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2018 in Review: Responses to Federal Tax Changes

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In this installment of Noonan's Notes, the authors review tax developments of 2018, including False Claims Act tax litigation, New York's silence on *Wayfair*, and states' response to the recently enacted limit on the state and local tax deduction.

New York has been front and center in the federalism debate ever since *The Federalist Papers*, a collection of essays that Alexander Hamilton, James Madison, and John Jay published in New York toward the end of the 18th century. Looking back on state and local taxes in 2018, it seems some things haven't changed 230 years later as the discussion over the constitutional division of power between states and the federal government continues.

The federal government and federal courts radically affected state and local taxes in both New York and the country as a whole in 2018. And the notable New York SALT news of 2018 only reminds us that taxes remain as important an issue affecting the state-federal relationship now as they were in 1788. Who knows? Maybe the authors of *State Tax Notes* in 2248 will look back on 2018 as proof again that some things never change.[1]

I. Response to the SALT Deduction Cap

One of the most dramatic 2018 changes affecting state and local taxes — particularly for individuals in high-tax states like New York — was the near-elimination of the state and local tax deduction in the federal Tax Cuts and Jobs Act (P.L. 115-97). Beginning in 2018, taxpayers can generally deduct only up to $10,000 of SALT payments as itemized deductions for personal income tax purposes.

For example, under prior law, a New York resident who paid $50,000 in state income taxes would have been entitled to deduct that payment from his federal taxes. Thus, assuming the taxpayer was in the highest tax bracket and not otherwise subject to the alternative minimum tax, the payment of $50,000 in New York tax would cost that taxpayer only around $30,000 in real dollars thanks to the federal deduction. Now, however, a taxpayer who uses the $10,000 cap for other state taxes, such as property tax, receives no deduction from federal taxable income. A $50,000 payment of New York taxes therefore actually costs the taxpayer $50,000. And obviously, when we get to taxpayers at higher income levels, the negative impact of this change continues to multiply — making it a significant issue.

In response to this change, states such as New York, Connecticut, and New Jersey have proposed (and in some cases passed) legislation to soften the impact of the lost deduction, including measures that shift tax payments from individual taxpayers to businesses either through an optional payroll tax (such as New York's employer compensation

[1] A cite to Noonan's Notes in 2248 would be pretty cool, too.

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expense tax[2]) or an entity-level tax (such as Connecticut's passthrough business tax[3]). States such as New York have also approved measures that allow taxpayers to make charitable deductions in place of tax payments, in effect restoring the lost SALT deduction with increased charitable deductions — which were not limited under the new federal law.[4]

However, the IRS has not taken kindly to many of New York's ideas. On August 23 the IRS released proposed regulations (REG-112176-18[5]) designed to block states' plans to allow taxpayers to make payments in lieu of taxes to various government-operated public purpose foundations in the hope that their resident taxpayers can then treat the payments as fully deductible charitable contributions.

REG-112176-18 declares that if a taxpayer makes a payment or transfers property to or for the use of an entity listed in section 170(c) (which includes contributions to states for exclusively public purposes), and the taxpayer later receives or expects to receive a state or local tax credit in return for that payment, the tax credit constitutes a return benefit — or quid pro quo — to the taxpayer that thereby reduces his available charitable contribution deduction. This negates any federal benefit for taxpayers. The IRS's proposed regulations are intended to prevent these types of workarounds for any "contributions after August 27, 2018."

The IRS's guidance led to quick and pointed responses from New York. On August 24, just three days before REG-112176-18 was due to take effect, Gov. Andrew Cuomo (D) issued a public alert under the not-so-subtle title, "Governor Cuomo Alerts New Yorkers to Deadline to Make Charitable Donations Before Politically Motivated IRS Regulations Take Effect."[6] Tell us how you really feel, governor. Cuomo then drafted a letter to the U.S. tax inspector general requesting an investigation as to whether partisan politics influenced the IRS's proposed regulations.[7] And even before the regulations took effect, New York, Connecticut, New Jersey, and Maryland jointly filed a complaint in the U.S. District Court for the Southern District of New York against the federal government, arguing that the SALT deduction cap is unconstitutional and should be blocked from enforcement.[8]

This back and forth shows that the Empire State has been quick to respond to the SALT deduction cap, but what's less clear is how successful these efforts to preserve a federal deduction will be. So with that in mind, how should ordinary New Yorkers react to the SALT deduction cap?

In our experience, the simplest response is to move, which requires neither complicated income shifting nor state laws designed to circumvent federal legislation. It just requires taxpayers to pack up their belongings and move to another state. Of course, as many former New Yorkers have learned, changing residency from one state to another is not as simple as getting a driver's license and spending a specific number of days outside New York. New York's residency laws require taxpayers to prove that they "left" the state with the intention of not returning and "landed" in a new jurisdiction with the intention of residing there at least on an indefinite basis. Proving this is not an easy task. And because states like New York require taxpayers to present clear and convincing evidence of the change,[9] any doubt gets resolved in favor of the tax department.

This obviously presents a conundrum. While New York appears to be doing everything it can to help its residents deal with the loss of the SALT deduction, it seems much less likely that the state will look favorably on those whose strategy involves jumping ship. To the contrary, we expect New York to be extra vigilant about making sure that taxpayers are honestly and legitimately claiming a change of residency and taking the necessary actions in support of their move.

[2] N.Y. Tax Law sections 850-857; TSB-M-18(1)ECEP, "Employer Compensation Expense Program," July 3, 2018.

[3] Conn. Gen. Stat. section 12-726; L. 2018 18-49 section 1.

[4] N.Y. Tax Law section 606(iii).

[5] REG-112176-18, 83 FR 43563, Aug. 27, 2018.

[6] Cuomo release (Aug. 24, 2018).

[7] Letter from Cuomo to J. Russell George, inspector general for tax administration (Sept. 9, 2018).

[8] *State of New York v. Mnuchin,* Dkt. No. 1:18-cv-06427 (S.D.N.Y. July 17, 2018).

[9] 20 NYCRR 105.20(d).

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II. New York Silence on *Wayfair*

On June 21 the U.S. Supreme Court issued its long-awaited *South Dakota v. Wayfair Inc.*[10] decision, which resoundingly overturned the *Quill*[11] physical presence nexus standard that had been the law of the land for sales tax purposes for 26 years. This was huge not only for the SALT community, but for anyone who buys or sells online.

State revenue officials and lawmakers have been copying and pasting S.B. 106 — the South Dakota law that was the subject of the litigation — onto their books as fast as they can hit "Ctrl C" and "Ctrl V." At last count, more than 30 states enacted similar threshold-based economic nexus rules. New York, however, even with one of the biggest retail markets in the country and its aggressive pursuit of online sales taxes remains deafeningly silent. The state Department of Taxation and Finance has declined to comment on *Wayfair*, saying only it is under review.

An existing New York law could possibly give the department the right to impose tax collection and payment requirements on out-of-state vendors who lack physical presence. Tax Law section 1101(b)(8)(i)(E) treats any person who "regularly or systematically solicits business in this state" as a vendor required to collect tax, so long as "such solicitation satisfies the nexus requirement of the United States constitution."[12] After *Wayfair*, it's possible that some solicitation would qualify as constitutional even without an in-state physical presence. Despite this general provision, we hope to hear more from New York on the issue soon.

While we applaud the state's ability to respond to the IRS's SALT deduction cap regulations within days, we encourage additional guidance on perhaps the Supreme Court's biggest SALT case of the past generation.

III. Other News and Notes

While the TCJA and *Wayfair* will likely dominate the 2018 headlines, other news, cases, and guidance also kept us busy over the past year.

A. *Sobotka* (Retroactively?) Reversed

A few years ago, our firm litigated and won the *Sobotka* case,[13] in which an administrative law judge in New York's Division of Tax Appeals held that the 183-day rule under New York's statutory residency laws did not apply to taxpayers who had a change of domicile during the tax year. More specifically, the judge held that only the days in the nonresident portion of the taxpayer's tax year counted for the 183-day test.

The tax department did not like this decision, and legislation was proposed to reverse it. But the proposal was originally styled as a "clarification," meaning that the change could have applied to all open tax years. The change went through as part of New York's fiscal 2019 budget,[14] but, in the final version, it was not retroactive. Rather, our strong opinion is that this is a *prospective* change only, beginning for tax years in 2019, which means that for tax years before 2019, the *Sobotka* issue is very much alive.

B. Hedge Fund Deferred Compensation Guidance

For years we've been following a ticking income tax time bomb that deals with a big 2017 issue for hedge fund managers receiving deferred income. In 2008 Congress eliminated a common mechanism used by cash-basis hedge fund managers to defer the receipt and recognition of certain incentive or management fees. Under section 457A, which was effective for fees earned for services rendered on or after January 1, 2009, hedge fund managers were limited in their ability to defer those fees. Before section 457A, the management company was able to defer the receipt and recognition of the incentive or management fees (per the deferral agreements) that were charged to offshore funds. Those fees were able to appreciate, tax-deferred, for up to 10 years. Because the management companies taking advantage of the benefit were cash-basis taxpayers, those companies — and therefore their owners — did not have to recognize the deferred fees until they were received. But under the new rules, the

[10] *South Dakota v. Wayfair Inc.*, 585 U.S. ___ (2018).

[11] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[12] N.Y. Tax Law section 1101 (b)(8)(i)(E).

[13] *Matter of Sobotka*, DTA No. 826286, ALJ Unit, Aug. 20, 2015. *See also*, Timothy P. Noonan and Andrew W. Wright, "A New Trump Card for New York Residency Audit?" *State Tax Notes*, Nov. 2, 2015, p. 375.

[14] A. 9509.

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ability to defer fees earned after January 1, 2009, was limited, and any fees earned and deferred before that date had to be recognized for tax purposes by the end of 2017.

As 2017 approached, many wondered what states (and cities) would do. It wasn't until 2018, however, that New York state issued a technical memorandum[15] and New York City issued a finance memorandum[16] addressing the issue.

The guidance instructed taxpayers to use the allocation factors and rules that apply in the year of recognition (that is, 2017), but use the facts and places of performance that existed in the year(s) the income was earned — that is, current apportionment rules with historic apportionment factors. Both the state and city publications, however, should be taken with a grain of salt. Because legislation and regulation remain absent, many taxpayers may take the position that these memoranda are nonbinding and merely advisory in nature. We'll save that argument for another day.

C. False Claims Whistleblower Actions

New York's False Claims Act authorizes private citizen whistleblowers (also known as relators) to bring treble-damage false claims lawsuits — subject to oversight by the attorney general — against taxpayers (along with their advisers) who have engaged in tax fraud or knowingly filed false tax returns. To encourage whistleblowers to come forward, the law offers potentially huge rewards for successful whistleblowers and includes strong protective measures to insulate them from retaliation. By enacting new whistleblower laws in 2010, New York took a step rejected by the federal government and most state false claims acts, which prohibit cases based on violations of tax laws. In 2018 we continued to see examples of New York's broad law.

In *Anonymous v. Moody's Corp.*,[17] for example, the New York State Supreme Court Appellate Division reversed a lower court's ruling and held that the plaintiff-relator had sufficiently alleged in its complaint that Moody's — along with Marsh & McLennan Cos. Inc. — knowingly submitted false information concerning the appropriate amount of tax to be paid by one of Moody's related captive insurance companies. This was despite the fact that Moody's had been audited by the state and entered into closing agreements for the tax due. Although not a final judgment on the merits of the whistleblower's claims, the case reminds us that taxpayers, even those entering into audit closing agreements, may continue to face new complaints regarding questionable or aggressive tax planning.

And on September 27, the New York attorney general announced a $30 million settlement for tax abuses with a hedge fund manager, Harbinger Capital Partners Offshore Manager LLC, adding to a previous $40 million settlement with a related investment management company, Harbert Management Corp.[18] The crux of the attorney general's case was Offshore Manager's failure to apportion any of its incentive fees from successful trading to New York, despite conducting its trading activities from a New York City office. Notably, state and municipal apportionment rules for hedge fund partnerships are complex — with minimal guidance from the state and city.[19] This raises the important question of how a person can "knowingly" violate a tax law that is not clear in the first place.

IV. What's Next?

With 2018 coming to a close, those of us who remain in New York should expect the trend of the past 230 years to continue and for tensions between Albany and Washington to remain when it comes to the proper enforcement of state taxes. But it's not all bad news. At least one thing has improved since the Democratic-Republican and Federalist feuds of the early 1800s: There were no deadly political duels in 2018. ■

[15] TSB-M-18(2)C, 3(I), "New York State Tax Treatment of Nonqualified Deferred Compensation" (Apr. 6, 2018).

[16] NYC Department of Finance, Finance Memorandum 18-6, "Recognition and Allocation of Deferred Income from a Non-Qualified Deferred Compensation Plan" (June 29, 2018).

[17] 2018 WL 4139963 (N.Y. App., Aug. 30, 2018).

[18] Release, "A.G. Underwood & NYC Corporation Counsel Carter Announce $30 Million Settlement With Investment Manager For Tax Abuses" (Sept. 27, 2018).

[19] Noonan, Ariele R. Doolittle, and Elizabeth Pascal, "Hedge Funds, Apportionment, and Whistleblowers in New York," *State Tax Notes*, June 26, 2017, p. 1263.

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