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High Net Worth Family
TAX REPORT
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President's fiscal year 2014 budget contains numerous tax provisions

President Barack Obama released his proposed budget for the government's fiscal year 2014 on April 10, 2013, and, not surprisingly, the budget contains a number of revenue-raising tax provisions. It is far too early to know whether Congress will enact any of these proposed provisions.

Income Taxes. The media has focused on a few proposals that would affect high-income taxpayers, including proposals to:

- Impose a limit so that itemized deductions cannot reduce a taxpayer's income tax to an amount less than an overall effective tax rate of 28 percent. The proposal, effective in 2014, would apply to taxpayers in the three highest rate brackets and would also impose a tax on otherwise-tax-exempt interest for these taxpayers.
- Adopt the "Buffett rule" by imposing an effective tax rate of not less than 30 percent of adjusted gross income for those taxpayers whose adjusted gross income exceeds $1 million. Certain special consideration would be given for charitable contributions. This proposal would become effective in 2014.
- Prohibit further contributions to retirement plans such as IRAs, 401(k) plans, and profit-sharing plans when the taxpayer's account balance reaches the actuarial equivalent of the maximum benefit then permitted in a defined-benefit pension plan. At present, that amount would be about $3.4 million and would be subject to annual change as the defined-benefit limit fluctuates with cost-of-living adjustments.
- Adopt the partnership "carried interest" provision. A proposal that has been floating around for years, this would subject partners who hold noncapital income interests in partnerships to tax at ordinary income rates, rather than at capital gains rates, when the partnership recognizes what would otherwise be capital gains income or when the partner sells his partnership interest. The provision would also apply to income

interests in a limited liability company if the company is treated as a partnership for income tax purposes.

Estate and Gift Taxes. The president's proposals in the estate and gift tax area include:

- Beginning in 2018, the tax rates and lifetime exemption amounts would revert to their 2009 levels. The maximum tax rate would be 45 percent. For estate tax purposes, the exemption amount would revert to $3.5 million, and for gift tax purposes, only $1 million of that exemption could be used to offset lifetime taxable gifts. The proposal would ensure that no estate or gift tax would result from the decrease in the exemption amount for those taxpayers who made gifts under the current higher exemption amount before 2018. In essence, the "permanent" estate and gift tax provisions enacted last year are permanent only until Congress changes them again.
- The long-discussed consistency rule would be adopted, requiring taxpayers to use the value reported on the Form 706 estate tax return as the income-tax basis of assets received from a decedent.
- Grantor Retained Annuity Trusts (GRATs) would become subject to a minimum term of 10 years and a maximum term of the grantor's life expectancy plus 10 years, and the remainder interest would have to have a value greater than zero. This proposal would apply to GRATs created after the date of the proposal's enactment.
- Dynasty (long-lasting) trusts, which are exempt from the generation-skipping transfer (GST) tax, would be limited to a term of 90 years. After 90 years, the GST tax exemption allocated to the trust would terminate. This proposal would apply to trusts created after the date of the proposal's enactment and to transfers made after that date to pre-existing trusts.
- Sales to so-called defective grantor trusts would be eliminated by providing that the property sold to these trusts would, upon the grantor's death, be included in the estate of the grantor for estate tax purposes. This rule would apply to sales occurring after the date of the proposal's enactment, regardless of when the trust was created.

We will keep you updated on further developments as the president's budget proposal works its way through Congress.

Taxpayer successfully exchanges his former residence under Section 1031

In *Adams v. Commissioner (Tax Court, January 10, 2013)*, the taxpayer owned a home in San Francisco that he occupied as his principal residence. In 1979, the taxpayer moved out of the home and rented it to a tenant. In 2003, the tenant moved out and the taxpayer sold the home through an exchange intermediary, hoping to purchase qualified replacement property and complete a Section 1031 exchange. The taxpayer had a son living in Eureka, California, and he bought a home there as the replacement property for his exchange. He rented the home to his son at a below-market rent because his son possessed building expertise and made significant improvements to the home while he was living there.

The IRS took the position that the Eureka home was not qualified replacement property for the exchange because the taxpayer bought it with the intention of letting his son live there at below-market rent. The Tax Court found in favor of the taxpayer, determining that the taxpayer did not intend for the rental to be at less than fair market value because the son agreed to make substantial improvements to the home. The opinion contains no discussion about whether the taxpayer should have reported the value of the improvements as additional rental income.

The lesson to take from this case is not the fact that the taxpayer prevailed but rather that he had to go to the Tax Court in order to prevail. The IRS did not like the fact that the replacement property was rented to a family member for a stated rent that was below current fair market value. This is not the optimal way in which to structure an exchange.

Tax Court allows some discount in valuing fractional interests in works of art

In *Elkins v. Commissioner (Tax Court, March 11, 2013)*, the decedent had owned an art collection consisting of 64 pieces, some of which were paintings by prominent artists including Jasper Johns, Jackson Pollock, Henry Moore, Sam Francis, Cy Twombly, David Hockney, Paul Cezanne, and Pablo Picasso. Following a series of estate planning-oriented transactions, the decedent ended up owning fractional interests in these works of art, and his children held the balance of the interests. The co-owners entered into an agreement whereby they all agreed that none of them would sell their fractional interest in the art unless the other co-owners joined in the sale. Following the decedent's death, the estate tax return filed for his estate claimed a 44.75 percent valuation discount for lack of control and marketability due to the fractional nature of the decedent's ownership of the art.

On its audit of the estate tax return, the IRS took the position that no discount should be allowed as a result of the fractional nature of the decedent's ownership. The IRS first argued that no weight should be accorded the agreement among the co-owners restricting sale because IRC Section 2703(a)(2) provides that property shall be valued without regard to agreements restricting the sale of the property unless certain exceptions apply, and none of the exceptions applied to the facts of this case. The IRS also argued that there should be no discount allowed for the decedent's fractional ownership because there was no market for the sale of fractional interests in works of art. This assertion was supported by the IRS's expert witnesses, who testified that where a work of art has multiple owners, it sells only when the owners all agree to sell the work, and then each owner receives his true percentage share of the art's sale value.

While the Tax Court agreed with the IRS on disregarding the agreement restricting sale, it nevertheless thought that some discount should apply for the fractional ownership. The court's reasoning relied significantly on the facts in the record, including that the decedent's children had expressed an affinity for the decedent's collection and wished it to remain in the family and that, following the decedent's death, each of the children had significant financial resources. From these facts the court concluded that if an unrelated party were to become the owner of a fractional interest, that party likely could sell his interest to the decedent's children at not more than a modest discount from the actual value of the fractional interest. Taking all of these facts into account, the court determined 10 percent to be the appropriate discount for the fractional nature of the decedent's ownership rather than the claimed 44.75 percent discount.

Attempt to complete a reverse exchange fails before California State Board of Equalization

In *Appeal of Patricia Bragg (SBE, November 2012)*, the California State Board of Equalization (SBE) determined that the taxpayer had failed in its attempt to complete a reverse like-kind Section 1031 exchange. In a reverse exchange, the taxpayer locates a property he wishes to purchase before he locates a buyer for the property he currently owns and wishes to sell. To ensure that the property the taxpayer wishes to purchase will not be sold in the interim, the taxpayer needs to find a friendly party or exchange intermediary to purchase the new property on his behalf and hold it until he can sell his current property. When he locates a buyer for his current property, he can sell it through the exchange intermediary and receive the replacement property from the intermediary to complete his exchange.

Naturally, the exchange intermediary does not want to incur any economic risk in connection with the purchase and holding of the real property that the taxpayer eventually wishes to acquire. The lack of risk creates the tax problems inherent in these transactions. Under the tax law, the like-kind exchange does not work if the taxpayer is considered to be the economic owner of the replacement property prior to the time he sells his current property. The exchange intermediary normally wants to transfer all of the risks and burdens and benefits of ownership of the replacement property to the taxpayer immediately through their contractual arrangement.

In the *Bragg* case, the intermediary did a good job of transferring these burdens to the taxpayer. The agreement between the taxpayer and the intermediary provided, first, that the intermediary would sell the replacement property to the taxpayer at the intermediary's cost to purchase the property plus the costs it incurred while it owned the property. The property was purchased with a loan that was guaranteed by the taxpayer, and the intermediary was not likely to make or lose any money by owning the property beyond the fee it charged. Second, the taxpayer was required to insure the property and pay the property taxes and other expenses of the property during the period the intermediary owned the property. Third, the taxpayer leased the property from the intermediary, but all rent that was paid by the taxpayer was credited to the purchase price when the taxpayer purchased the property from the intermediary. Fourth, the intermediary agreed that it would not further encumber the property during its period of ownership. Fifth, the taxpayer agreed to indemnify the intermediary against any loss or expense related to the purchase, ownership, or sale of the property; and sixth, if the taxpayer did not purchase the property from the intermediary after one year, the intermediary could terminate the exchange agreement and compel the taxpayer to purchase the property. Based on the above, the SBE determined that the taxpayer was the economic owner of the property from the date of the intermediary's acquisition, so the taxpayer did not receive this property in exchange for his current property.

While reverse exchanges are difficult, they are not impossible, and the IRS has established a safe-harbor procedure through which a taxpayer can accomplish a reverse exchange. The safe-harbor rules are contained in *Rev. Proc. 2000-37*, as later modified by *Rev. Proc. 2004-51*. As with a regular exchange through an exchange intermediary, the intermediary must be unrelated to the taxpayer. The key criterion is that the intermediary must transfer the property to the taxpayer within 180 days after it acquires the property — in effect, the same 180-day period the taxpayer has to acquire replacement property in a regular exchange after it sells its property. The taxpayer did not observe the 180-day limit in the *Bragg* case, so the taxpayer could not rely on the safe harbor.

If a taxpayer observes the 180-day limit, most of the factors that caused the taxpayer's exchange in *Bragg* to fail would be permitted. For example, the taxpayer can guarantee the loan the intermediary uses to purchase the property or can even loan the intermediary the purchase funds. The taxpayer can lease the property from the intermediary or manage the property. The price the taxpayer will pay to purchase the property can be fixed in the agreement. *Rev Proc. 2004-51* imposes the additional restriction that the taxpayer cannot own the replacement property before it is owned by the exchange intermediary.

While a reverse exchange can be done outside of the safe harbor, it is much more difficult because few intermediaries are willing to take the risks necessary to make them the economic owner for tax purposes.

California launches campaign to collect taxes from out-of-state entities

A common misperception is that an entity formed in a state other than California is not subject to tax by California, which is fueled by a considerable amount of advertising encouraging Californians to save taxes by incorporating out of state. In reality, where an entity is formed has no impact on how California taxes it. The Franchise Tax Board (FTB) has launched a publicity and enforcement campaign to increase the public's awareness of how out-of-state entities are taxed in California.

If a legal entity such as a corporation, partnership, or limited liability company is doing business in California, California taxes applicable to that type of entity apply. A California C corporation will be subject to the California Franchise Tax on that part of its net income apportioned to or sourced in California. S corporations are subject to the 1.5 percent S corporation tax on their net income apportioned to or sourced in California. A limited liability company is subject to an annual fee of up to $11,790, depending on the amount of gross receipts it has from California sources, up to a maximum of $5 million. Corporations, limited partnerships, and limited liability companies also are all subject to a minimum tax of $800 per year if they are doing business in California.

California expanded its definition of "doing business" in 2011. An entity is doing business in California under any of the following circumstances:

- The entity actively engages in any transaction in California for the purpose of financial gain or profit.
- The entity is organized or commercially domiciled in California. The commercial domicile is the principal location from which the business is managed.
- The entity has California sales in excess of the lesser of $500,000 or 25 percent of its total sales.
- The value of the entity's real property and tangible personal property located in California exceeds the lesser of $50,000 or 25 percent of the value of this property owned by the taxpayer.
- The entity's California compensation paid exceeds the lesser of $50,000 or 25 percent of the total compensation paid.

The FTB provided an example of the expansive definition. A California resident, Paul, is a member of a Nevada LLC. The LLC owns property in Nevada for which it hires a Nevada management company to collect the rents, etc. Paul has the right to hire and fire the management company and occasionally speaks with the management company by telephone. From these facts, the FTB concluded that Paul is actively engaging in business transactions on behalf of the LLC for financial profit in California, and therefore the LLC is doing business in California.

Last year the SBE decided a case in which it determined that a Nevada corporation was doing business in California. In *SUP, Inc. (SBE, November 14, 2012)*, the taxpayer was a Nevada corporation that served as the general partner of a Nevada limited partnership. All of the partnership's assets and business activities were located in Nevada. Another general partner of the partnership was a California corporation with a California address. Because the partnership had a California-based general partner, the partnership was considered to be doing business in California through the activities of its general partner. And because the partnership was doing business in California, the Nevada corporation was also considered to be doing business in California and was liable for the minimum franchise tax, adding further credence to the maxim: "Choose your partners carefully."

The LLC fee for 2013 must be estimated and paid by June 15, 2013, using Form 3536. The state can impose a penalty of $2,000 per taxable year if an entity from another state is doing business in California and does not properly qualify with the Secretary of State to do business and/or fails to file a tax return and pay the taxes and fees due. The penalty is due only if the FTB sends a written demand that a return be filed and the taxpayer does not file the return within 60 days. The penalty continues to apply if the entity's powers are suspended or forfeited and is in addition to any other penalties for nonfiling or nonpayment.

Be careful what you put in your e-mail

The United States District Court for the Eastern District of New York recently held, in connection with a criminal prosecution, that information a lawyer sent to his client by e-mail was not protected by the attorney-client privilege. In *United States v. Finazzo (February 2013)*, an estate planning attorney sent Mr. Finazzo an e-mail to his office e-mail address containing a list of assets to be covered by his estate plan. Some of the assets listed in the attorney's e-mail were interests in companies that were vendors to his employer, and he should have disclosed his ownership of these interests to the employer.

In a subsequent criminal prosecution arising, in part, from such undisclosed interests, Mr. Finazzo moved to exclude the material in the e-mail because it was in the form of a communication from his attorney subject to the attorney-client privilege. But Mr. Finazzo's employer had an e-mail policy that provided, in part, that an employee had no expectation of privacy with respect to e-mail communications to and from his company e-mail address. Any e-mail communication was subject to review and monitoring by the company without permission from the employee.

The court ruled that the communication was not privileged because, in order for a communication between an attorney and his client to be subject to privilege, the communication must be one the client intends to keep confidential and does, in fact, keep confidential. The client waives the privilege by disclosing the communication to third parties. The court ruled that the client could not have intended to keep the e-mail confidential because, under the company's e-mail policy, an employee's e-mail was subject to review and monitoring by the company at any time, and the communication was not privileged.

Even outside the criminal law arena, always be careful about what you say in an e-mail communication and what you attach to it. Any e-mail communication is likely to be preserved somewhere for an extended period. Under the rule of this case, no privilege applies to any communication with an attorney from your office e-mail account if your company has a similar policy, and most companies do have these policies.

Co-op shareholder permitted to deduct assessment for damage caused by a casualty

The United States Court of Appeals for the Second Circuit held that the shareholder of a cooperative housing corporation may deduct as a casualty loss her share of an assessment made to repair damage caused to the corporation's property by a casualty. In *Alphonso v. Commissioner (2d Cir., February 6, 2013)*, the taxpayer owned shares of Castle Village, a cooperative housing corporation that owned land and residential buildings in upper Manhattan, and, as is common, she also had a proprietary lease for her apartment unit from the corporation. A retaining wall collapsed on the property, causing considerable damage.

The corporation assessed the shareholders for the cost of repairs to the property. The taxpayer claimed a casualty loss deduction for her share of the assessment. The IRS disallowed the deduction on the basis that because the corporation owned the grounds on which the damage occurred, it could properly deduct the casualty loss — the taxpayer's lease was for her apartment, not for the grounds owned by the corporation. The IRS also argued that IRC Section 216 does not authorize this deduction because, by its terms, it allows stockholders of cooperatives to deduct only their share of the corporation's interest and property taxes and does not cover casualty losses. The Tax Court agreed with the IRS, and the taxpayer appealed to the Second Circuit.

The Second Circuit reversed the Tax Court, finding that the taxpayer's ownership of stock and her proprietary lease, augmented by the house rules, gave the taxpayer a sufficient property interest in the grounds that were damaged. While the taxpayer's lease covered only her own apartment, she did have the right to use the grounds and to exclude others who were not residents or guests of residents from any use of the grounds. The court ruled this was a sufficient interest in the property to allow the deduction of a casualty loss.

Taxpayer gets a break in connection with defective appraisal of donated property

We have reported recently on several cases that emphasize the strictness of the rules relating to charitable contributions of appreciated property. The IRS and Tax Court both have traditionally insisted on strict compliance with all of the various charitable contribution rules and procedural requirements, including a written acknowledgement of the gift by the donee and a qualified appraisal. In *Crimi v. Commissioner (Tax Court, February 14, 2013)*, the IRS acted predictably and disallowed the taxpayer's deduction for the contribution of real property to a county in New Jersey.

The IRS found fault with the form of donee acknowledgement. According to the IRS, the written acknowledgement contained an error in the description of the property, was not signed by the county, and did not include a statement as to whether any goods or services were provided to the donor. The appraisal was faulty because it was made earlier than 60 days before the donation, did not value the property as of the donation date, did not state the date of the expected contribution, did not recite that it was prepared for income tax purposes, described the property as having more acres than it had, and used market value instead of fair market value as the valuation standard.

In a surprising decision, the Tax Court was willing to overlook the various problems pointed out by the IRS. As to the acknowledgment from the donee, the court held it was signed on behalf of the county by someone with either actual or apparent authority to do so. The error in the description was minor and would not prevent the IRS from identifying the property. The acknowledgment letter also did state whether goods and services were provided because the gift transaction was in the form of a bargain sale in which the deduction claimed was for the value of the property in excess of the sale price, and the acknowledgment did state the amount paid for the sale.

While the appraisal was clearly defective, the court excused the defects for reasonable cause because the taxpayer relied on his CPA of more than 24 years to determine the requirements for the appraisal. Even though the CPA was wrong in this case, the court held that the taxpayer had reasonably relied on him. The statute specifically provides for the reasonable cause exception.

This case should not serve as justification for careless practice in connection with charitable gifts. The IRS was not prepared to show any leniency here, and the taxpayer was very lucky that the court did. Reasonable-cause arguments are usually a tough sell, and whether they will work is always uncertain. The best practice is to follow the rules carefully and not put yourself in a position of needing to rely on a reasonable-cause argument.

Private Letter Ruling suggests that assets held in a grantor trust and not included in grantor's estate may nevertheless receive a basis increase

In *PLR 201245006*, the IRS addressed a question that has been puzzling tax advisors for years. A person who was not a citizen or resident of the United States created a foreign grantor trust and funded the trust with shares of non-U.S. corporations. Upon his death, the trust provided that its assets were to be distributed to or held in trust for the grantor's children, some of whom were apparently U.S. taxpayers. Because the grantor was neither a citizen nor a resident of the United States and the trust's assets did not have a U.S. situs, the trust property was not subject to U.S. estate tax upon the grantor's death.

In addressing the income tax basis of the trust's assets following the death of the grantor, the IRS determined that these assets would receive a fair market value income tax basis under IRC Section 1014(b)(1), which accords a basis step-up to property "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." The IRS concluded that this description included the assets from the grantor trust that would go to the decedent's children upon the decedent's death.

Would the IRS issue this same ruling with respect to a wholly domestic grantor trust? A very common estate planning technique to transfer future asset appreciation to younger generation family members is the sale to a so-called defective grantor trust – a trust that is a grantor trust so the grantor will still be treated as the owner of the assets in the trust for income tax purposes and pay all income taxes due on the trust's income. At the same time, the trust does not contain any provisions that would cause the property it holds to be subjected to estate tax when the grantor dies. During the grantor's lifetime, he does not recognize any tax gain on the sale, and the trust does not get a stepped-up tax basis.

Whether the property will receive a basis step-up upon the death of the grantor has been uncertain, and advisors have expressed different opinions. Many believe that because the trust property is not subject to estate tax at the grantor's death, it likely does not receive a basis step-up. Others argue that, for income tax purposes, because the transfer to the trust is deemed to occur at the grantor's death, Section 1014(b)(1) should apply. The trust in *PLR 201245006* would have been included in the grantor's estate if he had been a United States taxpayer, where the usual defective grantor trust is drafted so that it will not be included in the grantor's estate. The IRS is not likely to agree that property held by such a trust receives a basis increase when the grantor dies.

New York Court of Appeals upholds Amazon Law

The New York Court of Appeals recently upheld the constitutionality of New York's Amazon law, which requires out-of-state (or remote) sellers to collect sales tax on taxable sales to New York customers based only on the sellers' referral agreements with New York residents and remit those taxes to the state.

New York's Amazon Law creates a rebuttable presumption that a remote seller is soliciting business in New York and is required to collect sales tax on all of its taxable sales to New York customers if (1) the seller enters into agreements with New York residents under which the residents, for a commission or other consideration, directly or indirectly refer potential customers to the seller, whether by link on an Internet website or otherwise; and (2) the seller has cumulative gross receipts of more than $10,000 during the preceding four quarters from sales to New York customers from such referrals. The New York State Department of Taxation and Finance released guidance explaining that advertising alone does not invoke the statutory presumption and that taxpayers can rebut the presumption if the contract with the New York resident prohibits the resident from engaging in any solicitation activities in New York on behalf of the seller and each resident submits an annual signed certification stating that the resident had not engaged in any such solicitation.

Amazon.com and Overstock.com, online retailers that did not have any offices, property, or employees in New York, each operated programs that paid commissions to New York residents when Amazon and Overstock made sales through links placed on the residents' websites. Amazon and Overstock argued that New York's Amazon Law is unconstitutional on its face because it violates the U.S. Constitution's Commerce Clause and Due Process Clause.

The Commerce Clause requires a substantial nexus with the taxing state before a state may require a seller to collect sales tax. The U.S. Supreme Court has interpreted this standard to mean that a seller must have a physical presence in a state before the state may require the seller to collect sales tax. The New York Court of Appeals suggested that the physical presence standard may be outdated because the Internet may allow an entity to have an impact on a foreign jurisdiction but submitted that this question would be for the U.S. Supreme Court to consider. The New York Court of Appeals noted that an in-state physical presence is necessary, but this presence need not be substantial, and that the presence requirement will be satisfied if economic activities are performed in

New York by the seller's employees or on its behalf. The court reasoned that Amazon's and Overstock's affiliation agreements with New York residents essentially allow Amazon and Overstock to establish an in-state sales force, and this relationship satisfies the substantial nexus requirement.

The Due Process Clause focuses on whether a party has purposefully directed its activities toward a state and whether, based on the party's contacts with the state and benefits derived from those contacts, requiring it to collect taxes for that state is reasonable. For the statutory presumption to be constitutionally valid, a rational connection between the facts presumed and a fair opportunity for the taxpayer to rebut the presumption must exist. The court found that it is rational to presume that, given the direct correlation between referrals and compensation, New York residents likely will seek to increase their referrals by soliciting customers in New York, and that the New York State Department of Taxation and Finance has provided a mechanism by which retailers will be deemed to have successfully rebutted the presumption.

The New York Court of Appeals' opinion likely provides comfort to other states that have adopted or are considering similar Amazon Laws. Amazon and Overstock may appeal the case to the U.S. Supreme Court, but Congress may resolve the issue first. Congress is considering legislation, the Marketplace Fairness Act of 2013, that would allow states to require remote sellers to collect and remit sales and use taxes on remote sales if the states simplify their sales tax systems and provide software to allow sellers to calculate sales taxes and file sales and use tax returns easily. The legislation exempts from these collection responsibilities remote sellers that generate less than $1 million in gross annual receipts in the preceding year from remote sales in the United States.

New York State enacts 2013-2014 budget

New York recently passed the 2013-2014 budget that is intended to close a $1.3 billion gap. While the budget contains no new taxes or fees, the budget legislation contains a few notable personal income, corporate franchise, sales tax, and other tax changes.

Personal Income Tax

- Extends through 2017 the current tax rate structure, including the 8.82 percent highest personal income tax rate for individuals whose New York adjusted gross income exceeds $1 million if single or married filing separately, $2 million if married filing jointly, or $1.5 million if filing as head of household.
- Extends the limitations on itemized deductions for charitable contributions through 2015 for high-income taxpayers. Taxpayers with New York adjusted gross income over $10 million are limited to a 25 percent New York State itemized deduction, and taxpayers with New York adjusted gross income of more than $1 million and less than $10 million are limited to a 50 percent New York State itemized deduction. Conforming amendments were made to the New York City Administrative Code.
- New York residents with New York adjusted gross income of between $40,000 and $300,000 who claim at least one dependent under the age of 17 on the last day of the tax year and have tax less other credits greater than or equal to zero will be eligible to receive a new child tax credit of $350 per year beginning in 2014.

Corporate Income Tax

- Phases in a tax reduction for qualified New York manufacturers.
- Enacts technical changes addressing a perceived loophole in the related member royalty add-back statute. Taxpayers who make royalty payments to related affiliates are required to add back the amount of the payments to taxable income if they deducted these payments when calculating federal taxable income. If the royalty recipient was also a New York taxpayer, the statute permitted the recipient to exclude the royalty income if the related member added back the deduction for the royalty payment expense. Taxpayers took advantage of this income exclusion by establishing a royalty payer in New York with a low business allocation percentage to satisfy the add-back prong of the transaction. This permitted the royalty recipient with the high-allocation percentage to receive the full income exclusion. The budget legislation closed this loophole by repealing the income exclusion and providing four alternative exceptions in its place. The add-back requirement does not apply generally if the taxpayer establishes that (1) the taxpayer's related member paid significant taxes on the royalty payment in other jurisdictions; (2) the related member paid all or part

of the royalty payment it received to a third party for a valid business purpose; (3) the related member is organized under the laws of a foreign country that has a tax treaty with the United States; or (4) the taxpayer and the Tax Department agree to alternative adjustments that more properly reflect the taxpayer's income. Additionally, the budget legislation links the term "related member" to the definition in IRC Section 465(b)(3)(c) but substitutes 50 percent for the 10 percent ownership threshold.

- The budget extends the Metropolitan Transportation Authority (MTA) business tax surcharge through 2018.

<u>Credits</u>

- Extends the Empire State Film production and post-production tax credits through 2019 and includes certain relocated talk or variety shows. The Governor's Office of Motion Picture and Television Development was awarded an additional $2.1 billion in tax credits to allocate in installments of $420 million per year in 2015 through 2019. Beginning in 2015, the amount of the allocation to the post-production credit increases from $7 million to $25 million. The post-production credit eligibility threshold for visual effects and animation (VFX) has been lowered to $3 million or 20 percent of total VFX post-production costs at a qualified New York post-production facility. In 2015 through 2019, film and post-production projects are eligible for an additional credit equal to 10 percent of the wages or salaries of individuals employed by a qualified film with a minimum budget of $500,000 or independent film production company for services performed in certain upstate New York counties.

<u>Sales Tax</u>

- Exempts from sales and use tax natural gas purchased in an uncompressed state and converted into compressed natural gas for use or consumption in the engine of a motor vehicle.

<u>Minimum Wage</u>

- Raises New York's minimum wage from $7.25 per hour to $9.00 per hour over three years ($8.00 by the end of 2013, $8.75 by the end of 2014, and $9.00 by the end of 2015).

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