REPORT #685

TAX SECTION

New York State Bar Association

COMMITTEE ON SALES, PROPERTY AND MISCELLANEOUS TAX
and
COMMITTEE ON NEW YORK STATE TAX MATTERS
Comments on Tax Proposals
in
Governor's 1991 Budget

Table of Contents

Tax Report #685

TAX SECTION
New York State Bar Association

VIA FEDERAL EXPRESS

March 22, 1991

Terrence M. Boyle, Esq.
Director, Law Bureau
New York State Department
of Taxation and Finance
Building #9
W.A. Harriman Campus
Albany, New York 12227

Re: 1991 Budget Bills

Dear Mr. Boyle:

Thank you for forwarding to us copies of the Governor's Budget Bills for our review. Enclosed are Comments on many of these proposals by the Tax Section's Committees on Sales, Property and Miscellaneous Taxes and New York State Tax Matters.

We are hopeful that these views prove useful to you.

Sincerely,

E. Parker Brown, II

Enclosure

cc: Elizabeth Moore, Esq.
Counsel to the Governor
The Capitol
Albany, New York 12224

The Honorable Melvin H. Miller
Speaker of the Assembly Assembly
Legislative Office Building
Albany, New York 12248

The Honorable Ralph Marino
President Pro-Tem/Majority Leader
Senate Legislative Office Building
Albany, New York 12247

The Honorable Tarky Lombardi, Jr.
Chairman, Senate Financing Committee
Room 913, Legislative Office Building
Albany, New York 12247

The Honorable Saul Weprin
Chairman, New York State Assembly
Ways and Means Committee
Room 923, Legislative Office Building
Albany, New York 12247

The Honorable John C. Cochrane
Ranking Minority Member
New York State Assembly
Ways and Means Committee
Room 444, State Capitol
Albany, New York 12248

The Honorable James Wetzler
Commissioner of Taxation and Finance
Department of Taxation and Finance
Building 9, State Campus
Albany, New York 12227

William F. Collins, Esq.
Deputy Commissioner and Counsel
Department of Taxation and Finance
Building 9, State Campus
Albany, New York 12227

The Honorable John Dugan
Tax Appeals Tribunal
Riverfront Professional Tower
500 Federal Street, Fifth Floor
Troy, New York 12180-2893

cc: Mr. Abraham M. Lackman
Director of Fiscal Studies
Senate Finance Committee
Agency Building 4 -- 16th Flr.
Albany, New York 12247

Mr. Dean Fuelihan
Deputy Secretary, New York
State Assembly, Ways and
Means Committee
The Capitol -- Room 404
Albany, New York 12248

The Honorable Donald Halperin
Ranking Minority Member
Senate Finance Committee
Room 918, Legislative Office Building
Albany, New York 12247

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON SALES, PROPERTY AND MISCELLANEOUS TAX

and

COMMITTEE ON NEW YORK STATE TAX MATTERS

Comments on Tax Proposals

in

Governor's 1991 Budget

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON SALES, PROPERTY AND MISCELLANEOUS TAX

and

COMMITTEE ON NEW YORK TAX MATTERS

Comments on Tax Proposals in Governor's 1991 Budget*

I. SUMMARY OF CONCLUSIONS AND PRINCIPAL RECOMMENDATIONS

The following comments of the Committee on Sales, Property and Miscellaneous Tax and the Committee on New York Tax Matters of the New York State Bar Association Tax Section treat in varying degrees of detail a great many of the bills proposed to the Legislature by Governor Cuomo as part of his 1991-92 Executive Budget. Of particular note is the strong support of the Committees for giving authority to the Commissioner of Taxation and Finance to appeal decisions of the Tax Appeals Tribunal to court. In the sales tax area the Committees recommend important technical modifications to the Governor's proposal limiting the sales tax exemption for industrial development agency projects; oppose the method chosen to revise the taxation of computer software; question the impact on New York business of taxing transportation charges for the first time; and support the imposition of penalties and interest on bulk purchasers.

---

* These comments were coordinated by E. Parker Brown, II. Principal drafters were Mark E. Berg, E. Parker Brown, II, Robert E. Brown, Paul R. Comeau, Edward M. Griffith, Jr., Mark S. Klein, James A. Locke, Kenneth I. Moore, Ronald Rabkin, and Arthur R. Rosen. Helpful assistance was received from Peter C. Canellos, John A. Corry, and Michael L. Schler.

The Committees question the wisdom of creating yet another article in the Tax Law for the taxation of interstate and international telecommunications services. The Committees urge the Legislature to be mindful of the possible effect on medium-sized New York corporations of the proposal to alter the Article 9-A receipts factor by adopting a “throwout rule”. And finally, the Committees oppose S corporation changes designed to overturn the recent decision of the Tax Appeals Tribunal in the Baker case.

II. COMMENTS ON BILLS

A. PROCEDURE

S.2982/A.4482 (Budget Bill 112; Dep't. Bill 268) Section 18 et seq. Re Judicial Review of Tax Appeals Tribunal Decisions and Judicial Award of Costs and Expenses

Existing Law

Under existing law, taxpayers, but not the Department of Taxation and Finance, may appeal adverse decisions of the Tax Appeals Tribunal in an Article 78 proceeding in the Appellate Division, Third Department.

Purpose of Bill

The Bill would afford the Department the same rights as taxpayers in seeking judicial review of adverse decisions of the Tribunal. In addition, the bill adds a new provision which would, under certain extremely limited circumstances, provide reimbursement to taxpayers who prevail in any judicial review of a Tribunal decision for the costs and expenses (including legal fees) of such judicial proceedings.

Summary of Provisions

Costs and expenses would be awarded to a prevailing taxpayer by the court unless the court determines that the position of the Department was substantially justified or that special circumstances made an award unjust. A fee award is only available to a very limited group of taxpayers:

1) Individuals having a net worth excluding their principal residence of not more than $50,000.

2) Unincorporated businesses, partnerships, corporations, associations and other organizations having no more than 100 employees and a net worth of no more than $250,000.

3) All charitable organizations exempt from tax pursuant to Internal Revenue Code Section 501(c)(3).

Analysis

The Tax Section has strongly supported giving the Department the right to appeal adverse decisions of the Tribunal since the creation of the Tribunal, and subsequent events have reinforced our view that it is essential to give such appeal rights to the Department.

The Tribunal has proven to be an impartial and independent forum for the resolution of tax disputes. We believe that the Tribunal has significantly improved the perception of taxpayers that their tax disputes in New York will be fairly resolved.

Unfortunately, the inability of the Department to appeal decisions of the Tribunal has caused the Department to take actions which we believe will diminish the public's perception of the Tribunal. The Governor's budget package contains two bills which would overrule two decisions of the Tribunal. Originally these bills were to be retroactive for all taxpayers other than those taxpayers involved in the decisions of the Tribunal. Currently, these bills would be retroactive to 1990. In effect, the Department is appealing adverse decisions of the Tribunal to the Legislature because it cannot appeal them through the judicial process. This is an inefficient procedure, which also tarnishes the standing of the Tribunal. In addition, we understand that the Department has instituted an Article 78 proceeding against the Tribunal as a result of a recent decision by the Tribunal. While we do not comment on the merits of this litigation, suffice it to say that it is unseemly for one state agency to sue another. We believe that the only reason for this action is the inability of the Department to appeal Tribunal decisions.

We firmly believe that the ultimate resolution of tax controversies can be accomplished more fairly and economically if the Department is afforded the same right to appeal that taxpayers enjoy. To date, the Department has used restraint in appealing administrative law judge decisions to the Tribunal, and we believe that the Department would use similar restraint in appealing adverse decisions of the Tribunal. Thus, we strongly recommend that this portion of the bill be adopted.

The bill also provides that in certain limited circumstances, a prevailing taxpayer could be reimbursed for its costs and expenses (including legal fees) in judicial proceedings to review Tribunal decisions. Unfortunately, this provision is provided for a very limited class of taxpayers who rarely have tax controversies that proceed to the courts. The provision is based upon Article 86 of the Civil Practice Law and Rules, commonly known as the “New York State Equal Access to Justice Act.” That article provides for the reimbursement of costs and expenses, including legal fees, to citizens who successfully bring a civil action challenging certain actions of the state, but only to the limited class of citizens who would be eligible for such relief under the bill.

Since a tax controversy is significantly different from the types of proceeding covered by Equal Access to Justice Act, it would seem that the bill may be using the wrong model. Rather, if a decision is made that awarding costs and fees to a prevailing taxpayer is the correct result if the Department is afforded the right to appeal Tribunal decisions, reimbursement could be modeled after Section 7430 of the Internal Revenue Code. Under Section 7430, any taxpayer who is a “prevailing party” in any tax litigation may be entitled to reimbursement for “reasonable litigation costs.” In order to be a “prevailing party”, the taxpayer must establish that the position of the IRS was not substantially justified and that the taxpayer has substantially prevailed in respect of the amount in controversy or with respect to the most significant issues involved.

Although Section 743 0 may be applied to costs of contesting federal administrative actions generally, such a result probably cannot be currently justified at the state level in light of the current budget problems. Moreover, since the purpose of reimbursing a taxpayer's judicial costs and expenses is a quid pro quo for allowing the Department to appeal Tribunal decisions, we suggest that such reimbursement initially be available only in those cases where the Department appeals a Tribunal decision. This should keep a level playing field for taxpayers and the Department and would not have a significant budget effect since the Department is unlikely to appeal many decisions.

B. SALES TAX

1. S.2951/A.4451 (Budget Bill 62; Dep't Bill 137) Re Industrial Development Agencies

Existing Law

Under existing law, industrial development agencies created pursuant to Article 18-A of the General Municipal Law ("IDAs") have a more expansive exemption from sales and use taxes than other tax-exempt organizations. In a typical IDA financing, an IDA will appoint the industrial or commercial user of the facility ("User") as the agent of the IDA in acquiring property or services for the facility. The courts have held that generally all purchases by the User as "agent" of the IDA are exempt from sales and use tax as a purchase by an exempt organization, whether or not the purchase is financed with IDA bond proceeds. See Wegmans Food Markets, Inc. v. Department of Taxation and Finance, 126 Misc.2d 144, aff'd. 115 A.D.2d 962, lv. denied 67

N.Y.2d 606. It is unclear under existing law whether the cost of ongoing activities, maintenance and repairs are exempt from sales tax if the User has a true agency relationship with the IDA. In addition, unlike other tax-exempt governmental organizations, rents charged by IDAs to Users are not subject to sales tax, even if such rents are attributable to tangible personal property. Rents received by other tax-exempt governmental organizations are exempt from sales tax only to the extent the property rented is not of a type ordinarily rented to third parties.

Purpose of Bill

The bill would limit the circumstances under which a User could make tax-exempt purchases as agent for an IDA and would clarify that expenses for ongoing activities, maintenance and repairs are not exempt from sales tax.

Summary of Provisions

Under the bill, purchases by a User would be exempt from sales tax as a purchase by an “agent” of the IDA only if:

1) The purchases are for a project authorized by the General Municipal Law and the property or services will be used or consumed directly in such project. Purchases for maintenance, repairs and other ongoing services and operations activities and expenses would not be exempt.

2) The User and the IDA must have a written agency agreement.

3) The property or services purchased by the User as agent are purchased or paid for with funds from the sale of bonds of the IDA.

4) The agency relationship must be explicitly disclosed in the agreement between the User and the third party vendor and on a bill specifying the property or services sold by the vendor to the User.

Analysis

The bill would limit the ability of IDAs to provide sales tax relief for Users of IDA sponsored projects. Whether this is a wise course of action is a political decision for the Legislature.

We recommend that consideration be given to modifying the bill to clarify that payments made by the User of a project to an IDA which are used by the IDA to repay its bonds are not subject to sales tax. These payments are normally made in the form of a “lease” or “installment sale” payment to the IDA. Although the State Tax Commission in the late 1970s initially took a contrary position, such payments have not been subjected to sales tax, and the sponsor might consider making it clear in the bill that no change in law is intended with respect to that issue.

In addition, we believe that the proposed new limitations could be easily avoided unless the bill is redrafted. For example, the new limitations apply only where a User purchases as “agent” for the IDA. If the IDA directly purchases the property or services for the project, no limitations apparently apply. Furthermore, the restriction that an agent can

purchase goods or services tax-free only to the extent that such purchases are made from bond proceeds is also easily avoided since bonds can be issued to comply with this requirement and subsequently be quickly repaid. Thus, we recommend that further consideration be given to the scope of the provision.

We also make two technical comments on the bill:

1) The sales tax exemption for purchases by an agent is not available unless the property or services are “purchased or paid for” with funds from the sale of IDA bonds. Since in many cases the purchases are “reimbursed” by the IDA many months after the agent has paid for such purchases with the agent's own funds, there seems to be no discernable policy reason why such purchases should not also be eligible for the sales tax exemption.

2) The effective date provision of the bill needs clarification. Section 3 of the Bill provides it will generally take effect on September 1, 1991 for any sale or rent made on or after such date. However, two “grandfather” rules are provided to protect certain existing arrangements. The first provides that the change in law does not apply if prior to September 1, 1991 there is a mutually binding written contract between an IDA or its agent and a contractor or subcontractor for a fixed price contract for the construction of improvements to real property. The second grandfather provision is more difficult to understand. It provides that if there is a mutually binding written contract between an IDA and its agent entered into before September 1, 1991, sales or rents paid pursuant to such contract are not subject to sales tax “if subjecting such sale [or] rent . . . to a tax imposed under article 28 would constitute an

event of default under a binding industrial development agency bond covenant in existence prior to the date this act shall have become a law”. It is very unclear what relief this grandfather provision is intended to provide since few if any bond covenants provide for an event of default if the rent becomes subject to sales tax. Such covenants normally require the User to pay any additional taxes, but it is not an event of default. We recommend that the grandfather provision be expanded to cover all existing IDA projects. Since Users have incurred substantial expense in using IDA financing at least in part to take advantage of the sales tax exemption, to later subject such transactions to sales tax would be unfair. Moreover, as drafted, the grandfather rule encourages Users to seek to amend their IDA bond covenants before the law is adopted in order to add an otherwise meaningless event of default. This is an unnecessary and costly burden to place on IDAs and Users in order to preserve their sales tax exemption.

2. S.2948/A.4448 (Budget Bill 59; Dep't Bill 123) Re Computer Software

Existing Law

Sales of tangible personal property and certain services are taxable, but there are numerous exemptions and exclusions. Intangible personal property is not taxable because it is not within the scope of the sales and use tax law.

As technology has changed, computer software has become increasingly important. Software did not receive special attention in 1965 when the sales tax law was enacted, but as the software industry has grown, sales tax authorities have focused on the tax status of software.

In the mid 1970's, New York State attempted to define software as taxable tangible personal property. As a result of extensive state-wide hearings, the Department of Taxation and Finance reversed its initial position. TSB-M-78(1)S confirmed that customized software is nontaxable intangible personal property. Prepackaged software sold without any modifications or analysis of customer requirements and certain software sold as an integral part of hardware is taxable as tangible personal property.

New York's interpretation distinguishes taxable pre-packaged software, such as a program purchased in a retail store, from exempt customized software, such as professional programming services. The definition of customized software includes any software where (i) preparation or selection of the program for the customer's use requires an analysis of the customer's requirements by the vendor or (ii) the program requires adaptation by the vendor to be used in a specific environment. If canned or pre-written software is modified before it is sold to the customer, the software is converted from taxable tangible personal property to nontaxable intangible personal property.

Purpose of Bill

Budget Bill #59 is designed to define computer software as taxable tangible personal property, while creating an exemption for software prepared according to the specifications of a specific purchaser.

Summary of Provisions

Section 1 of the bill will amend paragraphs 6 of subdivision (b) of Section 1101 of the Tax Law to include computer software within the definition of “tangible personal property.” Section 2 of the Bill adds a new paragraph (28) to subdivision (a) of Section 1115 of the Tax Law. This new paragraph creates an exemption for computer software prepared by its author for and to the specifications of a specific purchaser. This exemption is designed to exempt from taxation customer software. If canned software is sold in conjunction with exempt software, the canned software will be taxed on the actual selling price or, if higher, the price at which similar software is sold at retail. If one person modifies software authored by another, the person performing the modifications is deemed to be the author of only the modifications. The canned software remains taxable, but the modifications may qualify as nontaxable custom modifications if they are prepared for and to the specifications of the specific purchaser. Section 3 of the bill provides that it will take effect on September 1, 1991, and will apply to all sales of software made on or after that date unless (i) a vendor and purchaser entered into a written contract prior to May 1, 1991, (ii) the vendor segregated the property being sold prior to May 1, 1991, and (iii) the purchaser paid at least 10 percent of the purchase price prior to September 1, 1991.

Analysis

We question three aspects of the proposed legislation: the structure of the change, the hypothetical retail sale as a

basis for taxation, and the effective date language. With respect to the structure of the change, it is apparent that the change is intended to tax pre-packaged or canned software as tangible personal property. This is consistent with treatment in several other states. However, the legislation has been drafted in a manner which categorizes all computer software as tangible personal property, subject to an exemption for software which qualifies as customized. We believe this is inappropriate. In effect, the change defines a service (programming services) as tangible personal property. This is not desirable. We prefer a definition which includes only pre-packaged or canned software as tangible personal property.

The retail sale language is also unusual because it does not reflect commercial practices. There may be situations where hardware, pre-packaged software, and custom software are sold as a package at a discounted price which is less than the price of each component sold separately. In these instances, we question whether it is appropriate to impose sales taxes based upon a hypothetical retail price at which the pre-packaged software would have been sold separately. In these instances, we believe it would be more appropriate to calculate the tax based upon an apportionment which compares the separate retail selling prices of each of the components. It might be appropriate to give the vendor an election, permitting collection of the tax based upon either the separate retail price of the pre-written software or based upon a fraction of that retail price, with the numerator equal to the actual selling price of the package of products and services (e.g. customer software, pre-packaged software, and hardware) and the denominator based upon the suggested separate retail price of each of the components.

Finally, we believe the effective date language is peculiar because it requires an actual payment of a portion of the purchase price before September 1, 1991. This requirement should be eliminated. Furthermore, we do not believe that the contract date for purposes of the grandfathering should predate enactment of this legislative change. Bill #59 permits grandfathering for certain agreements made before May 1, 1991. If the legislation is not enacted until after that date, we believe the grandfathering date should correspond to the date of enactment.

We are hopeful that in the future the Department can coordinate the rules on taxation of software with the rules regarding taxation of information services in light of the increasing overlap between the two areas.

3. S.2947/A.4447 (Budget Bill 58.1; Dep't. Bill 220) Re Airline Food

Existing Law

Tax Law § 1105(d)(ii)(A) excludes from sales tax food and drink sold to an airline for consumption while in flight. Soft drinks and other non-food items (candy and snack foods) are taxable when sold to airlines which serve them for no additional charge.

Purpose of Bill

To tax all food and drink sold to airlines for loading in New York onto aircraft for consumption on the aircraft.

Brief Summary of Provisions

Effective September 1, 1991, Tax Law § 1105(d)(i)(4) will provide that sales of food and drink to airlines are taxable. The airline is treated as the consumer of the food and drink so that the resale exclusion will be unavailable.

Tax Law § 1105(d)(ii)(A) is amended to limit the pre-existing exclusion. A compensating use tax under Tax Law § 1110(E) is provided as is conforming legislation under § 1131(4) (definition of taxable services) and § 1210(b)(1) (authorizing cities and counties to tax these services).

Use tax credits for taxes paid to other states/localities are also enacted under Tax Law § 1118(7)(a) and § 1235(a) and (b).

Analysis

The tax is imposed on food and drink sold to an airline "for loading in this state for consumption on such aircraft." See proposed Tax Law § 1105(d)(ii)(A). The use tax counterpart under § 1110 will impose a compensating use tax on purchases of food and drink "for loading in this state onto aircraft for consumption on such aircraft." It appears, therefore, that the use tax only covers purchases made out of state "for loading in this state."

Food and drink loaded onto an airplane outside of New York State is apparently not covered by the compensating use tax. Although this is consistent as a matter of theory with the view that the loading of food on the airplane represents the consumption by the airline (and hence the justification for the

inapplicability of the resale exclusion), it offers airlines a tremendous incentive to “load-up” on food and drink in other states, without paying any New York State tax. We believe the Legislature should reject a proposal containing this flaw.

Additionally, the flat-out prohibition from the use of the resale exclusion creates a double-tax problem for any airline that may wish to charge passengers a separate price for meals (e.g. as People's Express did a few years ago). This is inconsistent with the general intent of the law which is to subject a transaction to tax only once.

4. S.2988/A.4488 (Budget Bill 81; Dep't Bill 130) Section 6 Re Mandatory Gratuities

Existing Law

Voluntary “tips” or gratuities are not subject to sales tax. Mandatory “tips” or gratuities are not subject to tax if the tip is separately stated, is designated a gratuity and all of the proceeds are turned over to employees. See 20 NYCRR § 527.8(1).

Purpose of Bill

To tax all mandatory gratuities included as part of a taxable receipt, rent, or amusement charge and such involuntary payments made by purchasers or patrons.

Summary of Provisions

Effective June 1, 1991, Tax Law § 1111 is amended by adding subdivision (j) to provide for the taxation of all gratuities that are charged as part of a taxable service, rent,

or amusement charge and any other non-voluntary payment made by a customer in a taxable transaction.

Analysis

The department's statement in support of this legislation maintains that it represents simplification and an attempt to limit the tax avoidance that occurs under current law. We are not sure it is really much simpler to tax 100% of a bill versus 100% of a separately stated portion of a bill. As far as tax avoidance is concerned, we were not aware of any great abuse under the old rule since, in order to be exempt as a gratuity, all of the “mandatory gratuity” had to actually be turned over to the employees. Accordingly, the recharacterization of a taxable receipt as a “mandatory gratuity” would only could occur in the smallest of businesses where the owner was the employee who would be receiving the money.

5. S.2946/A.4446 (Budget Bill 57; Dep't Bill 134) Re Telephone Answering Services

Existing Law

“Pure” telephone answering services are not subject to sales or use tax. Paging services and telephone companies that offer answering services are taxable if they sell an integrated answering/telephone service. See 20 NYCRR § 527.2(d)(2).

Purpose of Bill

To tax all telephone answering services.

Summary of Provisions

Effective September 1, 1991, Tax Law § 1105(b) is amended to add telephone answering services to the list of services subject to tax. Tax Law § 1131(4) is also amended to conform to this change. The use tax under § 1110(F) is amended to ensure that telephone answering services performed out of state for New York customers will be subject to the compensating use tax.

Tax Law § 1210 is also amended to give cities and counties the ability to tax these services.

Analysis

Allocation issues may be a problem. The use tax covers services performed out of state "when such service is received by or comes into possession or control of" a person in New York. See proposed § 1110(F). Thus, a New Jersey resident with a New Jersey telephone answering service will be subject to this new tax when she calls her service from Manhattan. It would be impractical for her to keep a log of the locations from which she places calls to her answering service. Must the answering service keep a log of the location of its customers when they call in, so that it tracks all services "rendered in New York"?

Use tax credit issues are also not addressed. There is no credit provided for cases in which another state taxes telephone answering services located in that jurisdiction.

6. S.2988/A.4488 (Budget Bill 81; Dep't. Bill 130) Sections 1 and 5 Re Delivery Charges

Existing Law

Under existing law no sales tax is imposed upon shipping and delivery charges for tangible personal property where such charges are separately stated on the sales invoice. Sections 1101(b)(3), 1110. Shipping and delivery charges are considered to be separately stated if they can be determined from information appearing on the face of the bill. If shipping and delivery charges are combined with handling costs in one amount, the entire charge is taxable. Regulation 526.5(g). TSB-M-84(13)S. But see Mtr. of Spencer Gifts. Inc., Tax Appeals Tribunal, July 27, 1989, 1989 N.Y.T.C. T—499.

Purpose of Bill

Increase sales tax revenues by ending distinction between treatment of separately stated shipping and delivery charges and those that are not separately stated or are combined with handling or other charges.

Summary of Provisions

Deletion of statutory exemption for separately stated shipping and delivery charges and insertion of language including such charges in the definition of taxable “receipt.”

Analysis

The Memorandum accompanying Budget Bill #81 describes current law on transportation charges as allowing vendors to “avoid” sales tax and maintains that the proposal reduces the opportunity for “avoidance”, simplifies computation of tax and ensures a more level playing field among competitors. On the

contrary, the existing law represents a conscious decision by the Legislature to exclude transportation costs from the definition of a “receipt” subject to tax. The proposal is a straightforward effort to reverse that legislative decision, presumably in the interest of raising revenue. It has nothing to do with creating a level playing field.

This is a major change in the law affecting commerce in New York. No policy reason has been cited (other than the insubstantial ones discussed above) for the proposal, and there is no evidence that the ramifications of the proposal have been considered (the effect on the publishing industry in New York City, for example). While we take no position on the advisability of the policy change, we do caution against such a far-reaching amendment of the law without a thorough advance look at its effect on New York businesses.

7. S.2988/A.4488 (Budget Bill 81; Dep't Bill 130) Sections 2-4 and 7 Re Moving Services

Existing Law

Under existing law moving services are not subject to the sales tax.

Purpose of Bill

Increase sales tax revenues.

Summary of Provisions

Insertion of statutory language taxing moving services:

(a) provided by persons in the regular trade or business of providing moving services,

(b) excluding the moving of property held for sale,

(c) including services performed in connection therewith such as packing, installation, and preparation, etc.,

(d) to the extent they are performed in New York State,

(e) excluding shipping and delivery of letters or packages by the US mail or private companies performing similar services,

(f) performed after August 31, 1991.

On interstate movements receipts would be prorated based on the percentage of the total mileage occurring within New York. Packing and other incidental services would be taxed in New York if they occur in New York. Local tax would apply at the point of destination in New York. If the destination is outside New York, the tax would be imposed by the locality of origin.

Analysis

We will not comment on the policy choice involved here. On a technical level we do note, however, that the proration on the basis of mileage seems an appropriate way to satisfy the constitutional requirement that a levy on interstate commerce be fairly apportioned.

8. S.2950/A.4450 (Budget Bill 61; Dep't. Bill 136) Re Penalties and Interest on Bulk Purchasers

Existing Law

Pursuant to Tax Law Section 1141(c) a purchaser in a bulk sale can, under certain circumstances, become personally liable for unpaid taxes determined to be due from the seller in the transaction. The Tax Department over the years had taken the position that "taxes" in this context included penalty and interest owed by the seller. However, in Mtr. of Velez v. Division of Taxation, 152 A.D.2d 87 (3d Dep't. 1989), the Appellate Division ruled to the contrary, holding that the Legislature did not intend that a bulk purchaser be liable for penalties and interest assessed against the seller.

Pursuant to Tax Law Section 1147(b) tax and penalty, but not interest, may be collected without regard to time limitations in the civil Practice Law and Rules. In Spancrete Northeast, Inc. v. Wetzler, Supreme Court, Albany Co., Oct. 26, 1990, the court ruled that, because Section 1147(b) does not specifically except interest from CPLR coverage, the three-year statute of limitations at CPLR § 214(2) applies.

Purpose of Bill

To obtain a legislative reversal of the Velez and Spancrete cases.

Summary of Provisions

Tax Law Sections 1141(c) and 1147(b) and (c) would be

amended by inserting “penalty or interest” after the word “tax”.

Analysis

The recent court cases altered what had been the understanding for many years regarding bulk purchasers' liability and the limitations period on the interest component of assessments. The effects of the cases are unfortunate, and the loopholes they create are appropriately plugged by Budget Bill 61. We would urge, however, that the Department adopt a flexible policy regarding remission of penalties when a bulk purchaser innocently fails to observe the requirements of Tax Law § 1141(c) and becomes exposed to personal liability.

C. EXCISE TAX

S.2944/A.4444 (Budget Bill 54.1; Dep't. Bill 155) Re Interstate and International Tele-communications Services

Existing Law

Under current law, receipts from intrastate telecommunications services are taxable under the State's broad-based sales tax. The sales tax has historically excluded receipts from interstate telecommunications activities because of concerns that the State could not constitutionally tax those activities under the U.S. Constitution's Commerce Clause. A 1989 Supreme Court case, Goldberg v. Sweet, 109 S. Ct. 582, however, upheld the authority of the states to impose an excise tax on interstate telecommunication services if properly constructed.

In addition, corporations primarily engaged in the telephone business are liable for various taxes under Article 9

(rather than the 9-A tax on general corporations). Telephone companies are subject to a tax on gross income, levied at 3%; a gross earnings tax, levied at .75%; a minimum tax set at the greater of $75 or 0.15% of the net value of the company's issued capital stock; a maximum dividends paid tax set at $0.000375 for each 1% of dividends paid if the dividend rate is 6% or more; and a 3-year tax surcharge on tax liability of 15% for 1990 and 1991 and 10% for 1992.

Telephone companies may also be subject to the temporary MTA tax; assessments for specific state and local purposes; city and village gross receipts taxes; local consumer entity taxes; school district telephone service taxes; and real property taxes.

Purpose of Bill

The bill imposes a 2% excise tax on interstate and international telecommunications services.

Summary of Provisions

The bill creates an entirely new article of the Tax Law -- Article 28-B -- that imposes a 2% excise tax on the gross purchase price of all telecommunications services (intrastate as well as interstate and international). A credit against the tax for receipts from intrastate telecommunications services is provided, however, to undo any impact on the current taxation of intrastate services, already taxed under the sales tax. Vendors will collect the Article 28-B tax net of the credit provided for intrastate services. The new tax is to be administered jointly with the sales tax.

In an attempt to meet the requirements of Goldberg v. Sweet, the tax is imposed on telecommunications services that originate or terminate in New York and which are charged to a New York number or billed to a New York number or customer. The bill also provides a credit to prevent “double taxation” by states or foreign countries. An exemption is provided for certain sales to vendors providing telecommunications services for resale. This exemption does not apply, however, to vendors providing services through customer owned or leased currency operated telephones, as well as to hotels, etc. providing services to guests. Such vendors can claim a credit, however, for taxes paid on services subsequently resold.

The bill also provides for the apportionment of interstate and international private telecommunications service charges in cases where the gross purchase price is not separately ascertainable for each use.

The effective date of the bill is September 1, 1991.

Analysis

An argument can be made that sales of interstate and international telecommunications services, like intrastate services, should be subject to a broad-based tax if no constitutional prohibition exists. Logically, however, such taxation should be imposed through an extension of the general sales tax.

For economic development reasons, however, the Governor is reluctant to tax interstate and international telecommunications services at combined state and local sales tax rates that exceed 8% in some locations, including New York City.

There is substantial concern that at rates approximating 8%, the additional cost imposed on New York businesses, in particular the City's already weakened financial services sector, could have significant adverse consequences, including the potential relocation of some firms in this sector to non—New York locations. Strapped for revenues, however, the Governor is willing to impose a tax at a 2% rate -- still good for some $32 million in revenue annually.

The decision to establish a lower rate of tax for interstate telecommunications with no piggybacked local tax has led to the need for an entirely new tax article and some of the complexities that ensue.

The obvious criticism here is that the State, if unwilling to tax these services at the going sales tax rate, should not further complicate its tax structure by creating a new “half a loaf” tax. The tax would add complexity to the taxation of an industry already saddled with an arcane and burdensome taxing regime. Further, long distance carriers pay hefty “utility type” taxes based in part on gross receipts, despite the fact that the long-distance telephone business has been deregulated.

In addition, carving out exceptions to the general sales tax scheme sets a bad precedent. If the sales tax is to be extended to cover new services, such services should be taxed at the uniform rate, and subject to the local tax as well. If that is unpalatable, for whatever reason, then the exemption for that service should continue. Halfway responses breed both complexity and inequity.

D. CORPORATE TAXES

1. S.2961/A.4461 (Budget Bill 80; Dep't Bill 138) Re “Throwout” Rule

Existing Law

The tax imposed on general business corporations by Tax Law Article 9-A is measured by whichever of four alternative bases results in the greatest amount: income, capital, minimum taxable income, or fixed-dollar minimum. In the process of computing the amount of income or capital properly apportioned to New York for purposes of the income or capital bases, the business capital portion of total capital or the business income portion of modified federal taxable income is multiplied by the business allocation percentage.

Current law provides that the business allocation percentage be determined by adding the following fractions and dividing by four: the corporation's payroll relating to employees based in New York (other than general executive officers) divided by the corporation's worldwide payroll (other than that relating to general executive officers); the corporation's taxable property located in New York (real and personal, owned and rented) divided by the corporation's tangible worldwide property (real and personal, owned and rented); and twice the corporation's receipts from services performed in New York and from sales of tangible personal property delivered in New York divided by the corporation's worldwide receipts. (For the minimum tax computation, the receipts factor is not double-weighted and the sum of the fractions is divided by three instead of by four.)

Summary of Provisions

The “throwout” proposal contained in Budget Bill #80 would alter the receipts factor by excluding from the denominator any receipts relating to sales of tangible personal property delivered to any jurisdiction in which the corporation, or a member of its New York combined group, would not be subject to tax on its net income if the destination jurisdiction imposed a tax identical to New York's Tax Law Article 9-A.

Analysis

The Memorandum in Support accompanying the bill asserts that the proposed amendment prevents certain income from “escap[ing] taxation.” It is important to note that the use of the term “escape” presupposes that all income of a corporation should necessarily be taxed by some state and that if federal constitutional or statutory constraints prevent a jurisdiction from imposing tax on a portion of a corporation's income, a “default jurisdiction” should be assigned the windfall.

The proposal would have a special effect in the context of combined reporting, which purportedly is a tool to ensure that the New York-related income and capital of taxpayer corporations is properly reflected in their franchise tax reports. Combined reporting is a method of allocating the income of a group of affiliated corporations to the various members of the group; tax is then imposed on the income allocated to corporations subject to tax in New York. The Department proposal, by not requiring the throwout of receipts relating to deliveries to jurisdictions where any member of the taxpayer's combined group is subject to tax, is treating the group as a single taxpayer for this purpose.

It should be noted that while this is a benefit to taxpayer corporations, it is a necessary complement to New York's approach at attributing the New York allocation factors of nontaxpayer corporations to the combined group's taxpayer corporations.

We would note that companies which merely ship goods to other states would lose their current beneficial treatment. Accordingly, the proposal would have its greatest impact on smaller and medium-sized New York corporations because they -- in contrast to larger corporations -- are more likely to lack taxable nexus with other jurisdictions.

2. S.2941/A.4441 (Budget Bill 51; Dep't. Bill 121) Re S Corporations

The Governor recently proposed a Budget Bill that would effect three important changes in the treatment of S corporations for New York State corporation franchise tax and New York State and City personal income tax purposes. The Bill would:

1. codify the Department's position that the shareholders of a federal S corporation that are not eligible to make the separate New York State S election because the corporation is not otherwise subject to corporation franchise tax, e.g., the corporation is not engaged in business in New York (an “Ineligible Corporation”) are treated for State and City personal income tax purposes as if they had made the New York State S election;

2. provide that the franchise tax imposed, pursuant to Tax Law § 210.1(g) on a federal S corporation for which the New York State S election is in effect (a “New York S Corporation”) is not deductible by the shareholders of the corporation for State and City personal income tax purposes; and

3. overturn the recent decision of the Tax Appeals Tribunal in William A. Baker. Jr., 90-1 N.Y.T.C. T-687 (Oct. 11, 1990), which allows the State resident credit under Tax Law § 620 to resident shareholders of a New York S corporation in respect of taxes imposed by other states on the S corporation. For the reasons discussed below, the Committees are opposed to the first and third of these provisions and recommend several modifications of the provisions in the Bill.

A) "Automatic" New York S Election

Existing Law

New York State applies pass-through tax treatment to a federal S corporation for corporation franchise and personal income tax purposes only if its shareholders make a separate New York City S election. New York City neither recognizes the federal S election nor provides for a separate New York City S election. As a result, Federal S corporations are subject to the City general corporation tax. In addition, resident S corporation shareholders are subject to City personal income tax on the S corporation items passed through to them for federal purposes unless the New York State S election is not made. Under Tax Law § 660(a), the shareholders of a federal S corporation may make the separate New York State S election only if the corporation "is subject to tax under article nine-a of this chapter." Thus, an Ineligible Corporation may not be a New York S corporation.

Tax Law § 612 and Admin. Code § 11-1712 provide that the following modifications (the "Hybrid Modifications") are to be made to a federal S corporation shareholder's federal income for State and City personal income tax purposes where the New York State S election "has not been made":

(a) For each year in which the New York S election has not been made, federal income is (i) increased by the amount of any item of loss or deduction passed through to the shareholder under IRC § 1366, and (ii) decreased by the amount of any item of income passed through to the shareholder under IRC § 1366. Tax Law § 612(b)(19)(A), (c)(22)(A); Admin. Code § 11-1712(b)(19)(A), (c)(22)(A).

(b) Federal income is increased by the amount of any distributions to the shareholder that are not taxable by reason of IRC § 1368 and that represent income from a year with respect to which the New York S election had not been made. Tax Law § 612(b)(20); Admin. Code § 11-1712(b)(20).

(c) When the shareholder's stock or indebtedness is disposed of, federal income is (i) increased by the amount of the increases in the federal basis of the stock or indebtedness, pursuant to IRC § 1367(a) in years for which the New York S election was not in effect, and (ii) decreased by the sum of (A) the amount of the reductions in the federal basis of the stock or indebtedness, pursuant to IRC § 1367(a) in years for which the New York S election was not in effect, and (B) the amount of any prior increases pursuant to (b) above. Tax Law § 612(b)(21), (c)(21), (n); Admin. Code § 11-1712(b)(21), (c)(21), (n).

See also Tax Law §§ 612(e), 617(a), 637(c); Admin. Code §§ ll-1712(e), ll-1717(a) (modifications are to be made in accordance with the shareholder's pro-rata share of the item to which the modification relates).

Although the Tax Law clearly requires that the Hybrid Modifications are to be made in any case in which the New York S election "has not been made," the Department of Taxation and Finance has taken the position that these modifications are not to be made where the New York S election was not made because the corporation is an Ineligible Corporation, e.g., the corporation is not engaged in business in New York. Douglas Condon, TSB-A-88(12)I (Aug. 24, 1988); TSB-M-84(11) I (Aug. 2, 1984).[1]

[1] Although the City has not expressed an opinion on this issue, following the State's position necessarily results in not making the Hybrid Modifications for City purposes as well.

Summary of Provisions

Sections 1, 3, and 6 of the Bill are intended to codify the Department's position in Condon. Section 1 would adjust the definitions of “New York S corporation” and “New York C corporation” in Tax Law § 208.1-A to require that both be “subject to tax under this . . . Article [9-A].” This would mean that an Ineligible Corporation could not be a New York S corporation or a New York C corporation.

Section 3 would amend Tax Law § 612(e) (adding Tax Law § 612 ((e)(1)) to apply the normal New York S corporation pass-through rules to all shareholders of federal S corporations that are not “New York C corporations.” Presumably, this is intended to cause the Hybrid Modifications not to be made in the case of (i) New York S corporations, and (ii) Ineligible Corporations. Section 3 would also add new Tax Law § 612(e)(2), which would provide that in the case of a shareholder of a federal S corporation that is a New York C corporation, i.e., the New York S election could have been, but was not made, the only modifications relating to the corporation's items that would apply would be the modifications described in (a) above -- those in Tax Law §§ 612(b)(19) (relating to the increase for passed-through items of loss and deduction), and 612 (c)(22) (relating to the reduction for passed-through items of income). Section 6 would apply the amendments in Section 3 to the New York City personal income tax. Under Section 7 of the Bill, these provisions of the Bill would take effect “immediately.”

Analysis

There are several problems with this portion of the Bill. First, although the Memorandum in Support describes this provision as a “clarification” of existing law, the Bill would work a major change in the treatment of Ineligible Corporations[2] Rather than “eliminating any ambiguity,” the Bill would modify a statute that currently is very clear: shareholders of any federal S corporation that for any reason is not the subject of a New York S election— including Ineligible Corporations -- must modify out of their federal income all federal pass-through items. Calling this fundamental change a “clarification” only further obscures the substantive change, which is already obscured by the fact that the change is the result of seemingly minor definitional amendments to Tax Law § 208.1-A. The Bill and Memorandum in Support at the very least should be amended to make it clear that current law does not clearly require what the Memorandum in Support calls “automatic New York State S treatment” for Ineligible Corporations.

Second, there are important policy reasons not to adopt this change in current law. One fundamental uncommon feature of the New York treatment of S corporations is that New York State requires a separate State S election. In light of the State constitutional prohibition against taxing undistributed corporate profits (N.Y. Const., Art. XVI, § 3), it is thought that the separate election is necessary to give the shareholders of a

[2] This perhaps explains the Bill's prospective-only effective date in this respect, as compared with the 1990 effective date for certain other provisions (discussed below).

federal S corporation the opportunity to consent to the pass-through treatment for New York State (and City) tax purposes. Imposing pass-through treatment on shareholders of Ineligible Corporations, who are not given the opportunity to make the election, is unfair and possibly unconstitutional. The unfairness of automatically treating Ineligible Corporations as New York S corporations is particularly acute when this provision is combined with the denial of State resident credits for taxes paid by the S corporation to other states, discussed below.

Third, even assuming that the Bill in this respect were sensible and fair, the means used by the Bill to accomplish its ends are inappropriate. As discussed above, the current statute contains numerous Hybrid Modifications, i.e., specific modifications for shareholders of federal S corporations with respect to which the New York S election has not been made. Rather than amending the specific Hybrid Modifications themselves, the Bill would amend Tax Law § 612(e), which by reference to Tax Law § 617 provides that the modifications to be made by an S corporation shareholder are made in the amount of the shareholder's pro-rata share. Although this amendment apparently is intended to apply the Hybrid Modifications only to New York C corporations, Tax Law § 612(e)(1), as amended by the Bill, would provide only that New York S corporations and Ineligible Corporations are subject to the modifications in Tax Law § 612. Failing to amend the Hybrid Modifications directly to reflect the intention expressed in the Memorandum in Support, e.g., by providing that the “has not been made” language in the Hybrid Modifications does not apply to Ineligible Corporations could permit an interpretation of Tax Law § 612(e)(1), as amended by the Bill, to mean that shareholders of Ineligible Corporations continue to be required to make the Hybrid Modifications.

Similarly, Tax Law § 612(e)(2), as amended by the Bill, is confusing. If, as is suggested in the Memorandum in Support, this provision is designed to "make explicit what is implicit under existing law" regarding New York C corporations, it is unclear why this is not accomplished by directly amending the operative Hybrid Modification provisions rather than Tax Law § 612(e). Further, if the intention of the Bill is that the Hybrid Modifications are to apply to federal S corporations that are also "New York C corporations," it is difficult to imagine why Tax Law § 612(e)(2), as amended by the Bill, would render wholly inoperative all but two of the Hybrid Modifications. For example, failing to make the modifications that normally apply when stock is disposed of will distort the amount of gain or loss on the disposition for State and City purposes. See Tax Law § 612(b)(21), (c)(21), (n); Admin. Code § 11-1712(b)(21), (c)(21), (n).

Finally, the effective date should be clarified. Rather than applying "immediately", the Bill should take effect for taxable years beginning after December 31, 1991. This will avoid confusion regarding estimated taxes during 1991.

B) Denial of Deduction for S Corporation Tax

Existing Law

Beginning in 1990, New York S corporations are subject to State corporation franchise tax at a special rate. The tax is equal to the greater of (i) the fixed-dollar minimum tax, and (ii) the allocated entire net income of the corporation multiplied by the excess of the highest corporation franchise tax rate (including surcharge) over the highest personal income tax

rate. Tax Law § 201.1(g). Because this tax passes through to and is deductible by the shareholders for federal purposes, the tax passes through to and is deductible by the shareholders for New York State and City personal income tax purposes. See Tax Law § 612(b)(3) and Admin. Code. § 11-1712(b)(3) (requiring add-back only of "income taxes"); TSB-M-84(8.5)(c) (Dec. 29, 1988) (the State corporation franchise tax and City general corporation tax are not "income taxes" for purposes of Tax Law § 612(b)(3)).

Summary of Provisions

Section 2 of the Bill would amend Tax Law § 612(b)(3) to require that, in the case of an S corporation shareholder, the "income taxes" required to be added back to federal income include both the income-based tax and the fixed-dollar minimum tax imposed on the S corporation under Tax Law § 210.1(g). Thus, the tax would no longer be deductible for personal income tax purposes. This provision would apply to taxable years beginning after 1990.

Analysis

The Memorandum in Support attempts to justify this provision on revenue grounds -- the purpose of the S corporation tax, i.e., capturing the full differential between the franchise tax rate and the personal income tax rate, is not fulfilled if the tax is deductible. Putting aside issues as to whether the S corporation tax is wise or fair, the Committees agree that the purpose of the tax is better achieved by making this amendment. However, the Bill should not be retroactive. Current law is clear that the S corporation tax is not added back to shareholders' federal income. The Bill should be effective for taxable years beginning after December 31, 1991.

C) Denial of Credit for Other States' Taxes.

Existing Law

Tax Law § 620(a) provides that residents are entitled to a credit against their personal income tax for any “income tax imposed for the taxable year” by another state, the District of Columbia, or a province of Canada, on income “derived” from such other jurisdiction and subject to New York tax. In addition, as noted above, “income taxes” imposed by any taxing jurisdiction, to the extent deductible in determining federal adjusted gross income, must be added back to federal income. Tax Law § 612(b)(3); Admin. Code § 11-1712(b)(3).

The Department of Taxation and Finance has acknowledged that certain taxes imposed by another state on a New York S corporation are treated as having been imposed on the shareholders of the corporation for purposes of Tax Law §§ 620(a) and 612(b)(3). James F. Matthews, TSB-A-89(5)I (June 14, 1989); Robert Spielman, TSB-A-90(13)I (Nov. 30, 1990); see also William A. Baker. Jr., 1990-1 N.Y.T.C. T-687 (Oct. 11, 1990); cf. Smith v. New York State Tax Commission, 120 A.D.2d 907, 503 N.Y.S.2d 169 (3d Dep't 1986). In addition, the Tax Appeals Tribunal recently held that income-based franchise taxes of another state are “income taxes” for purposes of the credit and addback provisions. William A. Baker. Jr., 1990-1 N.Y.T.C. T-687 (Oct. 11, 1990). The Department of Taxation and Finance closely followed the Baker decision in a recent Advisory Opinion. Robert Spielman, TSB-A-90(13)I (Nov. 30, 1990).

Summary of Provisions

Section 4 of the Bill would add new Tax Law § 620(d), which would provide that “income tax” within the meaning of Tax Law § 620(a), (i) includes any income tax imposed on or payable by a shareholder of an S corporation, without regard to whether a separate state S election was required, and (ii) does not include any tax imposed on or payable by the corporation. In addition, Section 2 of the Bill would amend Tax Law § 612(b)(3) to provide that the addback for “income taxes” does not apply to taxes imposed by other states on the S corporation, thus allowing a deduction for corporate-level taxes. Section 5 of the Bill would provide the same addback rule for New York City purposes. These provisions would apply to taxable years beginning after 1989.

Analysis

In the words of the Memorandum in Support, the Bill would “nullify the effect” of the Tribunal Decision in Baker and the Advisory Opinion in Matthews (as well as Spielman). The most pressing concern with similar legislation submitted last December was its retroactive effect. This has been eliminated in large part in the Bill, although it is not clear why the provision should apply to 1990 and 1991 taxable years. Taxpayers reasonably relied on Matthews and Baker in structuring their affairs in (and perhaps in filing their returns for) 1990 and 1991. The Bill should be effective for taxable years beginning after December 31, 1991.

The basic thesis of Tax Law § 620 is that income of a New York State resident derived from and taxed in another state should not be taxed again by New York. Memorandum of Department of Taxation and Finance, 2 Session Laws of New York 3467 (McKinney 1962); William A. Baker. Jr., 1990-1 N.Y.T.C. T-687, T-692 (Oct. 11, 1990); Smith v. New York State Tax Commission, 120 A.D.2d 907, 909, 503 N.Y.S.2d 169, 171 (3d Dep't. 1986). The Tribunal in Baker based its decision on the fact that denying a credit in the case of a resident taxpayer of an S corporation that pays tax to another state would result in the double taxation that Tax Law § 620 was designed to prevent. 1990-1 N.Y.T.C. at T-692.

The Bill, however, would reverse this clearly correct result and subject the income of resident shareholders of S corporations to double taxation. The double taxation would be reduced, but by no means eliminated by the deduction. The Memorandum in Support attempts to justify this double taxation on several grounds. First, the Baker decision causes New York to lose revenue -- shareholders receive a dollar-for-dollar reduction in tax by reason of the credit, but would reduce their tax by only 7.875 cents per dollar if a deduction were instead allowed. The Memorandum takes the position that this revenue loss is inappropriate because the Baker decision puts New York in the position of subsidizing other states' refusals to grant S corporation treatment. In reply to the double taxation argument, the Memorandum suggests that “the appropriate recourse is that S corporation treatment be provided by the other state.”

The problem with this argument is that it proves too much. Every application of Tax Law § 620 could be said to cause New York to subsidize other states' tax policies. For example, an individual who directly pays taxes to another state could be denied the credit on the ground that any double taxation is caused by the other state's insistence that it may tax income of a New York resident that is derived in the other state.[3] Presumably for this reason, the Tribunal in Baker correctly rejected a similar argument made in the Administrative Law Judge's opinion. See William A. Baker. Jr., 1989-2 N.Y.T.C. J-1397 (Dec. 14, 1989). The revenue loss caused by the interpretation of the Tax Law § 620 in Baker is not different in substance from that caused by every application of Tax Law § 620, and is justified by the policy against double taxation of New York residents.

Second, the Memorandum notes that Baker creates ambiguity as to the deductibility of the City general corporation tax by S corporation shareholders for State personal income tax purposes, and the characterization of State and City taxes for purposes of the federal limitation on state taxation of federal bond interest. This is puzzling given the following statement by the Tribunal in Baker:

---

[3] This is not to say that the credit should be available to subsidize another state's taxation of income that is not properly subject to tax by that state. The “derived” language in Tax Law § 620(a) is designed to deny the credit in that case.

> Our review of the full scope of the case law . . . indicates that courts will often construe the same tax differently depending upon the precise issue before the court. From this we conclude that we should not attempt, nor purport, to characterize the New Jersey and Connecticut taxes for all purposes but instead recognize that our inquiry is limited to whether these taxes are income taxes as that term is used in Tax Law § 620(a).

1990-1 N.Y.T.C. at T-691 to T-692 (emphasis added and footnote omitted).[4] It is, therefore, incorrect to state that the Baker decision casts doubt as to the proper characterization of New York's corporate taxes for purposes of other provisions of federal and state law.

More importantly, even if the Baker decision caused any ambiguity, the Bill does not in any way address the characterization of New York's corporate taxes. Rather, the Bill simply denies the credit under Tax Law § 620. This argument in the Memorandum simply does not justify the Bill.

Finally, the Memorandum argues that the Bill would "conform New York to the majority position among the states." The Memorandum supports this proposition with two "facts." First, the Memorandum cites the Multi-State Tax Commission's proposed alternatives to the American Bar Association's Model S Corporation Income Tax Act. Interestingly, the Memorandum does not discuss the Model Act itself, Section 1008(a), which specifically allows credit for the resident income-based taxes paid by the S corporation. So far, three states have enacted the Model Act, including Section 1008(a). The staff of the MTC has

[4] The Tribunal cited cases in which the New Jersey Supreme Court held the New Jersey franchise tax to be both an income tax and a franchise tax, depending on the purpose of the inquiry. 1990-1 N.Y.T.C. at T-692 n.1.

suggested that the MTC endorse the Model Act, as modified, to include an alternative (as distinguished from replacement) provision that would deny the credit. However, the MTC has not yet officially decided whether to endorse the Model Act as adopted by the ABA or with the two alternative credit provisions.

Second, the Memorandum states the following:

> As of 1989, among the states imposing a personal income tax, 22 deny the credit for corporate level taxes, 12 allow the credit, 3 allow income allocation in lieu of credit, and the remaining have no position.

These statistics apparently include in the number of states that "deny the credit for corporate level taxes" all states whose statutes do not explicitly allow the credit in this situation. However, in several states (including New York) in which the statute provides for a credit for taxes paid by a resident individual, the taxing authority or the courts have interpreted the statute to allow the credit to S corporation shareholders for taxes paid by the corporation. In this regard, a leading treatise on state taxation of S corporations reports that only seven states have expressly taken the position that an S corporation shareholder is ineligible for the credit,[5] and that in two of those states Virginia and Massachusetts -- this position was later overruled by legislation. 1 J. Maule, S Corporations: State Law and Taxation Para. 5:53 (1989 & Supp. 1990). On the other hand, 13 states (including New York) now expressly permit the credit -- either by statute or otherwise -- in this situation. Id.[6] To this number can now be added North Carolina and Alabama,

[5] These states are Iowa, Alabama, Illinois, Kansas, Wisconsin, Virginia, and Massachusetts.

[6] These states are New York, Maryland, Massachusetts, Pennsylvania, Hawaii, Minnesota, California, Georgia, Ohio, Oregon, Virginia, Wisconsin, and Colorado.

which have enacted the Model Act. The remaining states apparently have not yet taken a position on the issue. Thus, the Bill does not follow the rule of the majority of states that have actually considered the issue.

In summary, the Committees believe the arguments made in the Memorandum in Support of the Bill do not outweigh the plain fact that denying the credit would unfairly impose a double tax on S corporation shareholders.

3. S.2942/A.4442 (Budget Bill 52) Re Bank Tax

Existing Law

(1) Article 32, the franchise tax on banking corporations, imposes an alternate minimum tax measured by taxable assets. The term “taxable assets” means the average amount of assets which are properly reflected on a balance sheet, but does not include “interbank placements” in an amount not exceeding $500 million if the banking corporation's total assets are comprised of 20 percent or more of interbank placements. The term “interbank placements” means the average value of interest bearing funds having a maturity of less than one year, placed or deposited with a qualified nonaffiliated banking corporation.

(2) Under Article 32, a fixed minimum tax of $250 must be paid if it is the highest tax.

(3) Under Article 32, a bank may claim a credit for servicing mortgages acquired by the State of New York Mortgage Agency. The credit may not reduce a taxpayer's tax below zero but it can reduce a taxpayer's tax below the fixed minimum amount. Unused credits may not be carried over to other taxable years.

Purpose of Bill

The purpose of the bill is to amend the franchise tax on banking corporations by eliminating the exclusion for interbank placements from the tax measured by assets and requiring banks to pay no less than $325 in any taxable year.

Summary of Provisions

(1) The definition of “taxable assets” is amended to delete the exclusion for interbank placements. Because it is no longer needed, the definition of “interbank placement” is deleted.

(2) The statute is amended to increase the fixed dollar minimum tax from $250 to $325.

(3) The provision relating to the credit for servicing certain mortgages is amended to provide that the credit may not reduce a taxpayer's liability to an amount less than the fixed dollar minimum tax.

Analysis

(1) The elimination of the interbank placement exclusion has the potential of increasing an affected banking corporation's tax by $50,000. According to the memorandum in support of this bill, the vast majority of taxpayers which qualify for the “interbank placement” exclusion (those having interbank placements equalling at least 20 percent of total assets) are foreign country banks. Thus, in practice, this amendment can be viewed as placing foreign country banks on a par with domestic banks.

(2) The increase in fixed maximum tax to $325 brings the Article 32 fixed minimum tax in line with the low-end of the Article 9-A fixed minimum tax.

(3) The amendment to the mortgage servicing credit is consistent with the view that a banking corporation should pay no less than $325 in any taxable year.

E. PERSONAL INCOME TAX

S.2943/A.4443 (Budget Bill 53; Dep't. Bill 122) Re Personal Income Tax Rates and Brackets, Standard Deduction, and Household Credit

This proposed bill changes the rates and brackets that would have been in effect in 1992 and thereafter by making them the same as those in effect for 1990 -- thus nullifying previously enacted prospective tax decreases for many taxpayers. The bill does this by repealing the apparent schedules of Tax Law § 601 (which were not really in effect), instituting new schedules in their place, and repealing the “transitional schedules” of Tax Law § 699 (which were really the operative

provisions). The bill also eliminates increases in the standard deduction and deletes a phase-out of the Household Credit.

F. ESTATE AND GIFT TAX

S.2949/A.4449 (Budget Bill 60; Dep't Bill 135) Re Estate and Gift Tax Rates and Unified Credits

This proposed bill increases the estate and gift tax rates and their respective unified credits. As an example, the bill increases the top bracket for the estate tax from 21% to 26.3%. Additionally, although the percentage increase in the rates ranges from 15% in the lowest bracket to 25% in the highest, the interaction of the rise in NY rates with the federal state death tax credit means that the percentage increase in actual rates for the highest brackets is over 50%. The agricultural credit is also amended to preserve the credit in view of tax rate changes. The bill would be effective immediately, except that it would apply to gifts and transfers only after the enactment date and the estates of those dying only after the enactment date.