

All aboard! The impact of the NYS MTA payroll tax on alternative investment fund managers

by Brian J. Rebhun and Allison Wong

On May 7, 2009, New York Governor David Patterson signed into law Assembly Bill A08180, establishing the Metropolitan Commuter Transportation Mobility Tax (MTA payroll tax).¹ This bill was written to alleviate fare increases and service cuts that were adopted in April as part of the Metropolitan Transportation Authority's budget. The bill imposes a new tax on employers and self-employed individuals engaging in business within the 12 counties of the Metropolitan Commuter Transportation District (MCTD), which consists of all five boroughs of New York City, Nassau, Suffolk, Westchester, Orange, Dutchess, Putnam, and Rockland counties.²

The payroll tax is in addition to the MTA surcharge, which is imposed on corporations, transportation and transmission companies, banks, and insurance companies under Articles 9, 9-A, 32 and 33 of the New York tax law.³ Similar to the MTA payroll tax, the surcharge was enacted to help finance mass transportation expenditures in the district. Although originally enacted in 1982 as a temporary surcharge, it has been extended year after year. For corporate taxpayers, the 17 percent surcharge is calculated based on the 9 percent corporate franchise tax rate in effect since 1997.⁴

Undoubtedly, the MTA payroll tax further adds to the high tax burden on alternative investment fund managers doing business in the transportation district. While the intent of the tax is to fund vital mass transportation expenditures without having to significantly raise commuter fares, it may have the unintended effect of driving out alternative fund managers and prolonging the economic recession in New York. This article will discuss the self-employment issues associated with the new MTA payroll tax.

Imposition of MTA payroll tax on self-employed individuals

Effective for tax years beginning on or after January 1, 2009, individuals, including members of partnerships and LLCs that are treated as partnerships, who have net earnings from self-employment allocated to the transportation district are subject to the MTA payroll tax.⁵ The tax is 0.34 percent of the total net earnings from self-employment allocated to the district for the tax year. The tax applies only if the individual's net earnings from self-employment allocated to the transportation district are greater than \$10,000 for the tax year. The \$10,000 threshold test must be applied on an individual basis regardless of the taxpayer's filing status.

"Net earnings from self-employment" means an individual's net earnings from self-employment as defined under Internal Revenue Code (IRC) Section 1402, which defines self-employment income subject to Social Security taxes.⁶ However, the annual limitation on the amount of net earnings from self-employment subject to Social Security tax in computing the amount of net earnings from self-employment subject to the MTA payroll tax does not apply.

"Net earnings from self-employment allocated to the MCTD" means an individual's net earnings from self-employment that are attributable to a business carried on within the district.

"Business activity" is carried on within the transportation district if an individual has, maintains, operates, or occupies desk space, an office, a shop, a store, a warehouse, a factory, an agency, or other place in the

1 NY Assemb. B.A08180, enacted 5/7/09 as Article 23 of NY Tax Law; NY TSB-M-09(1)MCTMT (6/1/09).

2 NY Tax Law § 800(a); NY Public Authorities Law § 1262.

3 NY Tax Law §§ 209-B, 183-a(1), 184-a(1), 1455-B, 1505-a.

4 NY Tax Law § 209-B(1).

5 NY Tax Law § 801(b)(1).

6 NY Tax Law § 800(e).

district where his or her business matters are systematically and regularly carried on. Similarly, business activity is carried on outside of the MCTD if the individual has, maintains, operates, or occupies desk space, an office, a shop, a store, a warehouse, a factory, an agency, or other place outside the district where his or her business matters are systematically and regularly carried on.

Allocation of net earnings from self-employment

An individual is allowed to allocate net earnings from self-employment if business activities are carried on both in and out of the transportation district. If all of an individual's business activity is carried on within the district, all of the individual's net earnings from self-employment are allocated to the district.

An individual who has net earnings from self-employment from activity both in and out of the transportation district must allocate those net earnings for purposes of determining whether the \$10,000 annual threshold has been met and the amount of Metropolitan Transportation Authority payroll tax due. For this purpose, net earnings are allocated using the same rules that apply for purposes of the allocation of business income earned in and out of New York state under the personal income tax rules. Accordingly, if the individual keeps books and records that fairly and equitably show net earnings from self-employment from business activity in the transportation district, the individual may determine the part to be allocated to the district from those books and records.

If the books and records do not fairly and equitably show the net earnings from self-employment in the district, the individual must allocate his or her net earnings from self-employment using the three-factor (property, payroll, and receipts) equally weighted statutory formula method or another method that has been authorized by the New York state commissioner. Members of a partnership or an LLC treated as a partnership will need to obtain allocation information, if applicable, from the partnership or LLC. Individuals, partners, and members of an LLC should focus on the calculation of their three-factor allocation formula, as this will impact the amount of net earnings subject to tax. Partners and members should attempt to receive accurate flow-through income and apportionment information from the partnership and LLC. This is especially important when several tiers of partnerships and LLCs exist.

Estimated MTA payroll tax payments⁷

Individuals, including members of a partnership or an LLC treated as a partnership, who will owe MTA payroll

tax for the tax year must make estimated payments. The estimated payroll tax payments are due April 30, July 31, and October 31 of the current year, and January 31 of the following calendar year. An individual may pay all of his or her estimated MTA payroll tax with the first payment or pay it in four equal installments.

Safe Harbor Rule for 2010

The estimated tax rules that apply for purposes of New York state personal income tax apply to the MTA payroll tax except that there is no exception from estimated payments for taxpayers who expect to owe less than \$300 of MTA payroll tax for the tax year. Therefore, to avoid a penalty for underpayment for the tax year, the individual's total MTA payroll tax payment(s) must be: (1) at least 90 percent of the amount of the payroll tax due for the tax year; or (2) 100 percent of the payroll tax reported for the prior tax year or 110 percent if the individual's net earnings from self-employment allocated to the transportation district for the prior tax year is more than \$150,000. However, this rule does not apply for tax year 2009.

The estimated MTA payroll tax payments cannot be combined with any estimated New York state personal income tax payments.

Special rule for 2009

The MTA payroll tax is imposed on an individual's net earnings from self-employment allocated to the transportation district if those earnings are more than \$10,000 for tax year 2009. However, the individual's MTA payroll tax liability for the 2009 tax year will be computed using ten-twelfths of the total net earnings from self-employment allocated to the district. In the case of a member of a partnership that operates on a fiscal year basis, the partner will include in the computation ten-twelfths of the net earnings from self-employment allocated to the district for the partnership's entire fiscal year that ends in the 2009 tax year.

If an individual is subject to the MTA payroll tax for 2009, the initial estimated payment is due November 2, 2009, (due to October 31, 2009, falling on a Saturday). The estimated payment due November 2, 2009, should reflect 75 percent of the tax due for the 2009 tax year.

Annual MTA payroll tax reconciliation

An individual with net earnings from self-employment must file an MTA payroll reconciliation return to reconcile his or her estimated payroll tax payments. The return is due on or before the 30th day of the fourth month

⁷ NY Tax Law § 804(b).

following the close of the tax year. (For calendar-year taxpayers, this will be April 30.)

The MTA payroll tax reconciliation return must indicate the actual amount of tax due for the tax year and the estimated payments made during the year. Any additional payroll tax due must be remitted with the reconciliation return.

Any overpayment will be refunded or may be applied to the individual's estimated MTA payroll tax for the next tax year. However, the department will keep all or part of any overpayment (refund) if the individual owes: (1) a New York state tax liability; (2) New York City or Yonkers personal income tax liability; (3) a past-due support or a past-due legally enforceable debt to the IRS, a New York state agency, or to another state; (4) on a defaulted governmental education loan, state university, or city university loan; or (5) a New York City tax warrant judgment debt.

An automatic extension of time to submit the reconciliation return may be granted if an individual with net earnings from self-employment cannot meet the due date for filing the MTA payroll tax reconciliation return. However, an extension of time to submit the reconciliation return does not extend the time to pay the tax. Full payment of any balance due must be made with the request for extension.

Group composite returns allowed

In August 2009, the department released information regarding a partnership's ability to file a group return on behalf of its electing partners. The group return filing for the NY MTA payroll tax is available **for all partners, both New York residents and nonresidents.** The group return filing for MTA payroll tax is separate from the NY nonresident composite income tax return filing (Form IT-203-GR). A partner may participate in the group return filing for MTA payroll tax and still elect to file separately for New York state personal income tax purposes. When electing into the New York state group return for personal income tax purposes, one loses the ability to claim itemized deductions and exemptions versus filing separately. However, there is no difference in the calculation of the MTA payroll tax between filing separately and electing into the group return. Therefore, for the principals of alternative investment funds, it would most likely be advisable to elect into the group return to avoid the administrative burden of filing an annual reconciliation.

To qualify for the group filing, the partnership must have two or more qualified partners who want to file as a group, and all partners in the group must have the same filing period. Partnerships must file form MTA-599, *Application for Permission to Make Metropolitan Commuter Transportation Mobility Tax Group Estimated Tax Payments and File a Group Return*. For the 2009 tax year, Form MTA-599 must be filed by September 15, 2009. For all subsequent tax years, Form MTA-599 must be filed by March 15 of the tax year. Once approved, the partnership will be issued a special MTA payroll tax identification number, which must be used on the payroll tax group filings. An approval to file on a group basis will remain in effect unless it is revoked. Annual approvals are not required.

MTA payroll tax payments are made with Form MTA-5, *Estimated Metropolitan Commuter Transportation Mobility Tax Payment Voucher*. The estimated group payments are due at the same time as the employer payments. The group return will be filed on Form MTA-505, *Metropolitan Commuter Transportation Mobility Tax Group Return*, and is due April 30 for calendar year-end partnerships.⁸ Please note that any overpayments of the payroll tax cannot be refunded and can be applied only to the group estimated payroll tax account for the following year.

Partnerships and partners

If a partnership, including an LLC treated as a partnership, is doing business within the Metropolitan Commuter Transportation District, each partner will be subject to the MTA payroll tax based on his or her share of the partnership's net earnings from self-employment allocated to the district if his or her net earnings from self-employment allocated to the district are more than \$10,000 for the tax year.

The partnership must provide either the actual amount of net earnings from self-employment allocated to the transportation district or the allocation percentage to each partner so that the partner can determine the amount of the MTA payroll tax due. To determine the amount of net earnings from self-employment allocated to the district or the allocation percentage, see the methods described in the "Allocation of Net Earnings from Self-Employment" section. Basically, allocation of net earnings can be based on accurate books and records or based on application of the three-factor (property, payroll, and receipts) equally weighted statutory formula method.

⁸ Fiscal year partnerships must file on or before the 30th day of the fourth month following the close of the fiscal year.

The MTA payroll tax does not address how the new law applies to alternative investment fund managers, who may have complex partnership structures. For example, with regard to alternative investment funds, if the fund is carrying on a trade or business in the transportation district (i.e., loan origination), then the income received by the general partner would be considered earnings from self-employment. Generally, most investment managers are structured as limited partnerships under law, with the principals directly invested as limited partners and an LLC as the general partner. The principals of the investment manager are generally members of the general partner LLC. Based on the new law, the guaranteed payments made by the investment manager to its principals as limited partners would be considered net earnings from self-employment as well as the principals' share of the management and incentive fee earned through the general partner vehicle. The principals' guaranteed payment and general partner income from the investment manager would be subject to the MTA payroll tax based on the investment manager's apportionment to the MTA zone. The principals' general partner income will be subject to the payroll tax based on the allocation to MTA zone of the fund's trade or business income.

Estimated MTA payroll tax payments on behalf of nonresident partners

Partnerships that do business within the transportation district are required to make estimated MTA payroll tax payments on behalf of individual partners who are nonresidents of New York state except under the following circumstances: (1) any partner whose estimated MTA payroll tax required to be paid for the tax year by the partnership is \$300 or less; (2) any partner if the partnership files a group return and the partner has elected to be included on the group return; and (3) any partner who certifies to the partnership that he or she will comply in his or her individual capacity with the department's MTA payroll tax estimated tax filing requirements.⁹

Due to the different estimated due dates as well as the separate annual reconciliation required, estimated MTA payroll tax payments cannot be combined with any estimated New York state personal income tax payments the partnership may be required to make on behalf of nonresident partners.

Please note that the estimated payment requirement is allowed only for nonresident partners. As stated above, if a partner goes into the group return, estimated payments are not required, thus making the group return option more attractive from an administrative basis.

⁹ The partner must submit form MTA-405-E, *Certificate of Exemption from Partnership Estimated Metropolitan Commuter Transportation Mobility Tax Paid on Behalf of Nonresident Individual Partners*.

Modifications for the MTA payroll tax on New York state tax returns and reports

When preparing New York state tax returns, any deduction permitted for federal income tax purposes for the MTA payroll tax must be added back,¹⁰ and any refund of the payroll tax must be subtracted, for purposes of computing New York state taxes imposed by Articles 9-A (corporation franchise tax), 13-A (petroleum business tax), 22 (personal income tax), 32 (bank franchise tax), and 33 (insurance franchise tax) of the New York tax law, and New York City administrative code Sections 11-602 (general corporation tax), 11-641 (banking corporation tax), 11-712 (commercial rent or occupancy tax), and 11-1718 (city personal income tax). An interesting note is that the addback is not required for the New York City unincorporated business tax (UBT), pursuant to New York City administrative code Section 11-501. It is unclear as to why the UBT was not one of the enumerated taxes included.

A partnership must provide each member with his or her share of any addition or subtraction modification relating to the MTA payroll tax.

The penalties under Article 22 of the New York state tax law (personal income tax) also apply to the MTA payroll tax. These penalties may include, but are not limited to: (1) late filing penalty; (2) late payment penalty; (3) failure to file penalty; and (4) penalty for underpayment of estimated tax (self-employed individuals only). Interest also applies on any MTA payroll tax that is not remitted on or before the payment due date.

Conclusions

As described above, the MTA payroll tax is complex in how it is applied and calculated. While the tax is imposed on employers and self-employed individuals, employers face unique issues as do self-employed individuals. Employers must apply a series of tests to determine whether an employee's services should be allocated to the Metropolitan Commuter Transportation District. Basically, the tests try to determine where an employee conducts most of his or her business activities. Opportunities exist for tax planning as the locations for some employees are not easily determinable. Businesses may also be tempted to move some or all of its operations outside the transportation district.

¹⁰ NY Tax Law § 292(a)(8).

While the MTA payroll tax is calculated on 100 percent of a covered employee's payroll expense despite the fact that the employee may work both inside and outside of the district, the tax is calculated differently for self-employed individuals, partners, and LLC members. Only the net earnings allocated to the transportation district, typically by applying an apportionment factor, is subject to the tax. Accordingly, an accurate calculation of the allocation factor will have a significant impact on that entity's MTA payroll tax liability. Other issues that partnerships and LLCs must deal with include nonresident withholding tax requirements and electing to file group composite returns. Clearly, the payroll tax does not address how the new law applies to specific industry groups, such as alternative investment funds, that may have more complex partnership structures.

With the enactment of the MTA payroll tax, alternative investment fund managers operating in New York City will be subject to an additional tax burden. As the tax cannot be collected from employees, fund managers who are already hurting from the recession are likely to absorb the tax as an operating cost. While the proceeds from the tax will help keep mass transportation fares from significantly increasing, businesses within the transportation district will bear the financial burden, and these businesses may pass on the burden to consumers. Although there is no simple solution to budget deficits during a recession, the MTA payroll tax may be the final straw that enables alternative fund managers to leave New York City and other areas in the district, such as Westchester and Long Island, for the greener pastures of Connecticut, New Jersey, or even to a no personal income tax jurisdiction such as Florida.

For additional information, please contact your PricewaterhouseCoopers engagement team or any of the partners in our practice.

www.pwc.com/us/alternativenewsletter