REPORT #566

TAX SECTION

New York State Bar Association

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSALS TO AMEND

NEW YORK CORPORATE TAXATION

BY THE COMMITTEE ON NEW YORK STATE TAX MATTERS

June 17, 1987

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July 6, 1987

BY HAND

Honorable John P. Dugan
Deputy Commissioner & Counsel
New York State Department
of Taxation & Finance
State Camps, Building 9
Albany, NY 12227

Dear John:

I am enclosing a report by our Committee on New York State Tax Matters titled "Report on Proposals to Amend New York Corporate Taxation" which deals with the three proposals generally considered representing major positions: (1) A7262 (Assembly majority), (2) S4740 (Senate majority), and (3) 3430 (Governor). This report was written by Arthur R. Rosen. Helpful comments were received from Sheldon Cohen, Paul Comeau, William Colby, John Corry, Peter Faber, Arthur A. Feder, Hugh McCormick and Phil Spector.

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Sincerely,

Donald Schapiro

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July 6, 1987

BY HAND

Senator Donald M. Halperin
State Finance Committee
Room 918
Legislative Office Building
Albany, NY 13347

Dear Senator Halperin:

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Sincerely,

Donald Schapiro

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July 6, 1987

BY HAND

Honorable John Cochrane
Ways & Means Committee
Room 444
State Capitol
Albany, NY 12248

Dear Assemblyman Cochrane:

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Sincerely,

Donald Schapiro

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BY HAND

Honorable Saul Weprin
Chairman, Ways & Means
Legislative Office Building
N.Y.S. Assembly, Room 923
Albany, NY 12248

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July 6, 1987

BY HAND

Senator John J. Marchi
Senate Finance Committee
Legislative Office Building
N.Y.S. Senate, Room 804
Albany, NY 12247

Dear Senator Marchi:

I am enclosing a report by our Committee on New York State Tax Matters titled "Report on Proposals to Amend New York Corporate Taxation" which deals with the three proposals generally considered representing major positions: (1) A7262 (Assembly majority), (2) S4740 (Senate majority), and (3) 3430 (Governor). This report was written by Arthur R. Rosen. Helpful comments were received from Sheldon Cohen, Paul Comeau, William Colby, John Corry, Peter Faber, Arthur A. Feder, Hugh McCormick and Phil Spector.

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Sincerely,

Donald Schapiro

Enclosure

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REPORT # 566

TAX SECTION

New York State Bar Association

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July 6, 1987

BY HAND

Honorable Evan A. Davis
Counsel to the Governor
Executive Chamber
Second Floor
State Capitol
Albany, NY 12224

Dear Evan:

I am enclosing a report by our Committee on New York State Tax Matters titled "Report on Proposals to Amend New York Corporate Taxation" which deals with the three proposals generally considered representing major positions: (1) A7262 (Assembly majority), (2) S4740 (Senate majority), and (3) 3430 (Governor). This report was written by Arthur R. Rosen. Helpful comments were received from Sheldon Cohen, Paul Comeau, William Colby, John Corry, Peter Faber, Arthur A. Feder, Hugh McCormick and Phil Spector.

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NEW YORK STATE BAR ASSOCIATION TAX SECTION
REPORT ON PROPOSALS TO AMEND NEW YORK CORPORATE TAXATION

BY THE COMMITTEE ON NEW YORK STATE TAX MATTERS[1]

June 17, 1987

Numerous bills regarding corporate taxation have been introduced in the current session of the New York Legislature. These bills are in response to the 1986 federal Tax Reform Act; each is an attempt to return the "windfall" that is a result of the general conformity of the New York Tax Law to the Internal Revenue Code. If no changes to the New York Tax Law are made, there will be about a 10% increase in taxes paid by corporations to New York. Analysis and discussion throughout the state has focused on the major issues rather than on any particular proposal. This report will proceed in a similar manner with reference to the three proposals generally considered representing the major positions: A7262 (Assembly majority), S4740 (Senate majority), and A3430 (Governor).

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1 This report was written by Arthur R. Rosen, Helpful comments were received from Sheldon Cohen, Paul Comeau, William Colby, John Corry, Peter Faber, Arthur A. Feder, Hugh McCormick and Phil Spector.

We would note that our general report of March 5, 1987 ("Proposed Amendments to New York State Tax Law In Response to the 1986 Tax Law") comments upon aspects of the corporate franchise tax (at pages 43-48). To the extent that this report considers subjects also discussed in that report it represents further consideration of those subjects by the Committee. To the extent that we have not discussed matters discussed in that report, we confirm our conclusions in that report.

The major issues that will be discussed in this report are: (1) tax rates and the tax base; (2) the treatment of subsidiary capital and income; (3) the taxation of small business taxpayers; (4) the minimum tax; (5) the computation of taxable income; (6) the computation of the apportionment factors; (7) credits; (8) subchapter S corporations; (9) taxation under Article 9 rather than under Article 9A for certain regulated industries; (10) taxation of insurance companies; (11) taxation of banking companies; (12) pass through treatment for "REMICS"; and (13) certain tax-exempt entities.

None of the bills address the many controversial issues relating to combined reporting. A separate report on these issues will be prepared by the Tax Section in the near future.

1. TAX BASE AND RATES

Current New York Tax Law[2] imposes a franchise tax on general business corporations doing business in New York. The amount of tax is .09% of allocated subsidiary capital plus the greatest of the following: 10% of allocated net income; 178% of allocated capital; 10% of officers' salary plus income; $250.

The Assembly bill proposes to eliminate the tax on subsidiary capital (however, as discussed in Section 2 of this report, income from subsidiaries would become taxable) and also would eliminate the two alternative tax bases of allocated capital and officers' salary plus income. The Assembly bill also proposes to reduce the tax rate on allocated net income, the only remaining tax base, from the current 10% to 9% for 1987, 8-3/4% for 1988, and 8-1/2% for 1989 and thereafter.

The Senate bill would retain the tax on subsidiary capital but would eliminate the two alternative tax bases of capital and officers' salary plus income. It also proposes a reduction of the tax rate on allocated net income to 9%.

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2 Tax Law Section 210.

The Governor's bill provides for the elimination of only the tax base of officers' salary plus income. It also provides for the reduction of the tax rate on allocated net income to 9%.

The elimination of the alternative tax bases of capital and officers' salaries plus income and the elimination of the tax on subsidiary capital would be a major step toward a less complex tax system, an objective long sought by taxpayers, tax practitioners, and tax administrators. Although we recognize that the capital base provides some assurance that all corporations that benefit from state services will pay some tax, and that this is consistent with the nature of a franchise tax, we believe that imposing only a tax based on net income is consistent with the laudable goal of taxing according to the ability to pay and is a preferable approach. Further, taxing net income increases federal conformity, another important, worthwhile goal that the Tax Section has supported for many years. The officers' salaries plus income base represents a heavy-handed attempt to eliminate the need to review the reasonableness of officers' compensation. It is not needed (the federal tax authorities have been able to deal with this problem and the State authorities should be able to as well) and it should be repealed. The reduction of nominal tax rates is generally viewed as a positive step in enhancing the

competitive economic climate of New York. The Assembly bills contain all these beneficial provisions.

Current law[3] provides for a deduction from capital of short-term liabilities that are attributable to subsidiary capital, investment capital, or business capital. The Governor's bill, which retains the tax on capital, allows a deduction for all liabilities, both long-term and short-term, in the computation of capital. The Assembly and the Senate bills eliminate the tax on capital and, therefore, do not address this deduction.

Apparently, long-term liabilities are viewed under current law as the source of funds that are committed to the business and are thus characterized as part of a corporation's capital. The nondeductibility of long-term liabilities (or their inclusion in the computation of capital) reflects the historical property tax foundation of the tax on capital.[4] It can be argued that "long-term" debt is capital committed to the business.

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3 Tax Law Section 208.5.

4 See "The Article 9-A Franchise Tax: The Alternative Tax on Capital," a working paper prepared by the Staff of the Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law dated 2/26/86.

However, the fact that money is loaned for more than one year hardly "commits" it to the business and the point at which loaned funds are "committed" to a business will vary from industry-to industry.

The inclusion of long-term debt in the capital base has the effect of creating high levels of New York tax for corporations that have little or no taxable income and high debt-equity ratios as a matter of regular business practice.

We therefore support the Assembly and the Senate bills' approach of eliminating the tax on capital. If these approaches are are not enacted, however, we would support the Governor's approach and eliminate long-term debt from the base of the tax on capital.

2. SUBSIDIARY CAPITAL AND DIVIDENDS

Under current law[5] allocated subsidiary capital is taxed at a rate of .09%; concomitantly, 100% of interest, dividends and capital gains from subsidiary capital are deductible from net income. The Assembly bill eliminates the tax on subsidiary

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[5] Tax Law Section 210.1(b).

capital; as an offset, it proposes to eliminate the deduction from income of the income, gains and losses from subsidiary capital and provides for a deduction of fifty percent of dividends. This provision would effectively tax a portion of items such as interest income received from subsidiaries and 50% of dividend income received from subsidiaries. The portion subject to tax would be determined by the subsidiary's New York allocation factor. Neither the Senate proposal nor the Governor's bill proposes any changes in this area.

We believe that the amendments proposed by the Assembly may have a significant adverse effect on New York's status as a business domicile.

The elimination of the tax on subsidiary capital would, of course, help to simplify the New York corporate tax structure.

On the other hand, the inclusion of income, gains and losses from subsidiaries and an arbitrary 50% of subsidiary dividends in net income could significantly increase the tax burdens of large parent corporations that do business or are headquartered in New York and would lead to multiple taxation of the same income earned in New York. This will be a significant

detriment to the competitiveness of New York's business environment and would reverse a policy of over 40 years standing intended to encourage corporations to locate their headquarters in the State. AT a time when a number of major corporations have announced their intention to move their headquarters out of the state or that they are considering the step, this would be the wrong signal to send to the business community. This provision also would create a wide disparity between corporations that file on a separate company basis, and those that file on a combined basis. On a combined basis all income and dividends from a subsidiary corporation are eliminated. On a separate company basis, the income and dividends received from subsidiary corporations would be taxable to the parent under the Assembly's approach. We would note that the Assembly's approach would also create dramatic and undesirable differences in New York's tax burden where a corporate group does business outside the state, depending on whether the group does business through branches or subsidiaries.

3. SMALL BUSINESS TAXPAYERS

All three bills provide for relatively small reductions in the tax rates imposed on the allocated net income of “small business taxpayers.” A “small business taxpayer” is defined as a

small business corporation as defined in Section 1244(c)(3) of the Internal Revenue Code and that is not a part of Section 1504 affiliated group. (Disallowing small business treatment for corporations that are part of an affiliated group addresses, to some extent, the problem of multiple corporations being formed to take advantage of the lower tax rates.) The Assembly bill and the Senate bill further define "small business taxpayers" as those with incomes no greater than $290,000 while the Governor's bill has a $240,000 limit.

We understand that there may be economic or social benefits in providing for lower tax rates for small corporations. Lower tax also encourage small businesses to do business in the state. However, the reductions proposed are so small that we doubt that they will provide significant relief or incentives to small businesses. If a lower small business rate is to be provided consideration should be given to limiting its benefits with respect to commonly owned corporations, as the Internal Revenue Code does in Section 1561. On the other hand, the complexity that this would add to the Tax Law reinforces our view that the very small benefit does not justify the complexity it would bring to the law.

4. MINIMUM TAX

Current law[6] calls for a $250 minimum flat tax. The Senate bill provides a minimum tax of the higher of 3% of

[6] Tax Law Section 210.1(a).

allocated New York net income or $250. Both the Assembly bill and the Governor's bill provide for a minimum tax equal to the higher of $250 or 3% of a modified version of allocated federal alternative minimum taxable (AMT) income.[7] The Assembly bill allows a net operating loss carryforward in the AMT base. The other two bills do not.

If a minimum tax based on a percentage of income is necessary, a tax based on the federal AMT would be administratively more desirable. Most corporations will be required to compute the AMT for federal purposes and the data should be readily available, so the objectives of simplification and federal conformity would be met.

On the other hand, we would note that this new tax will increase the tax burden for many corporations in New York, a step –which may discourage them from expanding or remaining in the state.

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[7] Internal Revenue Code Section 55 et seq.

5. COMPUTATION OF TAXABLE INCOME AND CAPITAL BASES

A. Depreciation

Current law[8] provides for ACRS depreciation on New York assets only. Assets outside New York are depreciated in accordance with the Internal Revenue Code Section 167 as such section would have applied to property placed in service on or after December 31, 1980.

The Assembly bill and the Senate bill propose to conform New York depreciation for all property to the new federal depreciation methods (MACRS). This would be a significant benefit to taxpayers because it would reduce the administrative burden of maintaining multiple depreciation records.

The Governor's bill would limit federal depreciation conformity to assets in New York. This greatly reduces the potential tax benefit and increases the administrative problems for taxpayers and for the Tax Department.

We support the provisions in the Assembly and Senate bills which provide for full federal conformity.

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[8] Tax Law Section 208(b)(1).

B. Interest Addback

Current law[9] provides for the addback to federal taxable income of interest paid to stockholders, less 10% or $1,000, whichever is larger. All three bills would eliminate the interest addback rule.

We support the elimination of this addback to income. The addback is an arbitrary classification of a legitimate business expense and detracts from federal conformity.

C. Deductions Attributable to Subsidiary Capital

Current law[10] provides for the addback to federal taxable income of any amount of interest directly or indirectly (and any other amount directly) attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital. The Assembly bill repeals this section (if subsidiary income becomes taxable, as provided in the Assembly bill, the repeal of this addback would be necessary for internal consistency) while the Senate bill and the Governor's bill amend this provision to include any other amount indirectly attributable to subsidiary capital or to income, gains and losses from subsidiary capital.

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9 Tax Law Section 208(b)(5).

10 Tax Law Section 208(b)(6).

This area of New York corporate taxation has always been a source of confusion and controversy. It is often difficult to determine which expenses are indirectly attributable to subsidiary capital or to income, gains and losses from subsidiary capital, We do not support the amendments in the Senate and Governor's bills because they would compound the confusion in an already troublesome area in order to produce what we would judge to be relatively small amounts of revenue.

D. Taxes

Current law[11] provides for the addback to federal taxable income of New York State franchise and New York City general corporation taxes deducted on the federal return. The Assembly bill and the Governor's bill provide for the addback of all taxes on or measured by profits or income paid to any state or political subdivision, or to the District of Columbia; while the Senate bill provides for the addback of taxes measured by profits or income taxes paid to a state or to the District of Columbia but not of taxes paid to political subdivisions of a state (this is apparently a drafting oversight).

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[11] Tax Law Section 208(b)(4).

The addback of taxes measured by profits or income detracts from federal conformity and could substantially increase the tax liability of many taxpayers. On the other hand, this provision would bring New York law in conformity with the laws in most other stares in this respect and is consistent with the theory of apportionment. We therefore support the adoption of this provision.

6. APPORTIONMENT FACTORS

A. Property

For purposes of computing the property ratio of the business allocation percentage, owned real and personal property is currently valued, in theory, at average fair market value. Although the use of fair market value is not a statutory requirement (the law[12] refers to "average value"), regulation[13] require the use of average fair market value. However, in practice, most taxpayers use the cost of acquisition as the basis for valuing their property. Fair market value is usually difficult and costly to ascertain and the cost valuation method is not ordinarily challenged by the State Tax Department.

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[12] Tax Law Section 210.3(a).

[13] 20 NYCRR Section 4-3.1.

The Assembly bill and the Governor's bill would require the use of cost as the basis for valuing property, whereas the Senate bill would require the use of the federal income tax adjusted basis. All three bills provide for a one-time revocable election to use fair market value of property.

We favor the use of cost as the basis for valuing property. This method of valuation is used in most other states[14] and would cause no additional burden for New York taxpayers, whereas determining the federal adjusted basis for New York assets might entail significant administrative cost for some corporations. Also, using the cost of acquisition basis would give rise to fewer audit controversies than using the federal adjusted basis.

Moreover, if adjusted basis is used for assets both within and without the State, the net effect will be random, taxes will increase for some taxpayers and decline for others. On the whole, therefore, the revenue effect is likely to be small, if any, and we therefore would urge that the State avoid this change.

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[14] Acquisition cost is used for this purpose in the Uniform Division of Income for Tax Purposes Act which has been adopted by twenty-five other states. UDIPTA § 10.

Rented real property is currently included in the property factor. All three bills propose adding rented tangible personal property in the factor, and provide for a five-year phase in period of this addition.

We support the inclusion of rented tangible personal property in the property factor. This is common in many other states and is logically consistent because the use of such property by the taxpayer presumably generates income.

B. Receipts

Under current law[15] receipts from services are attributable to New York in computing the receipts portion of the business allocation percentage if the services were performed within the state. However, in the case of a taxpayer engaged in the business of publishing newspapers or periodicals, receipts arising from sales of advertising contained in such newspapers and periodicals are attributable to New York only to the extent that the newspapers and periodicals are delivered to points within New York.

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[15] Tax Law Section 210.3(a)(2).

Under the Assembly bill, for taxpayers engaged in businesses providing services for use in other states, other than transportation or the publishing of newspapers or periodicals, receipts derived from such services would be attributed to New York only to the extent that the purchaser of such services is located within the state. The extent of a purchaser's location within New York would be determined by the following criteria: (1) for purchases by governments: (a) for the state and its subdivisions, 100%; (b) for other states and their subdivisions, 0%; (c) for the federal government and its agencies, 10%; and (d) for the governments of foreign nations, 0%; (2) for purchases by corporations: (a) that are taxable under Article 9A, their latest issuers' allocation percentage; (b) for non-taxpayers who do not do business in New York, 0%; (c) for corporations taxable pursuant to Articles 9, 32 and 33, purchases would be apportioned pursuant to regulations.

This proposal would allow the service industry, for the first time, to allocate receipts to out-of-state sources and thus reduce the New York tax burden on receipts for services rendered in New York to customers based outside New York. We believe that this is a desirable change, in light of the fact that an ever increasing proportion of the gross national product, and particularly of New York's gross product, consists of services. Again, this step is desirable to encourage service businesses to locate in New York.

However, our support is subject to a number of technical comments. First, the bill should specify how income from services rendered to a large partnership (such as a law or accounting firm) or for that matter to an individual, is to be allocated.

Second, the Assembly allocation provision will impose an administrative burden disproportionate to the benefit and may in fact not be administrable. For instance, a taxpayer will have to determine if each of its customers does business in New York, under which section of the New York law the customer is taxed, and for an Article 9A-taxed customer, its latest issuer's allocation percentage. This type of record keeping would be extremely difficult for most large taxpayers, particularly since many customers will refuse to answer such inquiries. To provide a meaningful and obtainable benefit, compliance with this provision should be simplified. If the compliance issues can be resolved through regulations permitting apportionment based on statistical sampling of the taxpayer's business, for example, the allocation would presumably have a beneficial effect on the New York business climate. Alternatively, the State might undertake to provide statistical averages applicable to various industries which could be used by taxpayers as an alternative to making inquiries of their customers.

We would therefore support this provision of the Assembly bill, provided that the administrative problems can be resolved. We have no basis for tormenting on the fiscal impact of this measure, other than that it would encourage service businesses to remain in New York.

C. Minimum Tax Apportionment Factors

All three bills retain the current four-factor (with sales double weighted) for purposes of the ratio used in calculating the tax on allocated net income, but provide for a three-factor apportionment ratio for purposes of the minimum tax. The double weighted sales factor is an incentive for companies to locate their headquarters, manufacturing, and "back room" facilities in the state. It can be viewed as a "tax preference" which benefits taxpayers that have large amounts of property and payroll in New York and the majority of their sales out of state. Thus, the different formula for the minimum tax may be appropriate.

Use of two different allocation systems will also complicate the tax system in order to provide a marginal difference in effective rate of minimum tax. We doubt that this additional complexity will lead to a meaningful difference in revenues.

7. CREDITS

Current law[16] provides for an investment tax credit of 6% of the cost or other basis for federal income tax purposes of tangible property in New York, including buildings and structural components of buildings, that is principally used by the taxpayer in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture or commercial fishing. Where a taxpayer qualifies for the investment tax credit, an additional 3%, three-year employment incentive credit is allowed[17] if the average number of employees in New York is at least 101% of the prior year's average number of New York employees. A taxpayer is also allowed a research and development credit[18] of 10% of the cost or other basis of certain depreciable property used in the state for research and development in the experimental or laboratory sense.

At the election of the taxpayer, a deduction is currently allowed for a portion of amounts paid or incurred for

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[16] Tax Law Section 210.12.

[17] Tax Law Section 210.12A.

[18] Tax Law Section 210.18.

the construction, reconstruction, erection or improvement of either industrial waste treatment facilities or industrial waste treatment controlled process facilities, and either air pollution control facilities or air pollution controlled process facilities[19] in lieu of the investment tax credit. All eligible facilities must be located in New York.

All three bills reduce the investment tax credit (ITC) rate from 6% to 5%, the research and development tax credit from 10% to 9% and provide for a 5% credit for industrial waste treatment and air pollution control facilities in lieu of the optional deductions. All three bills replace the three year, 3% employment incentive credit with a two year, 2% credit.

The Assembly bill imposes graduated limitations on the ITC and the economic development zone credit. The limitations on the ITC rate range from 5% for investments of up to $200 million down to 1% on investments over $500 million. Limitations on the economic development zone credit range from 10% on investments up to $200 million down to 2% on investments over $500 million.

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[19] Tax Law Section 208(g).

With the repeal of the federal investment tax credit, the relative importance of New York's investment tax credit increases substantially. With the reduction of federal tax rates, the relative value of state credits also increases. However, it should be noted that the credits provide financial incentives for only certain taxpayers to locate or expand in New York. Service industries, for example, receive no benefit from the tax credits. The relatively minor reductions in the investment tax credit and the employment incentive credit rates are not seen as hindering economic development in New York. On the contrary, these reductions in the tax credits are understood to be a chief source of financing for the tax reduction aspects of all three bills and should be viewed in this context. The elimination of the optional depreciation deductions and the provision for tax credits simplifies tax compliance for taxpayers.

There has been much discussion regarding the elimination of all tax credits and the passing of this tax increase on to all corporate and other business taxpayers in the form of a lower tax rate. We urge that this be considered inasmuch as all taxpayers would receive some benefit and a further reduction in the nominal rate would be a significant benefit to the New York business climate. This is particularly so in light of the fact that the state's investment tax credit has been eliminated for businesses

operated as partnerships or proprietorships. Elimination of the credits would also contribute to the simplification of the New York State tax structure and the relevant tax returns.

8. SUBCHAPTER S CORPORATIONS

The Governor's bill proposes to make New York S treatment mandatory for resident shareholders of all corporations that are federal S corporations. This bill would continue to require these shareholders to include in their New York personal taxable income their pro rata shares of the corporation's income. With respect to New York tax on income attributable to nonresident shareholders, the Governor's bill would impose the tax on the corporation rather than on the nonresidents.

First, we believe that an S corporation should not be bound to be taxed as an S corporation for New York State purposes simply because it is so taxed for federal purposes. In many cases, an S election may be sensible for federal tax purposes but undesirable for state purposes. For example, if most of a corporation's income is allocated outside New York State and a majority of its shareholders reside outside the state, its shareholders may prefer to have the corporation file and pay New

York franchise tax rather than have to file New York State individual returns. Any tax saving may be more than offset by the cost and complexity of filing multiple New York personal returns and estimated tax returns. The Governor's proposal would deny such a corporation this flexibility.

The simplification objective of the governor's proposal could be achieved in a different way, by allowing a corporation which has properly made a federal S election to make its State election as late as the time it files its first State S return (to which the consents of all the shareholder could be attached).

The Governor's bill would also require the S corporation to pay corporate franchise tax on the share of its New York source income allocable to its nonresident shareholders. We do not think present law in this connection should be changed. The corporate franchise tax so imposed will in many cases increase the tax imposed on nonresident shareholders, since the corporate tax is imposed at a single rate. The imposition of a New York franchise tax on the S corporation's income attributable to its nonresident shareholders would reduce the net worth of the New York resident shareholders as well as that of the nonresident

shareholders thus unfairly allocating the burden of the tax. The shareholders might attempt to compensate for this by reducing the distributions to nonresident shareholders. However, this would very likely destroy the corporation’s S status for federal and state purposes because it would run afoul of the Code requirement that an S corporation have only one class of stock. I.R.C. § 1366(b)(1)(D). Moreover, the Internal Revenue Service is likely to hold that the deduction of the corporate franchise tax for federal income tax purposes could not be marshalled against the income of the nonresident shareholders. Cf. Rev. Rul. 87-14, I.R.B. 1987-6, 14.

The Governor's bill provision requiring the corporation to pay franchise tax on its income allocable to nonresident shareholders makes sense only as a response to the problem of collecting tax from nonresident shareholders. If this has proved to be a real administrative problem, then consideration might be given to imposing the corporate franchise tax only to the extent that an S corporation's nonresident shareholders failed to pay their New York State tax. The tax would be imposed on the non-paying nonresident shareholders' allocable share of the corporation's New York source income. Although this solution seems conceptually simple, we believe its administrative implementation might be quite complex and it would still unfairly place part of the burden of the nonresident's tax on the corporation's resident shareholders.

9. ARTICLE 9 TAXPAYERS

Under current law, transportation corporations and public utilities are subject to taxation under Article 9[20] (tax on gross receipts and capital) of the Tax Law rather than under Article 9A[21] (tax on net income or capital). Historically, heavier tax burdens have been imposed on regulated monopolistic corporations than on unregulated competitive corporations. Recently, certain industries, such as the transportation industry and portions of the telecommunications industry, have been opened to competition. They are still regulated (to varying degrees) but operate in a competitive business environment and no longer have monopoly control in the market. However, these regulated corporations which are now subject to a significant measure of competition continue to be taxed under the same scheme as regulated monopolistic utilities.

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[20] Tax Law Sections 183, 184, 186 and 186-a.

[21] Tax Law Section 210.

The Assembly bill removes certain transportation corporations from the definition of corporations subject to taxation under Article 9 which effectively places them under taxation of Article 9-A as general business corporations. The Senate and Governor's versions do not have any such provision.

We generally favor taxes based on ability to pay i.e., on net income. Although the Assembly provision is commendable as a first step, singling out the transportation industry does not appear to be the best approach. If it is deemed inappropriate to tax competitive businesses under schemes designed for regulated monopoly businesses, this relief should be granted across the board to all such businesses (as provided in S7262, passed by the Senate in 1986).

10. INSURANCE COMPANIES

Life Insurance Companies

The Senate bill reduces the tax on premiums for life insurance companies from 1.0% to .8%. The apparent intent of the reduction in the premium tax rate is to avoid a windfall for New York State. The premium tax rate plus the tax on net income cannot, under current law,[22] exceed 2.6% of premiums.

[22] Tax Law Section 1505.

Thus, the reduction of the premium tax may be illusory. To give effect to the apparent legislative intent underlying the Senate bill, therefore, it would be necessary to reduce the limitation on the amount of total franchise tax to less than 2.6% of premiums.

The reduction in the "losses incurred" by insurance companies for 15% of tax exempt interest and deductible dividends required by the Internal Revenue Code[23] has not been taken into account. Inasmuch as such items are separately included in entire net income (at least partially), it appears that the amount by which the "losses incurred" deduction is reduced should be allowed as an additional modification to entire net income.

In decoupling from current federal treatment, and restoring prior treatment, the Governor's bill does not have any provision for a reduced tax rate but allows a special deduction from entire net income equal to 20% of life insurance company taxable income. Both the Senate bill and the Governor's bill clarify that, for the deduction in computing entire net income for insurance companies of 50% of dividends other than from

[23] Internal Revenue Code Section 832(b)(5)(B)

subsidiaries, a life insurance company may deduct 50% of the company's share of such deductions.

Property and Casualty Insurance Companies

The Senate and the Governor's bills also provide for five new deductions and four new additions to income in computing entire net income of property and casualty insurance companies. Three of these deductions allow non-life insurance companies to deduct the amount which is not deductible under the Internal Revenue Code for unearned premiums for the current year. Another deduction allows non-life insurance companies, to avoid the recapture of “excess” unearned premiums under Article 33 of the Tax Law, even though recapture is required by the Code. The fifth new deduction permits non-life insurance companies to deduct the difference between discounted and non-discounted unpaid losses at the end of the current taxable year. The first three additions to income require non-life insurance companies to add back to income the amount of unearned premiums which is not added under the Code at the end of the preceding taxable year. The fourth addition requires non-life insurance companies to add back to income the difference between discounted and non-discounted unpaid losses at the end of the preceding taxable year. The effect of these deductions and additions is to restore the deductions for unearned premiums and unpaid losses to pre-federal Tax Reform Act of 1986 levels.

All Insurance Companies

The Senate bill allows MACRS depreciation on all insurance company property and the Governor's bill allows MACRS on New York insurance company property only.

Both bills make technical amendments to conform the New York Insurance Code (Article 33) to the Internal Revenue Code changes.

The Assembly bill does not make any revisions to the taxation of insurance companies.

None of the bills address the elimination of the alternative bases of capital and officer's salary plus income. In an effort to simply the tax law for all taxpayers, the elimination of these bases needs to be addressed, as it has been for general business corporations taxable under Article 9A.

We generally support the Senate bill in that it is an attempt to return the windfall from the insurance industry to that industry in the form of a reduced tax rate and through other measures. This proposal is also a positive step in the elimination of a tax on gross receipts rather than on net income.

11. BANKING COMPANIES

Both the Senate and Governor's bills propose changes to the Article 32 franchise tax on banking corporations. Rates would be unchanged. The Senate bill would (i) conform depreciation for New York State tax purposes to depreciation for federal tax purposes, (ii) in the case of a commercial bank, provide a state bad debt reserve that differs significantly from the reserve allowed for federal purposes to smaller banks (and formerly allowed larger banks) in that it does not allow a deduction of the amount necessary to maintain current levels of reserves; and (iii) establish a modified bad debt reserve for mutual savings banks, savings and loans associations and similar institutions. The Governor's bill makes only the latter two changes.

Under the Senate and Governor's bills, the federal repeal of the reserve method and the recapture of existing reserves for commercial banks would be effectively disregarded for New York State tax purposes, and all commercial banks would be required to use a reserve method based on experience to compute the bad debt deduction. Large banks would be required to establish and maintain a reserve for losses on loans. The loan loss reserve balance for the first day of the bank's tax year beginning in 1987 would be the same as the balance on that

day of the reserve maintained for federal tax purposes. The bad debt deduction for each year would be the same amount formerly allowed for federal tax purposes based on six years of loss experience, i.e., the amount necessary to increase the year-end balance of the reserve to the amount that bears the same ratio to loans outstanding at year-end that actual bad debts for the current and five preceding years bears to the sum of the amount of loans outstanding at the close of each of those years.

Small commercial banks, which are still allowed to use the experience reserve method or the percentage reserve method for federal purposes, would be required to deduct for New York State tax purposes the excess of the reserve maintained for federal tax purposes over its New York reserve and would be required to include in income the excess of its New York reserve over its federal tax reserve.

We support the Senate bill's return to conformity for purposes of the depreciation deduction.

The state bad debt reserve deduction, which may be expected to be less than the deduction formerly allowed, is unlikely to return to the banks the windfall resulting from the federal elimination of the bad debt reserve for larger banks.

Moreover, absent evidence that the magnitude of the gross assets of the taxpayer should affect the method of calculating an item of deduction, the state bad debt reserve deduction will not treat similar taxpayers similarly without regard to their size. Accordingly, we recommend that the bad debt reserve provisions be modified to return any windfall attributable to the loss of the bad debt reserve deduction and to treat all commercial banks similarly by allowing a Section 585 bad debt reserve deduction without regard to the provisions of Section 585(c). Treating similar taxpayers uniformly and returning the federal windfall to the taxpayers from whom it came may be more important than full federal conformity.

12. PASS THROUGH TREATMENT FOR "REMICS"

The Tax Law should be amended to include a provision corresponding to the new federal provisions relating to "real estate mortgage investment conduits" (REMICs). This is a new type of pass-through entity, analogous to a regulated investment company or partnership, designed to hold interests in real estate mortgages. If the entity (which may in form be a corporation, partnership or trust) meets the statutory requirements and elects REMIC status (a) the entity itself is generally exempt from federal income tax, (b) holders of so-called "regular interests" in the entity are taxed as debtholders in the entity, and (c)

holders of so-called “residual interests” in the entity are taxed as partners in the entity. We believe the State's treatment of a REMIC and its owners should conform to the federal treatment. The general conformity rules may be sufficient to assure conformity at the holder level (although further study would be required to be certain of this), but a new provision will be required to assure that the REMIC itself is not subject to State income or franchise tax.

Failure to take this step will simply make it more difficult for New York's financial service industry to do business and will not generate any additional tax revenue for the State.

13. CERTAIN TAX EXEMPT ENTITIES

Another new provision added to the Internal Revenue Code by the Tax Reform Act of 1986 is Section 501(c)(25) dealing with real estate ownership by exempt organizations. An anomaly in the New York law has been its lack of exemption provisions paralleling those in Section 501 of the Internal Revenue Code. The New York law should be amended to provide explicitly for exemptions for non-business corporations comparable to those provided by Section 501 of the Internal Revenue Code,

particularly section 501(c)(2) and 501(c)(25). The status of such corporations presently depends upon an implied nonapplicability of the corporate franchise tax to a corporation that does not have a business purpose. Although the status of an operating charitable organization may not be in doubt, there is a clear need to add to the New York law counterparts to Section 501(c)(2) and to new Section 501(c)(25) of the Internal Revenue Code. They are necessary to facilitate investment in New York real estate or other investment property by pension trusts and other exempt organizations through stock corporations that can insulate the other assets of these exempt organizations from potential liabilities such as those associated with real estate ownership. A bill passed by the New York legislature in 1966 would have rejected the illogical position of the tax regulations that the qualification for exemption under New York law of a Section 501(c)(2) corporation depends upon whether or not stock is issued. This bill was vetoed on the ground that such a specific exemption was incongruous in the context of a statute that had no general exemption provision. Thus, there is a pressing need for statutory clarification of the requirements for exemption from the franchise tax, and such clarification could be simply accomplished by statutory reference to the relevant Internal Revenue Code provisions.

Here again the absence of such provisions in the present Tax Law simply makes it more annoying and difficult to do business in New York while not raising any revenue.