTI”) Apportionment
- Part D: Decouple from Internal Revenue Code (“IRC”) Federal Basis for NYS Manufacturing Test
- Part F: Extend the Three-Year Gift Addback Rule
- Part G: Eliminate Internet Tax Advantage

The principal drafters of this report were: Jack Trachtenberg, Jennifer S. White, Megan L. Brackney, Paul R. Comeau, Maria Eberle, Joshua E. Gewolb, Jeremy P. Gove, Elizabeth Kessenides, Lindsay M. LaCava, Dennis Rimkunas, Irwin M. Slomka. Helpful comments were received from Kim Blanchard, Austin Bramwell, Robert Cassanos, Jeremy P. Gove, Alan S. Halperin, Stephen B. Land, Deborah L. Paul, Arthur R. Rosen, Michael Schler, and Gordon E. Warnke. This report reflects solely the views of the Tax Section and not those of its individual members, the NYSBA Executive Committee or House of Delegates, or any other party.
Part O: Permanently Extend the Tax Shelter Provisions and Update Tax Preparer Penalties

Part X: Exclude from Entire Net Income Certain Contributions to the Capital of a Corporation

Part Y: Close the Carried Interest Loophole

Part Z: Make Technical Corrections to Various Provisions of the Tax Law and the Code

Part VV: Enact the Cannabis Regulation and Taxation Act

Discussion

I. Part C: Provide a Sourcing Rule for GILTI Apportionment

A. Current Law

Under Article 9-A of the Tax Law, a corporation’s business income is defined as its entire net income minus investment income and “other exempt income.”\(^2\) For a corporation other than a foreign corporation, the computation of entire net income starts with federal taxable income, with certain adjustments not relevant to this discussion.\(^3\)

A corporation apportions its business income to New York State using a single apportionment factor that is composed of prescribed receipts, net income, net gains, and other items of income or gain included in business income, with the portion attributable to New York

\(^2\) Tax Law § 208.8.
\(^3\) *Id.* at § 208.9.
based generally on customer-based sourcing.\textsuperscript{4} Similar rules apply under the New York City business corporation tax.\textsuperscript{5}

\textbf{B. Proposed Changes}

Part C, Section 1 of the Budget Bill would add a new category of receipts for inclusion in the apportionment factor, denominated “net global intangible low-taxed income” (“net GILTI”). Net GILTI is defined as global intangible low-taxed income included in federal gross income pursuant to IRC § 951A (“GILTI”), less the allowable IRC § 250(a)(1)(B)(i) deduction. The proposal would include net GILTI in the apportionment factor by including this net amount in the denominator of the fraction but no portion of GILTI in the numerator. The proposal is predicated on the assumption that the stock of the controlled foreign corporation (“CFC”) that generates GILTI is business capital, and thus the amount of a corporation’s net GILTI from that CFC is includable in the corporation’s business income. It would apply to taxable years beginning on or after January 1, 2018.\textsuperscript{6}

\textbf{C. Comments}

We begin by noting that New York has multiple options for addressing GILTI under Article 9-A, including, but not limited to: (i) decoupling from the IRC, and therefore excluding net GILTI from the taxable income base; (ii) including net GILTI in the taxable income base, but not in the apportionment factor; (iii) including net GILTI in the taxable income base and the apportionment factor, as the Budget Bill proposes, by including net GILTI in the denominator, but not the numerator of the apportionment factor; or (iv) including net GILTI (or some other amount) in the

\textsuperscript{4} Tax Law § 210-A.
\textsuperscript{5} New York City Admin. Code, Subch. 3-A.
\textsuperscript{6} Part C, Section 2 of the Budget Bill would also apply to the New York City business corporation tax. Our comments apply equally to that section.
taxable income base, and including the gross receipts of the CFC that generated the net GILTI (or other amount) in the apportionment factor as if the CFC generating the GILTI were a domestic affiliate. At this time, we take no position as to New York coupling or decoupling from the IRC in respect of GILTI but rather assume, for purposes of this Report, that New York does not decouple. As well, on the assumption that New York does not decouple, at this time, we neither

---

7 Presumably, if gross receipts are used in the apportionment factor, only those gross receipts relating to the income included in the taxable income base should be so included. For example, in Case1(C) discussed in the text below, all gross receipts giving rise to GILT are included in the apportionment factor because gross (rather than net) GILT is included in the taxable income base. Even in Case 1(C), however, if there were net deemed tangible income return under IRC § 951A((b)(2) (“NDTIR”) that reduced the gross GILT inclusion, arguably the portion of the gross receipts attributable to that NDTIR should be excluded from the apportionment factor or NDTIR should be added back to the taxable income base.

8 In April 2018 the Legislature passed legislation to address some provisions of the Tax Cuts and Jobs Act of 2017 (the “TCJA”). The legislation did not address GILT. As a result, because the computation of entire net income under Article 9-A starts with federal taxable income, both GILT and the 50% GILT deduction are includable in the computation of a corporation’s entire net income. Such income is presumably business income under Article 9-A if the stock of the CFC that generates GILT constitutes business capital. In June 2018, legislation to decouple from the federal treatment of GILT was introduced and passed in the New York State Senate. The legislation, however, did not pass in the New York State Assembly. As such, GILT remains includable in the computation of a corporation’s entire net income. We note that a few states (e.g., Georgia and South Carolina) have enacted legislation to decouple from GILT altogether. Other states (e.g., Connecticut, Illinois, Kentucky, Michigan, North Dakota, and Oklahoma) have administratively determined that they will treat GILT in the same manner that they treat Subpart F income and, therefore, in those states, it is treated as dividend income eligible for full or partial state dividend received deductions. New Jersey, on the other hand, has issued administrative guidance under which GILT will not be treated as a foreign dividend or deemed dividend income, and instead provides for a direct allocation of GILT based generally on the state’s share of GDP over GDP in all states with which the taxpayer has economic nexus. We note that under New York’s pre-2015 corporate tax regime, the New York State Department of Taxation and Finance took the position that Subpart F income qualified as dividends, thus qualifying under Article 9-A for either full exclusion from the tax base as a dividend from subsidiary capital or a partial exclusion pursuant to the 50% deduction allowed for dividends received from entities owned 50% or less by the shareholder. See, e.g., Advisory Opinion, American International Group, Inc., TSB-A-87(23.1)C, TSB-A-88(7.1)C (N.Y.S. Dep’t of Taxation & Fin., Nov. 2, 1992).
object to, nor endorse, the Budget Bill’s approach, but rather seek to highlight issues that we believe may merit continued study. Further, we take no position on any constitutional issues that may be raised in connection with New York’s approach to GILTI. We would be open to providing a report on the above issues.

The initial key question then is, on what basis should New York, which employs customer-based apportionment under Article 9-A, include GILTI in the computation of the apportionment factor, which is used to apportion all of a corporation’s business income? We agree with the underlying principle in the Budget Bill that if GILTI is to be includable in a corporation’s business income under Article 9-A, it should be reflected in the corporation’s apportionment factor in some manner in order to properly reflect the corporation’s business income and capital. The Budget Bill proposes to include 100% of GILTI (net of the IRC § 250 deduction) in the denominator of the apportionment fraction, but zero in the numerator of the fraction. This appears to be based on the view that GILTI constitutes foreign source income, and therefore no portion of it should be included in the numerator of the fraction.

For tax years beginning after 2014, New York shifted to a market-based apportionment approach. The Budget Bill’s approach to factor representation of GILTI, however, could be considered inconsistent with the principles upon which market-based apportionment is based. If a CFC were, instead, a domestic entity included in the taxpayer’s Article 9-A combined return, the apportionment would take into account the entity’s New York receipts, and the denominator would include all of the entity’s relevant business receipts. Including “net GILTI” in the denominator is a very different approach from including all of the receipts related to the generation of GILTI. The example below indicates the potentially substantial difference in a corporation’s New York tax liability if net GILTI is included in the allocation factor, as compared to the CFC’s receipts.
Example 1: Assume that a corporation subject to Article 9-A has the following items of income and receipts:

- $1,000,000 of business income on total business receipts of $10,000,000. Under the relevant customer sourcing apportionment rules, assume that 50% of the receipts are attributable to customers in New York and are includable in the numerator of the apportionment factor, while the entire $10,000,000 would be included in the denominator; and
- $1,000,000 of gross GILTI (before the IRC § 250 deduction), associated with $10,000,000 of receipts attributable to non-New York customers, and $500,000 of net GILTI.

Case 1(A) - Taxing GILTI Consistent with the Budget Bill’s Proposal: Under the Budget Bill’s proposal, the total income included in the corporation’s business income, before apportionment, is $1,500,000 ($1,000,000 plus net GILTI of $500,000). The apportionment factor would be computed by including $5,000,000 in the numerator (50% of $10,000,000) and $10,500,000 in the denominator, resulting in an apportionment factor of 47.62% and apportioned business income to NYS of $714,286.

Case 1(B) – Removing GILTI from the Apportionment Factor: If GILTI, although included in the tax base, were not included in the denominator of the receipts factor, the apportionment factor would be computed by including $5,000,000 in the numerator and $10,000,000 in the denominator, resulting in an apportionment factor of 50% and an apportioned business income of $750,000. This would result in greater taxable income in NYS, as compared to the Budget Bill proposal.
Case 1(C) – Including the CFC’s Receipts in the Apportionment Factor: Had the CFC that generated the GILTI been a domestic affiliate, with full inclusion of the entity’s receipts in the apportionment factor denominator, the result could be dramatically different than the results under the Budget Bill proposal. While the total income included in the corporation’s business income, before apportionment, would arguably be $2,000,000 (because there would be no Section 250 deduction if this were earned by a domestic corporation), the apportionment factor would be computed by including $5,000,000 in the numerator and $20,000,000 in the denominator. Accordingly, there would be an apportionment factor of 25% and apportioned business income of $500,000. This assumes, though, that none of the CFC’s gross receipts would have been apportioned to NYS; to the extent the CFC’s customers were in NYS, the result would differ.

This example illustrates that the inclusion of net GILTI in the denominator offers some factor representation relief but potentially much less than if inclusion of the CFC’s factors were allowed, as would be the case if the CFC had been a domestic subsidiary. This impact is most evident where the CFC does not have receipts attributable to New York customers. If the CFC did have such receipts attributable to NY customers, they should be included in the numerator of the apportionment factor, which could ultimately result in a larger tax liability than including just net GILTI. However, such approach, again, would be consistent with inclusion of a domestic subsidiary.

Example 1 compares the results of the Budget Bill’s proposal to a full look-through approach. However, it is also worth comparing the results of the Budget Bill approach to an approach whereby New York State decouples from the federal tax rules and excludes GILTI altogether. The following example goes to this point:
Example 2: Take the same facts as above, but also assume that the corporation in the example has $1,000,000 of other income from domestic sources. In addition, assume none of the items relating to this $1,000,000 of other income are includible in either the numerator or the denominator of the apportionment factor because such income represents dividends and net gains from sales of stock:

Case 2(A) - Decoupling from GILTI: If New York decoupled from the federal GILTI provisions, the corporation’s apportionment factor would be: $5,000,000/$10,000,000, or 50%. The taxpayer in this example has $2,000,000 of domestic taxable income, and half ($1,000,000) would be apportioned to New York. GILTI would not be taxed.

Case 2(B) - Taxing GILTI Consistent with the Budget Bill’s Proposal: As described in Case 1(A) above, under the Budget Bill, net GILTI is included in the denominator of the apportionment factor. This means the corporation’s apportionment factor becomes $5,000,000/$10,500,000 or 47.62%. Applying this apportionment factor to the corporation’s total business income of $2,500,000 ($1,000,000 of domestic business income, plus $1,000,000 of dividends and net gains from sales of stock, plus $500,000 of net GILTI) results in $1,190,476 being taxable in NYS.

Effectively, $190,476 of incremental income is being taxed in NYS, as compared to decoupling from the federal rules.

Under the facts in this Case 2(B), the amount of incremental income subject to NYS tax increases as the net GILTI increases. For example, if the corporation’s net GILTI were $1,500,000 rather than $500,000, the corporation’s income subject to NYS tax would increase from $1,190,476 to $1,521,739.
The Budget Bill proposes an approach which appears to make certain assumptions. The first assumption is that net GILTI is a unique and special category of income in and of itself, and should be reflected in the apportionment factor, but without looking through to where the CFC’s own income is earned using a market-based approach. In some respects, the Budget Bill’s approach is taxpayer-favorable. While only net GILTI is included in the denominator, 100% of the income is considered not to be derived from New York sources (i.e., it is excluded from the numerator). On the other hand, the Budget Bill’s approach is generally less taxpayer-favorable than decoupling.

The Budget Bill proposal seemingly attempts to apply a “rough justice” approach. We do believe there are major challenges with this approach. Apart from the potential distortions noted above, the fact that the states are taking altogether different approaches from one another to GILTI could lead to distortive results overall.

Further, we acknowledge that, as with the other sourcing rules included in Article 9-A, there is unlikely to be a single methodology that will result in the fair apportionment of income to New York for all taxpayers. To account for this systematic reality, the Tax Law provides that the Commissioner may require, and that taxpayers may request, an alternative apportionment method in limited circumstances. Specifically, N.Y. Tax Law § 210-A states that

\[
\text{[i]f it shall appear that the apportionment fraction… does not result in a proper reflection of the taxpayer's business income or capital within the state, the commissioner is authorized in his or her discretion to adjust it, or the taxpayer may request that the commissioner adjust it, by (a) excluding one or more items in such determination, (b) including one or more other items in such determination, or (c) any other similar or different method calculated to effect a fair and proper apportionment of the business income and capital reasonably attributed to the state. The party seeking the adjustment shall bear the burden of proof to demonstrate that the apportionment fraction determined pursuant to this section does not result in a proper reflection of the taxpayer's business
}\]
income or capital within the state and that the proposed adjustment is appropriate.

This alternative apportionment provision remains available to address any potential distortive effects of the Budget Bill proposal on a taxpayer’s business income and business capital.

If the Budget Bill’s proposal is adopted, one could argue that the New York State Department of Taxation and Finance (the “Department”) should be amenable to taxpayers employing the existing alternative apportionment authority when the statutory apportionment formula’s inclusion of net GILTI in the denominator of the apportionment factor does not properly reflect the taxpayer’s New York business income or business capital. Under this view, the Department could consider incorporating into its existing alternative apportionment draft regulations examples to guide taxpayers seeking alternative apportionment arising from the net GILTI inclusion proposed by the Budget Bill. On the other hand, given that GILTI is taxable in the hands of minority shareholders, this approach could lead to an uneven playing field in that minority shareholders would not likely find themselves in a position to prove and take advantage of alternative apportionment.

II. Part D: Decouple from the IRC Federal Basis for NYS Manufacturing Test

A. Current Law

Under Article 9-A of the Tax Law, a “qualified New York manufacturer” is subject to tax at a rate of zero percent on its business income base and to other beneficial rates for purposes of the tax on business capital and the fixed dollar minimum tax. A “qualified New York manufacturer” is a manufacturer that (i) has property in New York that is described in section 210-B.1(b)(i)(A) of the Tax Law (i.e., property that qualifies for the New York Investment Tax Credit)

---

9 See Tax Law §§ 210(1)(a)(vi), (b).
and either (a) the adjusted basis of such property for federal income tax purposes at the close of
the tax year is at least $1,000,000 (“NYS Property Basis Test”), or (b) all of its real and personal
property is located in New York; and (ii) is principally engaged in qualifying activities (the “NYS
Principally Engaged Test”).10 A taxpayer or, in the case of a combined report, a combined group,
shall be “principally engaged” in qualifying activities for purposes of the NYS Principally Engaged
Test if, during the taxable year, more than 50% of the gross receipts of the taxpayer or combined
group, respectively, are derived from receipts from the sale of goods produced by such qualifying
activities.11 A taxpayer, or in the case of a combined report, a combined group, that does not
satisfy the NYS Principally Engaged Test may still be a qualified New York manufacturer if the
taxpayer or combined group employs at least 2,500 employees in manufacturing in New York
during the tax year and has property in the state used in manufacturing with an adjusted basis for
federal income tax purpose at the close of the tax year of at least $100,000,000.12

For purposes of the New York City business corporation tax, a “qualified New York
manufacturing corporation” is subject to tax on its business income at rates ranging from 4.425%
to 8.85%, depending on the amount of its business income.13 A “qualified New York
manufacturing corporation” is (i) a manufacturing corporation principally engaged in the
manufacturing and sale of tangible personal property (the “NYC Principally Engaged Test”), and
(ii) has property in the state described in Code § 11-654(1)(k)(5) and either (a) the adjusted basis
of such property for federal income tax purposes at the close of the tax year is at least $1,000,000

10 Id.

11 Tax Law §§ 210(1)(a)(vi), (b).

12 Id.

(“NYC Property Basis Test”) (collectively, with the NYS Property Basis Test above, the “Property Basis Tests”), or (b) more than 50% of its real and personal property is located in the state. A taxpayer or, in the case of a combined report, a combined group, shall be “principally engaged” in the manufacturing and sale of tangible personal property for purposes of the NYC Principally Engaged Test if, during the tax year, more than 50% of the gross receipts of the taxpayer or combined group, respectively, are derived from receipts from the sale of goods produced by such activities.

B. Proposed Changes

Part D of the Budget Bill would amend the definitions of “qualified New York manufacturer” and “qualified New York manufacturing corporation” by changing the measure of property located in the state for purposes of the Property Basis Tests from adjusted basis for federal income tax purposes to adjusted basis for New York State tax purposes. Specifically, Part D proposes to amend sections 210(a)(vi) and 210(b)(2) of the Tax Law, and 11-654(1)(k)(4)(ii) of the Code to use the adjusted basis of property for “New York State tax purposes” instead of the adjusted basis of property for “federal income tax purposes.”

C. Comments

The proposed changes to decouple the Property Basis Tests from adjusted basis for federal income tax purposes are necessary as a result of the TCJA. Under the TCJA, IRC § 168(k) was amended to allow taxpayers to immediately expense 100% of the cost of certain newly acquired property. This immediate expensing reduces the adjusted basis of such property for federal income tax purposes to zero in the year of purchase. Accordingly, it would be virtually impossible for

---

14 See id. at §§ 11-654(1)(k)(4)(i), (ii).
New York State or City taxpayers to utilize the advantages offered by IRC § 168(k) for federal income tax purposes, while also using that same property to satisfy the Property Basis Tests.

The Budget Bill proposes to use the adjusted basis that is used for New York State tax purposes. However, we note that neither the Tax Law nor the Code include a definition of New York-specific “adjusted basis.” We recommend that a taxpayer’s adjusted basis for New York State tax purposes be reduced by the amount of any depreciation deductions allowed under the Tax Law rather than being reduced by the amount of any depreciation or expense deductions allowed under the IRC. Because Tax Law § 208(9)(b) and Code § 11-652(8)(b)(16) decouple from IRC § 168(k), the Tax Law does not incorporate the concept of immediate expensing. Thus, any adjusted basis of newly acquired property under this definition would not be zero in the year of purchase. For clarity and avoidance of doubt, we recommend that the Budget Bill be amended to include an explicit definition of adjusted basis for New York State tax purposes as proposed above.

III. Part F: Extend the Three-Year Gift Addback Rule

A. Current Law

i. Lifetime Gifts

New York does not have a gift tax, and its estate tax exclusion has lagged behind the federal exclusion. Part X of Chapter 59 of the Laws of 2014 (Chapter 59) instituted broad estate tax reform, including a new requirement applicable to certain gifts made on or after April 1, 2014, by a decedent who was a New York resident at the time of the gift. The new provision said if a New York decedent died within 3 years of making a taxable gift, such gift had to be included in the decedent’s New York gross estate. This requirement was added to deter New York residents from transferring large amounts of wealth shortly before death solely to take advantage of the higher federal estate tax thresholds, while at the same time reducing their otherwise taxable New York
estate. This gift addback provision was made inapplicable to decedents dying on or after January 1, 2019, because on that date the New York and federal estate tax exemption thresholds were expected to coincide, eliminating the incentive for deathbed gifts.

B. Proposed Changes

i. Lifetime Gifts

The New York and federal estate tax exclusions did not coincide on January 1, 2019 due to a provision in the TCJA which doubled the federal exclusion as of January 1, 2018. As a result, there is a difference of more than $5 million per individual between federal and state estate tax thresholds. This gap revives the need for the limited gift add back in order to prevent revenue losses from deathbed gifts. Part F of the Budget Bill would extend the sunset to decedents dying on or after January 1, 2026, the date the estate tax amendments made by the TCJA are set to expire.15

C. Comments

The New York State Executive Budget Memorandum in Support of the Governor’s Fiscal Year 2020 Executive Budget (the “Support Memorandum”) claims that the Budget Bill’s proposed extension of the three-year “add-back” provisions under Tax Law § 954(a)(3) is necessary due to the difference between the current gift and estate tax basic exclusion amount available under the IRC and the applicable credit amount available for New York State estate tax purposes.16 For calendar year 2019, the basic exclusion amount for federal gift and estate tax purposes is $11.4 million, and the applicable credit amount available for New York estate tax purposes is

15 See FY 2020 Executive Budget Memorandum in Support, p. 13.

16 Id.
$5.74 million. According to the Support Memorandum, because New York does not impose a gift tax, absent the three-year add-back, residents are incentivized to take advantage of the increased federal gift tax exemption by making up to $11.4 million in tax-free gifts prior to death.\textsuperscript{17} Therefore, New York State loses out on the estate tax that would have been payable on the $11.4 million had the gift not been made.\textsuperscript{18} By enacting the Budget Bill’s proposal, New York State hopes to deter residents from making such gifts by drawing them back into the New York gross estate.\textsuperscript{19} The three-year add-back under the Budget Bill’s proposal would expire in 2026, when the federal basic exclusion amount is expected to align with the applicable credit for New York estate tax purposes.\textsuperscript{20}

While the Support Memorandum is correct in its assertion that the three-year add-back will deter New York residents from making certain lifetime gifts, the tax incentive to make lifetime gifts is not driven by the excess of the federal basic exclusion amount over the New York applicable credit amount. Indeed, even if an individual makes a gift that is limited to the New York applicable credit amount, the individual will save on New York estate tax by making a gift if there is no add-back rule. Likewise, gifts beyond the federal basic exclusion amount may lead to substantial estate tax savings absent the add-back. Simply put, the misalignment of the federal basic exclusion amount and the New York State applicable credit amount does not appear to rationalize the three-year add-back. The perceived abuse addressed by the three-year add-back relates to so-called “deathbed gifts.” Because New York has no gift tax, prior to the enactment of

\begin{itemize}
\item $5.74 million.
\item \textsuperscript{17} FY 2020 Executive Budget Memorandum in Support, p. 13.
\item \textsuperscript{18} \textit{Id}.
\item \textsuperscript{19} \textit{Id}.
\item \textsuperscript{20} FY 2020 New York State Executive Budget, Revenue, Article VII Legislation, Subpart F, Section 1.
\end{itemize}
the three-year add-back, a New York domiciliary could reduce his or her aggregate estate and gift tax by making a gift immediately prior to death. The add-back rule closes off this planning strategy by including such gifts within the New York gross estate.

Though the three-year add-back rule prevents individuals from avoiding New York estate tax via deathbed gifts, the add-back causes additional federal estate tax. Under Section 2058 of the IRC, a federal estate tax deduction is allowed for any estate taxes paid to any state, but only to the extent the property taxed at the state level is included in the decedent’s gross estate for federal estate tax purposes. Because the gift is not otherwise includible in the decedent’s gross estate for federal estate tax purposes, the amount of New York estate tax incurred on a gift that is added back to the decedent’s gross estate for New York estate tax purposes will not be deductible at the federal level. Given the period covered by the add-back – three years – and the adverse estate

---

21 See I.R.C. § 2058(a).

22 The New York three-year add-back applies only to gifts not otherwise included in the decedent’s federal gross estate. See Tax Law § 954(a)(3).

23 Section 2053(a)(3) allows a deduction for claims against the estate; however, as the deduction is not available for tax on the three-year add-back, as a claim, to be deductible, it would have to be a personal obligation of the decedent existing at the time of the decedent’s death. The chart below depicts the difference in the combined effective gift and estate tax rate (assuming a 16% New York estate tax rate and a 40% federal gift and estate tax rate) with respect to (i) a testamentary disposition, (ii) a lifetime gift which is subject to add-back, and (iii) a lifetime gift which is not subject to add-back:

<table>
<thead>
<tr>
<th>Combined Effective Gift &amp; Estate Tax Rate on Transfer</th>
<th>No Lifetime Gift; Testamentary Disposition</th>
<th>Lifetime Gift with Add-back</th>
<th>Lifetime Gift without Add-back</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>49.6%</td>
<td>56.0%</td>
<td>40.0%</td>
</tr>
</tbody>
</table>
tax consequences, there is a negative effect on persons who might make gifts absent the three-year add-back. Yet, the absence of a New York gift tax suggests that, as a policy matter, New York does not want to discourage residents from making gifts.

We recommend that, in determining how best to formulate tax legislation, New York focus on the underlying policy considerations. The add-back was designed to discourage “deathbed” transfers which would reduce the New York Estate Tax, and there is no suggestion that New York intended to increase the total federal and New York estate tax above what would be due absent the gift. The goal of discouraging “deathbed” transfers should be balanced against the negative effect on individuals who otherwise would make gifts. Accordingly, we recommend that New York consider limiting the add-back to gifts made within one year prior to death to target gifts that are more likely intended to avoid New York estate tax on the eve of an expected death.24 Alternatively, if New York maintains an add-back which extends beyond one year prior to death, we recommend that New York consider reducing the estate tax inclusion with respect to gifts made more than one year prior to death. For example, New York may consider including in a resident’s gross estate

The interplay between the New York add-back and Section 2058 of the IRC results in a combined effective gift and estate tax rate of 56.0% on the added-back lifetime gift, as compared to a 49.6% combined effective gift and estate tax rate had the individual not made the lifetime gift.

24 There are instances in the tax law where the measuring period is one year. For example, under Section 1014(e) of the IRC, if appreciated property is transferred to a decedent by gift within one year of death and such property passes from the decedent to the donor at the decedent’s death, there is no step up in basis at death. See I.R.C. § 1014(e). Additionally, some states that include gifts in contemplation of death in the decedent’s gross estate for state tax purposes have adopted rules with lookbacks of less than three years. See, e.g., Me. Rev. Stat. tit. 36 § 4102(7)(C) and Pa. Stat. § 9107(c)(3), applying a one-year lookback; Md. Code, Tax-Gen § 7-201(d)(1)(iii) and Vt. Stat. tit. 32 § 7402(14)(C), applying a two-year lookback. Five states other than New York have adopted a three-year lookback. See, e.g., Iowa Code § 450.3(2); Ky. Rev. Stat. § 140.020(2); Minn. Stat. § 291.016, subd.2; Neb. Rev. Stat. § 77-2002(2); N.J. Rev. Stat. § 54:34-1.c.
100% of the value of gifts made within one year prior to death, while including only 50% of the value of gifts made between one and two years prior to death and 25% of the value of gifts made between two and three years prior to death. By limiting the add-back to one year prior to death (or limiting the adverse tax consequences for gifts that occur more than one year prior to death), the rule would continue to deter individuals from making deathbed gifts solely to avoid New York estate tax, while mitigating the relatively harsh tax consequences for those who make gifts followed by death beyond one year after the gift.

Finally, for the reasons discussed, we do not see a policy rationale for sunsetting the add-back rule, as the potential advantages of deathbed gifts are created by the lack of New York gift tax and exist regardless of the relative sizes of the federal and New York exclusion amounts. Consequently, we recommend that consideration be given to eliminating the expiration date of the add-back rule.

IV. Part G: Eliminate Internet Tax Advantage

Part G of the Budget Bill proposes a major change to the way sales and use taxes would be collected for sales made through so-called “marketplace providers.” The marketplace proposal would shift the burden of collecting sales tax from the retailer to the “marketplace provider” that “facilitates sales of tangible personal property.” The Budget Bill’s proposal also has the effect of increasing the reach of New York’s authority to require the collection of sales tax on online sales made by out-of-state sellers through marketplace providers with New York State nexus. Additionally, it would shift responsibility for the collection of sales tax for sales by an in-state seller to the marketplace provider in regard to particular sales.

A. Current Law
Under current law, the responsibility to collect and remit sales taxes on taxable sales is limited to “vendors.”\textsuperscript{25} A vendor is defined as a person “making sales” that has a sufficient connection to New York State to require the vendor to collect and remit sales tax on sales to customers in the State.\textsuperscript{26} In certain circumstances, an agent of the vendor can be treated as a “co-vendor,” with joint responsibility for collecting and remitting the sales tax.\textsuperscript{27} When sales tax is not collected by the vendor on a taxable sale, the purchaser is obligated to remit use tax with respect to the use of the purchased property.\textsuperscript{28}

Because vendors are defined as the persons actually making sales, a party that merely facilitates a sale between a seller and a buyer through a physical or online marketplace forum is not a vendor and does not have tax collection responsibilities, even if such party has nexus with New York. The responsibility for collecting sales tax lies with the seller itself. Critically, an out-of-state seller that does not otherwise have nexus with New York does not establish nexus by selling goods through an online marketplace with nexus in New York, and is not required to collect and remit sales tax on sales made through an online marketplace.\textsuperscript{29} This does not relieve New York purchasers from liability for use tax, however,\textsuperscript{30} and use tax is generally acknowledged to be

\textsuperscript{25} Tax Law §§ 1131(1), 1132(a)(1).

\textsuperscript{26} Tax Law § 1101(b)(8).

\textsuperscript{27} Id. at § 1101(b)(8)(ii)(A).

\textsuperscript{28} Id. at § 1110.

\textsuperscript{29} Id. at § 1101(b)(8)(v)(A).

\textsuperscript{30} Id. at § 1110.
In an effort to increase use tax compliance, and in lieu of having purchasers compute the use tax on each individual purchase, New York offers a simplified method whereby residents can elect on their personal income tax return to pay an estimated aggregate use tax on all purchases costing less than $1,000 each, which estimate is based on the residents’ taxable income.32

B. Proposed Changes

Part G of the Budget Bill would alter the structure of the current law by placing the burden of collecting tax on sales facilitated through an online or physical marketplace on the “marketplace provider.” Under the proposal, a “marketplace provider” is defined as any person who “facilitates a sale of tangible personal property” by a “marketplace seller.” A marketplace provider facilitates sales when it (i) “provides the forum” in which, or by means of which, the sale takes place, and (ii) such person or an affiliate of such person either collects the receipts paid by a customer to a marketplace seller for the sale of tangible personal property or contracts with a third party to collect such receipts.33 A “forum” includes an internet website, catalog or similar forum, or a physical forum, such as a “shop, store, or booth.” The proposal would apply to sales made on or after September 1, 2019.

C. Comments

31 See Memorandum in Support, Part G, stating that the proposal will increase revenues by $125,000,000 in 2020 and $250,000,000 annually thereafter.

32 NYS Form IT-201i (2018), p. 27

33 Persons are affiliated if one person has an ownership interest of more than 5%, whether directly or indirectly, or where a greater than 5% ownership interest is held directly or indirectly in each of such persons by another person or group of other persons that are affiliated. Budget Bill, Part G § 1.
At the outset we note that in June of last year, the U.S. Supreme Court issued its decision in the matter of South Dakota v. Wayfair, Inc. 138 S. Ct. 2080, which fundamentally changed the underlying constitutional jurisprudence that had resulted in New York’s inability to directly impose sales tax on many Internet sales. New York now treats as a vendor responsible for sales tax collection any person that for the immediately preceding four sales tax quarters satisfied the following:

1. The cumulative total of the person's gross receipts from sales of tangible personal property delivered into the state exceeded $300,000, and
2. Such person made more than 100 sales of tangible personal property delivered in the state.34

The proposals contained in Section G of the Budget Bill were originally introduced in earlier budget bills prior to the Wayfair decision, which expanded nexus to include certain out-of-state sellers making sales into New York.35 Given the recent seismic shift in the application of the U.S. Constitutional limitations to taxation, we recognize that the landscape in which this proposal is being made has changed substantially.

i. Marketplace Provider Rules Generally

Though we note that the number of states with marketplace statutes is growing, the proposed approach in the Budget Bill would nevertheless significantly differ from the general nationwide practices as to the party responsible for collecting sales tax on sales facilitated through third-

---

34 NYS N-19-1 (January 2019) (citing Tax Law §§ 1101(b)(8)(i)(E), 1101(b)(8)(iv)).

35 See New York State FY 2015-2016 Executive Budget, Part X.
The proposal would impose significant compliance obligations and potential tax liabilities on marketplace providers. Marketplace providers will be required to undertake a greater administrative burden, as under the proposal the designation of collection responsibility is mandatory—if a marketplace provider facilitates sales, the marketplace provider will be responsible for sales tax compliance for those sales. Specifically, marketplace providers will be tasked with determining the taxability of each sale. This may be especially difficult in the case of goods excluded from the tax base and transactions involving purchasers providing exempt certificates. We note that administering the casual sale rules also may be particularly difficult. Indeed, this may be analogized to imposing a sales tax collection responsibility on in-state co-vendors (discussed below). The Tax Section expresses no opinion on this provision as a policy matter, although we note that it would represent a substantial change.

The shifting of responsibility for collecting tax from the marketplace seller to the marketplace provider appears to have two major effects. First, with respect to sellers that already have nexus in New York, it would appear to relieve them of the responsibility of collecting sales tax and shift that responsibility to the marketplace provider. Second, it appears to provide a mechanism for the collection of sales tax for sales by sellers that do not have any nexus with New


37 Budget Bill, Part G § 3.

38 See, e.g., TSB-A-86(13)S (N.Y.S. Dep’t of Taxation & Fin., Mar. 26, 1986) (ruling that a household appliance telephone ordering service is responsible for collecting and remitting sales tax as a co-vendor on sales made on behalf of out-of-state suppliers).

39 We note that under the proposal, in order to be relieved of responsibility for collecting sales tax, the seller must obtain a “completed certificate of collection” from the marketplace provider which states that the marketplace provider will collect the sales tax. See Budget Bill, Part G § 3.
York because the marketplace provider would be responsible for collecting and remitting the tax on sales made by both in-state and out-of-state sellers.

ii. **Nexus**

New York’s recently issued *Wayfair* guidance discussed above applies to “vendors.” The Department finds support for its position in Tax Law § 1101(b)(8)(i)(e), which includes within the definition of a vendor a person systematically soliciting business in New York to the extent that “solicitation satisfies the nexus requirements of the [U.S.] Constitution.” The Budget Bill does not seek to impose collection obligations on marketplace providers by including them within the definition of a vendor. Rather, the proposal creates the new classification of persons (i.e. “marketplace providers”) that are included within the definition of “persons required to collect tax.”

As such, the current guidance as applied to vendors does not explicitly apply to marketplace providers. The Budget Bill’s proposal does not include any language to establish when a marketplace provider will be deemed to have nexus with New York. We urge the Department to amend the definition of a marketplace provider to include applicable nexus standards. We suggest that the same nexus standards described above that are applicable to vendors be adapted to this situation. Specifically, the marketplace provider would have nexus when the cumulative total of the person’s receipts from sales of tangible personal property delivered into the state exceeded $300,000, and such person made more than 100 sales of tangible personal property delivered in the state.

To the extent the Department wishes to impose the same nexus standards that it does on out-of-state vendors, we also request clarity as to how the $300,000 in gross receipts and 100 transactions tests would apply to marketplace providers. Specifically, it is unclear whether the economic nexus standard would apply to the receipts and sales of the marketplace provider itself,
or would be based on the cumulative receipts and sales of the marketplace sellers, including the sales of third parties the marketplace provider helps to facilitate.

Further, we note the deletion of language from prior proposals that would have stated that a person who facilitates sales exclusively by means of the Internet is not a marketplace provider if its annual sales have been no more than $150,000,000 for every calendar year after 2016.40 We note that the Support Memorandum references that the tax will apply to “large” marketplace providers, but no such limitation appears in the statute.

iii. Scope of Application

The proposed marketplace requirements are limited to sales of tangible personal property. We note that for purposes of New York’s sales and use tax, tangible personal property includes computer software,41 therefore bringing within the ambit of the marketplace provider provisions those online marketplaces that sell software applications and computer games. Prior versions of proposed marketplace reporting requirements also included sales of occupancies or admissions, which are not part of the Budget Bill’s proposal.42

Under the proposed definition, an entity is a “marketplace provider” only if it collects the receipts paid by a customer. We understand that there are “peer-to-peer” online marketplaces where the buyer has the ability to pay the seller directly, resulting in the marketplace provider not collecting such receipts. It appears that such sales are excluded from the application of this section, especially in light of the deletion of language that has been present in former marketplace

40 New York State FY 2017-2018 Executive Budget, Part AA.

41 Tax Law § 1101(b)(6).

42 New York State FY 2015-2016 Executive Budget, Part X.
reporting proposals that provided that the term “marketplace provider” included organizations that arrange for exchange of messages between customers and sellers.\textsuperscript{43}

We also understand that there are companies that create and manage websites that are branded in the name of the selling business and may provide the types of services identified in the definition of a “marketplace provider.” For example, in addition to creating a website for the seller, such companies may also collect the receipts from the seller’s customers through the website and remit them to the seller. If the intent of the proposal is to treat as a “marketplace provider” an entity that facilitates sales through a website address that is specific to a single business, rather than a website address that identifies a marketplace, then we recommend that the proposal make that clear.

iv. \textit{Other Matters}

The Budget Bill states that a marketplace seller would generally be relieved from its duties to collect tax if it has received in good faith a properly completed certificate of collection from the marketplace provider certifying its compliance. It then goes on to provide that the Department may (i) develop a contractual provision or approve a contractual provision developed by the marketplace provider which, if included in the contract, will have the same effect as the certificate of collection, and (ii) provide by regulation or otherwise that inclusion of such provision in the publicly available agreement between the marketplace provider and the marketplace seller will have the same effect as the certificate of collection. We note that this provision differs from the rules applicable for other sales tax exemptions. For example, a certificate of exemption must be obtained from a non-profit organization; it is not sufficient to recite in the contract that the organization is non-profit. We are unclear as to the meaning and scope of the prong requiring

\textsuperscript{43} \textit{Id.}
inclusion of the contractual provision in a publicly available agreement and suggest that this be clarified.

The Budget Bill also states that the Department may provide by regulation or otherwise that a marketplace seller will be relieved of duty to collect tax for sales facilitated by a marketplace provider only if such marketplace provider is not on a list on the department’s website of marketplace providers whose certificates of authority have been revoked at the commencement of the applicable quarterly period. We are concerned about the potential burden on smaller sellers of needing to check this list on such a frequent basis and would suggest that an annual period be considered to account for the potential burden on small sellers.

v. Alternative Co-Vendor Approach

One alternative to the Budget Bill’s approach that could achieve the apparent policy objectives would be to amend the Tax Law to permit a marketplace provider to be treated as a co-vendor under Tax Law § 1101(b)(8)(ii). Under existing law, the Department has the authority to treat any “salesman, representative, peddler or canvasser” as the seller’s agent, and thus as jointly liable for collecting and remitting the sales tax.44 By allowing the Department to treat the marketplace provider as a co-vendor, the marketplace seller would remain the party primarily responsible for collecting and remitting the tax, but where the Department determines it would be efficient for administration of the tax, the marketplace provider could be held jointly responsible. Under this approach, whether or not a marketplace seller has New York nexus, the marketplace provider could be treated as responsible for collecting the sales tax upon reasonable notice by the Department.

vi. Effective Date

44 Tax Law § 1101(b)(8)(ii).
We note that the 30-day amendments to the Budget Bill accelerate the effective date of the proposal from September 1, 2019, to June 1, 2019. We do not comment on whether such acceleration would impose an undue compliance burden on affected marketplace providers, but we urge that consideration be given to that question before proceeding with the accelerated effective date.


A. Current Law

   i. Tax Shelter Provisions

   Tax Law § 25 contains New York’s tax shelter penalty and reporting requirements. These requirements are modelled after the federal rules for disclosure of a reportable transaction. The Tax Law requires that any taxpayer who enters into a reportable or listed transaction, as those terms are defined by IRC § 6011 and corresponding treasury regulations, must attach a duplicate of the taxpayer’s federal reportable transaction disclosure statement to the taxpayer’s New York return for the taxable year at issue. Additional disclosure requirements are provided for taxpayers, and material advisors, who have participated in “New York reportable transactions”, i.e., New York listed transactions, New York confidential transactions, and New York transactions with contractual protection. Failure to properly report any of these transactions subjects taxpayers and certain advisors to enhanced penalties and extended statutes of limitations for assessment.

45 Tax Law § 25(a)(1).

46 Id. at § 25(a)(2); 20 NYCRR § 2500.3.

47 See, e.g., Tax Law §§ 683(c)(11); 685(p), (q), and (r); Tax Law §§ 25(f)(1)-(3).
ii.  \textit{Tax Preparer Penalties}

The current tax preparer penalties, found in Tax Law § 685(aa), are scheduled to expire on July 1, 2019. The provisions provide for penalties of $1,000 per violation against the tax return preparer if there is an understatement of liability due to (i) a position for which there was not a reasonable belief that the tax treatment in that position was more likely than not the proper treatment, (ii) the income tax preparer knew or reasonably should have known of such position, and (iii) the position was not adequately disclosed. The Tax Law also provides for penalties of $5,000 per violation if the tax return preparer acted willfully or with reckless or intentional disregard of rules or regulations.

Tax Law § 658 also requires tax return preparers to sign returns and claims for refund and to furnish certain identifying information on returns and claims for refund. The Tax Law previously had penalty provisions for tax return preparers who failed to comply with these requirements, but those penalty provisions were repealed in 2009.\(^{48}\)

\textbf{B. Proposed Changes}

i.  \textit{Tax Shelter Provisions}

Part O, section 1 of the Budget Bill would make the tax shelter penalty and reporting requirements currently in effect permanent.

ii.  \textit{Tax Preparer Penalties}

Part O of the Budget Bill would amend the preparer penalty provisions of Tax Law §§ 685(aa) and (u) to strengthen the Department’s ability to enforce the Tax Laws by imposing penalties against tax return preparers who take return positions that (i) cause the understatement

\(^{48}\text{See L. 2009, c. 59 legislation; pt. VV, § 3.}\)
of tax or improperly increase a claim for refund, (ii) fail to sign a return or claim for refund, or (iii) fail to furnish the tax return preparer’s identifying number on tax returns.

Specifically, Part O, section 2 of the Budget Bill would replace the current version of Tax Law § 685(aa) to provide for penalties of between $100 and $1,000 for every return on which an understatement of liability or increased claim for refund is due to a position where the preparer “knew, or reasonably should have known, that said position was not proper, and such position was not adequately disclosed on the return or in a statement attached to the return.” The Budget Bill further provides for a penalty of between $500 and $5,000 if the tax return preparer takes a position on an income tax return that understates the tax liability or increases a claim for refund resulting from the preparer’s reckless or intentional disregard of the law, rules, or regulations.49

Next, Part O, section 3 would add a new section to Tax Law § 685(u) providing for penalties for failure to sign a return or claim for refund. Preparers would be subject to a penalty of $250 for each failure to sign a return or claim for refund (unless such failure was due to reasonable cause and not willful neglect). The maximum amount of penalties for each year is $10,000, unless the taxpayer was penalized under this provision in the preceding calendar year, in which case the penalty is increased to $500 per violation with no cap.

Part O, section 3 would also add a new section to Tax Law § 685(u) providing for penalties against tax return preparers who fail to furnish identifying numbers. The penalty would be $100 for each failure, up to a total of $2,500 each year. If the tax return preparer has been penalized under this provision in the preceding calendar year, the penalty is increased to $250 per violation with no cap.

49 Please note that the text of proposed § 658(aa)(4) says “tax return prepared,” but this appears to be a typographical error and should say “tax return preparer.”
C. Comments

i. Tax Shelter Provisions

We support making Tax Law § 25, and related penalty and statute of limitations provisions, permanent. The transactions covered by these provisions are those that have the most potential for abuse. The disclosure requirements, penalties, and extended statutes of limitations provide the Department with the tools that it needs to identify and examine these transactions, and where appropriate, curtail abusive transactions.

We note, however, that in 2005, along with Tax Law § 25, New York enacted a provision imposing penalties for promoting abusive tax shelters. This provision is also schedule to expire and be deemed repealed as of July 1, 2019. Specifically, Tax Law § 685(bb) provides for a penalty of 50% of the gross income derived (or to be derived) by a person who promotes an abusive tax shelter. These penalties apply when a person organizes a tax shelter, makes or furnishes a statement regarding a tax benefit that the person knows or has reason to know is false or fraudulent as to any material matter, or makes or furnishes a gross valuation overstatement.

Tax Law § 685(bb) is another important enforcement tool for the Department and is not duplicated by other penalty provisions. Tax Law § 685(bb) applies to a broader category of transactions than Tax Law § 25, and it is not limited to tax return preparers, like Tax Law § 685(aa) (discussed below). In addition, the penalties under Tax Law § 685(bb), which are 50% of the fees derived from the activity, may be much greater than those under Tax Law § 685(aa), which are only up to $5,000 per violation if the tax return preparer’s conduct was willful. We are unsure whether maintaining the July 1, 2019 expiration date for the penalties under Tax Law § 685(bb) was intentional. If not, we suggest that the Department consider making permanent Tax Law §
685(bb)’s powerful enforcement tool to discourage and penalize the most egregious cases of the promotion of abusive tax shelters.

ii. **Tax Preparer Penalties**

The purpose of the proposed provisions is to clarify and enhance penalties against tax return preparers who take positions that are not supported by the Tax Law, and to ensure that penalties for failing to sign returns (or claims for refund) and failing to furnish identification numbers apply to all tax preparers (and not only those required to be registered with the Department under Tax Law § 32).

Through the enactment of Tax Law § 32, New York has already taken significant action to improve tax preparation services for New Yorkers. A task force report issued by the Department cited “serious problems within the tax preparer industry and the impact of these problems on consumers of tax preparation and related services.” The report pointed to studies by the Office of the Treasury Inspector General for Tax Administration and the General Accounting Office finding that returns prepared by unlicensed tax return preparers “often contained inaccuracies with significant tax consequences such as sizable unjustifiable refunds,” and that many of these errors were due to “willful or reckless omissions or misstatements.” In response, New York created a registered return preparer program in 2014, and issued regulations governing standards for conduct for all tax return preparers pursuant to Tax Law § 32.

The proposed legislation will further aid the Department in enforcing the Tax Law and ensuring that New York taxpayers receive high quality tax return preparation services and are not

---

50 New York State, *Report of the Task Force on Regulation of Tax Return Preparers*, for submission to the Department of Taxation and Finance, the Governor, and the Legislature (Sept. 28, 2011), at p. 3.

51 *Id.* at pp. 3-4.
taken advantage of by unscrupulous preparers. We support this effort, but have a few comments regarding the proposed tax preparer penalties in Part O, section 1 of the Budget Bill (to be codified at Tax Law § 685(aa)).

First, the proposed statute penalizes tax return preparers for taking positions that are “unreasonable,” a standard which is met if the preparer “knew, or reasonably should have known, that said position was not proper.”52 We have concerns as to whether this is an administrable standard for penalties. It does not indicate the level of certainty that is required before a preparer can take a position on a tax return, and suggests that anytime a position is disallowed, the preparer could be subject to penalties. We do not believe that this is the standard that the Legislature should impose, as there can be good faith disagreements regarding the interpretation of the Tax Law or the particular facts and circumstances supporting a return position.

Tax Law § 685(aa) is modelled after IRC § 6644. Under IRC § 6694, the general definition of an “unreasonable position,” is:

(A) In general.—Except as otherwise provided in this paragraph, a position is described in this paragraph unless there is or was substantial authority for the position.

(B) Disclosed positions.—If the position was disclosed . . . and is not a position to which subparagraph (C) applies [tax shelters and reportable transactions], the position is described in this paragraph unless there is a reasonable basis for the position.53

Similarly, Circular 230, which contains regulations governing practice before the Internal Revenue Service, cross-references this definition of “unreasonable position,” in 31 C.F.R. § 10.34, “Standards with respect to tax returns and documents, affidavits and other papers.”

52 Budget Bill, Part O, § 2; Proposed Tax Law § 685(aa)(1) (emphasis added).

53 IRC § 6694(a)(2)(A) and (B).
For tax return preparers who are certified public accountants, the American Institute of Certified Public Accountants (“AICPA”) describes a similar standard in its Statements on Standards for Tax Services. Statement 1, Tax Return Positions, provides that “a member may prepare or sign a tax return that reflects a position if (i) the member concludes there is a reasonable basis for the position and (ii) the position is appropriately disclosed.”

The concepts of substantial authority, reasonable basis, and adequate disclosure found in these provisions have been developed by the courts and taxing authorities under New York and federal law. As noted above, New York has already issued regulations governing tax return preparers under Tax Law § 32. Those regulations provide that

[a] tax return preparer may not willfully, recklessly, or through gross incompetence… advise a client to take a position on a tax return or claim for refund, or prepare a portion of a tax return or claim for refund containing a position that: (a) lacks a reasonable basis; (b) is an unreasonable position; or (c) is a willful attempt by the tax return preparer to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the tax return preparer.

The proposed standard found in the Budget Bill that the preparer knew or reasonably should have known that the position was “not proper” is inconsistent with 20 NYCRR § 2600-4.3(h), as well as the federal and industry standards. Moreover, there is no guidance as to whether “not proper” is intended to be a higher or lower standard than that described in the New York regulations. In order to avoid confusion as to both the applicable standard for return positions, and in the enforcement of the preparer penalties, we recommend that the “not proper” language be removed from the proposed statute, and instead, language similar to IRC § 6694 be included to the


55 20 NYCRR § 2600-4.3(h)(1)(ii).
effect that the position either must be supported by substantial authority, or have a reasonable basis and be adequately disclosed.

Second, although the definition of “tax return preparer” encompasses preparers of all New York tax returns, including income tax, estate tax, sales tax and use tax, and other tax returns, the proposed statute only appears to provide for penalties for unreasonable positions on income tax returns. We recommend that the reference to “income tax” be eliminated so that the provision applies to all returns, as it is in the interest of the Department and the public to ensure the standards for return positions are satisfied on all returns, not only income tax returns. This would be consistent with federal law. Specifically, IRC § 6694 was amended in 2007 to expand its application to all tax return preparers, and not just income tax preparers.57

VI. Part X: Exclude from Entire Net Income Certain Contributions to the Capital of a Corporation

A. Current Law

As part of the TCJA certain changes were made to IRC §118, which generally provides that the gross income of a corporation does not include any contribution to its capital. Prior to the change in law, there was an exclusion from this provision where contributions in aid of construction or any other contribution from a customer or potential customer were not considered a contribution to capital and thus were included in the receiving corporation’s gross income.

56 Part O, § 3 of the Budget Bill defines “tax return preparer,” by reference to Tax Law § 658(g), which states, in relevant part, that “the term ‘tax return preparer’ means any person who prepares for compensation, or who employs or engages one or more persons to prepare for compensation any return or claim for refund. The preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund. . . Tax Law § 658(g)(5).

The TCJA added a new exclusion from the general rule, whereby any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such) is also not considered a contribution to capital and is included in the receiving corporation’s gross income.

Currently, corporations follow IRC §118 when determining their Article 9-A or Article 33 tax liability and their New York City business corporation tax, general corporation tax, or banking corporation tax liability because the starting point for the computation of these tax bases is federal gross income. Accordingly, the federal limitations specifying that a contribution by a governmental entity or a civic group to a corporation is included in gross income will apply for New York State and City purposes. As a result, this provision results in certain state and local tax incentives awarded to corporations being subject to tax.

**B. Proposed Changes**

Part X of the Budget Bill would decouple Article 9-A and Article 33 taxes, as well as New York City general corporation tax from IRC § 118, resulting in the capital contributions a corporation receives from a governmental entity or a civic group being excluded from a taxpayer’s gross income subject to tax in New York.

**C. Comments**

The Tax Section does not take a position on whether decoupling from IRC §118 is advisable. However, if this provision passes, it would be advisable for the exclusion from gross income to be applied not just for purposes of Article 9-A and Article 33 taxes and the New York City general corporation tax. The decoupling from this provision should also be applied to the definitions of entire net income in the New York City business corporation tax (Code § 11-652 et seq.) and the New York City banking corporation tax (Code § 11-641 et seq.).
VII. Part Y: Close the Carried Interest Loophole

A. Current Law

The Tax Law has no special provisions dealing with income from a carried interest. In general, partnership income that is taxed to the partners has the same character in the hands of the partners as it had in the hands of the partnership, regardless of how the partner acquired his or her partnership interest. For example, partnership investment income, including long-term capital gains, flows through to the partners and is treated the same in their hands even if one or more partners acquired their partnership interest in exchange for services rendered to the partnership or other partners.\(^\text{58}\)

A carried interest is an interest in a partnership that is disproportionately high relative to the partner’s capital contribution. It is common for the organizers of an investment partnership to contribute a small amount of the partnership’s capital but to receive a much higher interest in partnership profits. Arguably, this disproportionate interest is received in exchange for services rendered in organizing and/or operating the partnership. Nevertheless, New York State, mirroring the federal income tax treatment, has treated income from a carried interest just like any other partnership income that is taxed to the partners.

Until the enactment of the TCJA, the IRC contained no special provisions for carried interest income and the Internal Revenue Service treated the income as retaining the character that it had in the hands of the partnership. The TCJA amended IRC § 1061 to provide, in general, that

\(^{58}\) References to partnerships and partners include limited liability companies and their members to the extent that they are treated as partnerships and partners for income purposes.
a partner who received a partnership interest in connection with the performance of substantial services would not treat long-term capital gains realized by the partnership as long-term capital gains unless the property sold by the partnership had been held by the partnership for more than three years. IRC § 1061 does not treat carried interest income as income received in exchange for services or as business income; its only effect is to convert what otherwise might have been long-term capital gains to short-term capital gains.

B. Proposed Changes

Part Y of the Budget Bill would add a new section 44 to the Tax Law and would amend sections 208.6(a), 617(b), 631(d), and 632(b) to change the treatment of carried interest income. The provisions are intended to “close the carried interest loophole” by treating carried interest income as income from a trade or business and not as capital gains. One consequence of this recharacterization would be that carried interest income would be taxable to a nonresident of New York to the extent that the partnership’s income was attributable to New York sources. In addition, the Budget Bill would impose a 17% “carried interest fairness fee” on a portion of carried interest income. The fee would remain in effect until the IRC is amended to treat the provision of investment management services for federal tax purposes substantially the same as under the Tax Law.

C. Comments

An identical proposal was included in New York’s FY 2018-2019 Executive Budget.\(^{59}\) The Tax Section again takes no position with respect to whether carried interest income should be

\(^{59}\) See New York State FY 2018-2019 Executive Budget, Part M.
treated as business income or should be given favorable tax treatment. For the benefit of the reader, we have restated our comments regarding this proposal. 60

The Budget Bill applies the new regime to income that a partner is deemed to have received from “investment management services.” Section 44 defines this phrase as including investment advice regarding the purchase or sale of securities as defined in section 475(c)(2) of the IRC, real estate held for rental or investment, and certain partnership interests, including managing, acquiring, or disposing of such assets, arranging financing with respect to the acquisition of such assets, and related activities.

The operative provision of section 44 indicates that a partner who performs investment management services for a partnership will not be treated as a partner with respect to the partner’s distributive share of income, gain, loss, and deduction, including guaranteed payments, “that is in excess of the amount such distributive share would have been if the partner had performed no investment management services for the partnership.” That excess amount will be treated as a business receipt for services and for purposes of the personal income tax as income attributable to a trade, business, profession, or occupation. Similar provisions would apply to an S corporation shareholder. An exception would be provided for certain real estate businesses. A partner or shareholder will not be deemed to be providing investment management services if at least 80% of the average fair market value of the partnership’s assets consists of real estate held for rental or investment.

It may be difficult to determine whether a partner received all or part of a partnership interest in exchange for investment management services. It does not automatically follow that an interest that is disproportionate to a partner’s capital contribution is received in exchange for

60 See Report of the Tax Section of the New York State Bar Association, Report No. 1391 (Mar. 9, 2018) at 12-16.
investment management services or, for that matter, for any services. For example, the organizers of a partnership might be willing to give a particularly prestigious individual a disproportionately high partnership interest because the person’s name may enhance the partnership’s reputation or ability to attract other investors or otherwise assist in relations with private or public organizations. Other partners might simply strike a hard bargain and succeed in negotiating for a partnership interest that is disproportionately high relative to their capital contributions.

The new regime applies to income received by a partner for services performed by that partner. As written, it would not apply to income received by a partner who received a partnership interest as a gift from a person who performed services for the partnership (e.g., the service provider’s spouse or children).

Section 44(c) provides for “an additional tax, referred to as the ‘carried interest fairness fee’.” This fee is equal to 17% of the amount treated as business income under section 44(b). This fee will remain in effect until “federal legislation has been enacted that treats the provision of investment management services for federal tax purposes substantially the same as provided in this section.” It is not clear what kind of federal legislation would be needed to result in a termination of the fee. The bill converts investment income to business income. If Congress wanted to completely eliminate favorable treatment for capital gains realized by partnerships that had partners with carried interests, it could do so by expanding on the approach taken by the TCJA and simply providing that all long-term capital gains realized by a partnership will be treated as short-term capital gains to the extent that they are passed through to carried interests. That would eliminate any federal preference for carried interest income, but it would not treat that income as business income as the New York statute does. It would still be investment income for other
purposes of the federal tax laws. That would arguably not result in treatment “substantially the same as provided” in the New York law.

The carried interest provisions take effect only if Connecticut, New Jersey, Massachusetts, and Pennsylvania all adopt legislation “having substantially the same effect as this act.” It is unclear what this phrase means. In the unlikely event that all four states adopt some kind of legislation dealing with carried interest income, they could take different approaches. They could recharacterize carried interest income as business income but not impose a punitive “fairness fee”, or they could impose a “fee” that was much lower than New York’s fee.

Our only new comment regarding the proposed carried interest provision pertains to the proposal’s effective date, which is contingent upon similar proposals being enacted by Connecticut, New Jersey, Massachusetts, and Pennsylvania. Since the original proposition of the carried interest provision in the fiscal year 2018-2019 Executive Budget, New Jersey has enacted a similar tax on carried interest. New Jersey’s law will levy a 17% carried interest tax on general partners of investment funds once New York, Connecticut and Massachusetts have enacted legislation having the same effect. It is unclear whether New Jersey’s legislation has “substantially the same effect” as the carried interest proposal in the Executive Budget. No similar proposal has yet been enacted by Connecticut, Massachusetts, or Pennsylvania.

VIII. Part Z: Various Technical Changes to the Tax Law and the New York City Administrative Code

Part Z of the Budget Bill includes a number of proposed technical changes intended to clarify various provisions of the Tax Law and the Code. The provisions are intended to ensure that tax statutes are clear, accurate and up to date with the most recent provisions in corresponding federal, state, and city tax provisions. The corrections are also intended to ensure that the language
conforms to legislative intent. We welcome the added clarity that these changes bring to the Tax Law and the Code. We suggest additional changes to ensure complete clarification of the application of that provision.

A. Current Law

Tax Law § 213-b(a) relates to estimated payments of franchise tax and metropolitan transportation business tax surcharge for S-corporations. Further, Tax Law § 213-b(e) states that if an estimated payment exceeds the taxpayer’s corresponding liability, interest shall be paid from the date of payment to the fifteenth day of the third month following the close of the taxable period.

B. Proposed Changes

Part Z, § 4 of the Budget Bill proposes to remove provisions in Tax Law § 213-b(a) related to the requirements for S-corporations to make estimated payments of metropolitan transportation business tax surcharge. The provisions would be removed because S-corporations are not subject to the metropolitan transportation business tax surcharge. Part Z, § 5 of the Budget Bill also proposes to amend Tax Law § 213-b(e) for purposes of determining the end date for interest paid to taxpayers on estimated tax overpayments from the third month to the fourth month following the close of the taxable period. This amendment conforms to changes in related return due dates.

C. Comments

In order to further clarify the franchise tax estimated payment requirements for S-corporations, we recommend that Tax Law §213-b(a) is further amended to state that “[p]rovided, however, that every taxpayer that is subject to the tax imposed by section two hundred nine of this chapter that is a New York S corporation must pay with the report . . .” This will ensure clarification that the estimated payments are related to the franchise tax.
IX. Part VV: Enact the Cannabis Regulation and Taxation Act

A. Current Law

The use of cannabis for recreational purposes is currently illegal in the state of New York. The use of medical cannabis, however, is legal in New York under § 3362 of the Compassionate Care Act.\(^{61}\) To obtain medical cannabis, a patient must be diagnosed with one of several serious conditions, and the patient must receive certification from a medical professional.\(^{62}\) Additionally, the patient must register with the Department of Health’s Medical Marijuana Program and obtain a Registry Identification Card.\(^{63}\)

The current excise tax on medical cannabis is seven percent of the gross receipts from medical marijuana sold or furnished by a registered organization to a certified patient or designated caregiver.\(^{64}\) The law defines “gross receipt” as the amount charged for the provision of medical cannabis, without any deduction for: the cost of materials, labor, or services; other costs, interest, or discount paid; or any other expenses.\(^{65}\)

B. Proposed Changes

Part VV of the Budget Bill proposes to legalize the recreational use of cannabis, and Article 20-C of the Tax Law would impose a number of requirements on prospective cannabis businesses, including taxation, registration and renewal, and keeping returns secret. Additionally, Article 20-C enumerates penalties in the case that a person violates one of the provisions.


\(^{62}\) Id. at § 3361.

\(^{63}\) Id. at § 3363.

\(^{64}\) Tax Law § 490(2).

\(^{65}\) Id. at § 490(1).
Under Taw Law § 493, New York would impose a tax on the cultivation of cannabis flower and cannabis trim at the rate of one dollar per dry-weight gram of cannabis flower, and twenty-five cents per dry-weight gram of cannabis trim. The tax distinguishes between cultivators and wholesalers. If the wholesaler is not the cultivator, the wholesaler collects the tax from the cultivator at the time of transfer to the wholesaler. If the wholesaler is the cultivator, the wholesaler pays the tax at the time of sale or transfer to the retail dispensary. If the cultivator is the retail dispensary, the tax accrues at the time of sale to the retail customer.

A twenty percent excise tax would also be imposed on a wholesaler for the transfer of cannabis from a wholesaler to a retail dispensary. If the wholesaler is not a retail dispensary, the tax is computed based on the invoice price charged by the wholesaler to a retail dispensary. If the wholesaler is a retail dispensary, the tax is twenty percent of the price charged to the retail customer, and it accrues at the time of sale to the customer. The transfer by wholesaler to the retailer is also subject to an additional two percent county tax. Lastly, as in the case of medical cannabis, recreational cannabis is exempt from sales tax.

As discussed in more detail below, the Budget Bill also proposes to modify the taxpayer secrecy provisions under Article 20-B, Excise Tax on Medical Marihuana, by removing any references to the sharing of information with the federal government. Similarly, § 496 of Article 20-C, as proposed by the Budget Bill, does not address whether New York intends to share the information it obtains with the federal government.

C. Comments

i. Interaction of IRC § 280E with the Proposed Cannabis Legislation

IRC § 280E states:

No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business
if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.

Currently, New York law follows IRC § 280E through its conformity to the IRC. As a result, cannabis businesses may not claim the same deductions that other businesses may because the federal government continues to list cannabis as a Schedule I drug. New York’s conformity with the IRC puts an additional fiscal burden on cannabis businesses, which appears inconsistent with New York’s position that cannabis is a legitimate business undertaking. The Legislature may therefore want to consider following in the footsteps of some other states, such as Washington and Colorado, that have decoupled from IRC § 280E.

ii. Taxpayer Secrecy Provisions in Regard to the Federal Government

The current taxpayer secrecy statute contained in Article 20-B, the excise tax on medical marihuana, gives the Department discretion not to share such taxpayer information with the Internal Revenue Service. The statute also explicitly prohibits the Department from sharing any of the taxpayer information with the Internal Revenue Service, unless the Internal Revenue Service agrees “not to divulge or make known in any manner the information so supplied.”66 Presumably, this language is designed to prevent the Internal Revenue Service from sharing this information with any law enforcement agencies.

Notably, the Budget Bill seeks to remove from § 491 of Article 20-B references to the Internal Revenue Service. The taxpayer secrecy provisions under the proposed Article 20-C also make no mention of the Internal Revenue Service. The proposed language is, therefore, silent as to what happens if the Internal Revenue Service requests New York tax returns pertaining to

66 Tax Law § 491.
medical and recreational cannabis. This ambiguity raises two issues. On the one hand, the silence could be interpreted as New York’s Commissioner not having the discretion to share tax return information with the federal government. On the other hand, the implication could be that restrictions on sharing tax return information do not apply with respect to the Internal Revenue Service at all. Given that cannabis—in all forms—remains illegal under federal law, this distinction might be of critical importance to cannabis businesses. We recommend that the Legislature provide additional clarity regarding the proposed omission of the reference to the Internal Revenue Service in the context of taxpayer secrecy.

iii. The Imposition of the Twenty Percent Tax

In the Budget Bill, the tax base amount subject to the twenty percent tax depends on whether a wholesaler and a retailer are two separate entities or a single entity. In the separate entity context, the twenty percent tax is imposed on the wholesale price and in the single entity context, the twenty percent tax is imposed on the retail price.

We assume that the difference in timing and the tax base amount subject to the twenty percent tax is because a wholesale price may not be available where a wholesaler and a retailer are one and the same. We note that the proposal would likely result in materially different tax amounts collected due to the margins built into the retail price. Possibly, the proposed statute would treat similarly situated taxpayers differently, resulting in a future constitutional challenge.

It is unclear whether any such potential arrangements would create arm’s-length pricing issues. In any event, to avoid any disparity in the imposition of the tax, the Legislature may want to consider imposing an excise tax at a lower rate on the retail price regardless of the operating structure of the cannabis business. Further, given the relatively new nature of the proposed taxes, we welcome the Department promulgating regulations to further clarify the Department’s position.