

NY Tax Talk: Questions In Corporate Franchise Tax Regs Case

By **Elizabeth Cha and Chelsea Marmor** (October 31, 2024, 3:53 PM EDT)

This article is part of a quarterly column that examines recent developments in New York tax law. In this installment, we focus on a pending challenge to New York's Corporate Franchise Tax regulations.

The first challenge to New York's Corporate Franchise Tax regulations is already in high gear: *Paychex Inc. v. Department of Taxation and Finance*.^[1]

Paychex, an employment support services company,^[2] initiated an Article 78 proceeding in the Supreme Court, Albany County, against the New York Department of Taxation and Finance challenging two subsections of the regulations specifically, and the retroactive application of the regulations generally, arguing that the nine-year retroactive application is unreasonable and excessive with no legitimate public purpose.

Background

Although New York's corporate tax reform took effect Jan. 1, 2015, it took the department almost a decade to adopt the regulations. For many years prior to and during the State Administrative Procedure Act notice and comment period, the department issued numerous draft regulations, many of which included substantial revisions to the prior drafts. Each successive draft drew several comments, including concerns regarding the potential retroactive application of the regulations.

Further, as such commenters noted, it had been the department's practice to adopt amendments to the Business Corporation Franchise Tax Regulations with prospective application.^[3] Despite these concerns, the department remains determined to apply the regulations retroactively effective as of Jan. 1, 2015.^[4]

New York courts have held that whether retroactive application of a regulation is permissible, or whether it violates a taxpayer's due process rights, requires an evaluation of (1) the forewarning of the change and the reasonableness of the reliance on the former law or regulation, (2) the length of retroactivity, and (3) the public purpose of the retroactivity.

For example, in *Matter of Dominion Textile (USA) Inc.* in 1995, the New York Tax Appeals Tribunal rejected the taxpayer's argument for retroactive application of a corporate tax regulation.^[5] One reason for rejecting the taxpayer's argument was that the statute for which the regulation was



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promulgated was ambiguous and the regulation was a change in the department's long-standing interpretation of the statute.

Paychex Complaint

Paychex similarly argues that the regulations are in conflict with long-standing New York and federal tax policies.

At issue in the case, is whether the payments that Paychex receives from its customers as reimbursement for the wages it pays to worksite employees should be included in the definition of business receipts for purposes of computing Paychex's apportionment factor for sourcing New York income.

Pursuant to the regulations, "reimbursement of expenses" received from a customer is not included in the definition of business receipts. The regulations further include an example, which states that the fees that a professional employer organization, such as Paychex, receives from its clients to pay its employee wages and other expenses are not considered business receipts.

Citing to the definition and use of the term "receipts" in New York sales tax statutes and the Internal Revenue Code, Paychex argues that the regulations create a new definition of receipts that is inconsistent with the term's plain meaning and its use in other tax contexts. For this reason, Paychex argues that the department should not be given deference in its interpretation of the term "receipt."

Further, in addition to challenging the retroactive application of the regulations as a violation of its due process rights, Paychex also challenges the department's unofficial position that it may choose not to impose penalties on taxpayers who relied on drafts of the regulations in taking a tax position. Paychex argues that its equal protection and due process rights may be violated because the department failed to set out criteria that it will follow in making such determinations, leaving the door open for the potential for arbitrary and unforeseen enforcement of the penalties.

Department's Response

In response to Paychex's complaint, the department filed its answer and motion for summary judgment seeking dismissal of the complaint on the merits, with prejudice. The department argued, among other things, that Paychex did not exhaust its administrative appeals and there was no final agency determination warranting an Article 78 proceeding. Paychex was still under audit when the complaint was filed.

Implications

If the court finds in favor of the department that any challenge to the retroactive application of the regulations must first exhaust the administrative process, then Paychex along with every other corporate taxpayer could be in limbo for many years. Challenges would need to work their way through department audits, Division of Tax Appeals determinations, and the Tax Appeals Tribunal decisions, where even cases that move quickly can take a long time until final resolution.

Further, as Paychex has raised in this case, the department's positions as adopted in the regulations, especially where such positions conflict with the language of New York's Corporate Franchise Tax, raise questions regarding whether the department should be granted deference in its interpretations of New

York's tax laws.

The court's decision will also likely affect New York City's Business Corporation Tax regulations, which are currently being drafted, and New York City's decision as to whether to apply the BCT regulations on a retroactive basis. Tax reform for the BCT took effect for tax years beginning on or after Jan. 1, 2016, and New York City has at least initially indicated that it intends its BCT regulations will be retroactive to Jan. 1, 2016.

The question of retroactive application, which affects tax periods that are currently under audit, is of such magnitude that the court should find a way to give taxpayers clarity now on what they should expect. Given the magnitude of the court's decision, it would be highly beneficial if the court could offer a clear and definitive ruling as soon as possible.

According to the department, the new regulations could be applied to any taxpayer for any open tax periods that may be subject to audit. Providing clarity on this question is essential to ensuring that taxpayers can adequately assess prior positions and prepare for any potential challenges.

In the event that the court does not provide the necessary clarity, perhaps by agreeing with the department that the case is not ripe, taxpayers should nonetheless take proactive steps, such as maintaining thorough documentation for prior tax periods and considering potential reserve positions.

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[1] Paychex Inc. v. Department of Tax'n & Fin., Index No.: 904047-24 (N.Y. Sup. Ct. Albany Cnty, 2024).

[2] Paychex's services include payroll processing and Professional Employer Organizations ("PEO"). Paychex's PEO business is an all-in-one administrative solution that allows its clients to manage employee benefits, human resources, payroll, and compliance. PEOs are regulated under the Professional Employer Act ("NYPEA") and must register with the Department of Labor.

[3] NYSBA Tax Section, Report No. 1481, "Proposed Regulations Addressing New York Tax Reform," (Oct. 9, 2023).

[4] N.Y.S. Dep't Tax'n & Fin., 20 N.Y.C.R.R. Ch. 1, Pts 1 through 9, subch. A, "Assessment of Public Comment," Part M (Aug. 19, 2023).

[5] DTA No. 812248 (N.Y.S. Tax App. Trib. May 25, 1995).