REPORT #677

TAX SECTION

New York State Bar Association

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New York State Bar Association

January 2, 1991

The Honorable Mario M. Cuomo
Governor of New York
The Capitol
Albany, New York 12224

Dear Governor Cuomo:

We write to voice our particular objection to the retroactive features of two current Governor's Budget Bills, each of which would reverse for 1990 and past years a decision of the Tax Appeals Tribunal, and in one case an Advisory Opinion of your Commissioner of Taxation and Finance. In each case the State passed a statute; the Tax Appeals Tribunal (and in one case the Commissioner of Taxation and Finance) read that statute with a result the executive now finds undesirable; and these bills would reverse those readings retroactively for 1990 and years already past. We can think of few actions more directly contrary to the concept of the rule of law or better designed to convince our citizens that New York State's government cannot be trusted to deal with them fairly.

The Bill Memorandum for one of these bills -- which would allow a deduction rather than a credit for income taxes paid to other states -- describes this legislation as necessary to your plan to eliminate the budget deficit. We cannot believe that the revenue produced by the retroactive features of these bills could be very large. We urge that you

balance against these revenue estimates the irreparable long-term harm this type of legislation does to the business community's faith that the State will deal with its taxpayers fairly.

We are also concerned by the impact of such legislation on the position and prestige of the Tax Appeals Tribunal. That Tribunal can have little significance if the executive moves to reverse its decision retroactively each time it hands down an important decision adverse to the State.

Credit for Income Taxes of Other States

In June, 1989 an Advisory Opinion of the Commissioner of Taxation and Finance held that shareholders of a New York State resident S corporation could credit income taxes the corporation paid to another state on income included in the shareholder's New York State taxable income against their New York State income taxes. Matthews, TSB-A-890(5)I. This year, the Tax Appeals Tribunal held that a resident shareholder of an S corporation could credit against his income tax another state's franchise tax measured by income and paid by the S corporation because the franchise tax was essentially an income tax. William A. Baker, Jr., 1990-1 N.Y. Tax Cases T-687 (October 11, 1990). In the Baker proceedings the Commissioner agreed to the correctness of the Matthews opinion, but then argued that the S corporation shareholder should deduct but not credit the tax in question because it was a franchise rather than an income tax. The Commissioner argued that the courts of the state imposing the tax should determine whether it was an income tax, creditable for New York personal income tax purposes, or a franchise tax, which may only be deducted. The Tax Appeals Tribunal disagreed, holding that the tax in question was really an income tax because it was measured by income. The Commission could not appeal the decision.

The Matthews Advisory Opinion allowed a tax credit to resident shareholders of S corporations for corporate income taxes paid to other states. Baker produced the same result for corporate franchise taxes measured by income. It should be noted that although S corporation treatment is mandatory for resident shareholders of foreign S corporations that have no New York taxable presence, New York S corporation treatment is elective for resident and nonresident shareholders of S corporations that would otherwise be subject to New York franchise tax, i.e., that have a taxable presence in New York. Thus, taxpayers may have elected New York S corporation treatment for 1989 or 1990 in reliance on

the Matthews decision.[1]

The proposed legislation would amend the Tax Law to reverse Matthews and Baker, allowing S corporation shareholders credit only for income taxes paid to another state which are imposed directly on the shareholders. Taxes imposed on the corporation itself measured by income, whether denominated income or franchise taxes, would be deductible, but not creditable, by its shareholders.

The proposed legislation is retroactive, in that it seeks to determine tax liability for 1990 and previous years even though it will be enacted in 1991. The Bill would not only deny credits for all tax years beginning after 1989, but also apply retroactively to cut off all claims for refund or credit of tax for all years that have not yet been paid or credited at the date of enactment.[2] Thus taxpayers who elected New York S corporation

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[1] We are mindful that taxpayers can not rely upon Advisory Opinions issued to other taxpayers. Nevertheless, absent some authority to the contrary taxpayers do rely upon such Advisory Opinions. Moreover, the Baker decision confirms the validity of the position taken in the Matthews Advisory Opinion.

[2] There would seem to be technical defect in the Bill as drafted. The Memorandum in Support states the retroactive effect to be as described above. The Bill itself, however, states that sections three, five and six apply to taxable years after 1989, but that only section six applies retroactively to any claims for credit or refund for year before 1990 that have not yet been paid or credited. Section three excepts from add-back by an S corporation shareholder any state or local income taxes imposed on the shareholder level. Thus the shareholder will not be able to claim a deduction for tax paid at the corporate level. Section five provides that the credit will be allowed to shareholders if the tax was imposed at the shareholder level. Section six amends the New York City resident income tax to conform it to the rest of the Bill. If only section six is applied retroactively, only New York City residents would apparently be precluded from making claims for refund or credit for tax years before 1990. Yet this result makes no sense. We can only conclude that the Bill as written erroneously makes section six retroactive but intends to make section five (the credit provision) retroactive.

treatment relying on the availability of the credit for 1990 would be denied a benefit they were clearly entitled to expect when they elected. Even more shocking is that under the Bill, taxpayers who filed returns claiming the credit but who were erroneously denied it, and who have appeals pending, will be denied the result afforded to similarly situated taxpayers whose returns happened to be processed correctly the first time. Similarly, those who filed without claiming the credit due them but who subsequently learned of their error will not be allowed to amend their returns to claim the credit. On the other hand, taxpayers who claimed these taxes as credits in originally computing their tax for years before 1990 are apparently unaffected by this legislation.

We think it is grossly unfair of the State to attempt to retroactively deny the benefit of credits to which the Tax Appeals Tribunal and the Commissioner of Taxation and Finance had ruled they were entitled when other taxpayers have received the benefit of the credit for the same taxable year.

We would note further that our reaction to the retroactive features of this Bill should not be taken to indicate our approval of the Bill's substance even if it is amended to apply only prospectively. In effect, the Bill will cause New York residents to pay more than one state-level tax on income that arises in other states, if they want to carry on business through an S corporation. If they carried on the same business as individuals they would clearly be entitled to a credit for these taxes against their New York State tax. Thus, the legislation is flatly contrary to the general trend of taxation of S Corporations, which has been to treat them as tax transparent. The denial of a credit for income taxes of other states would be simply one more irrational feature of New York State taxation which would motivate shareholders of S corporations to move elsewhere. Thus, although this bill may generate some small amount of additional tax in the short run, its long run effect is likely to be to erode the State's business and tax base.

Business Facility Tax Credit

Proposed Budget Program Bill #125 would again reverse retroactively present law reflected in a 1988 Tax Appeals Tribunal decision, Columbian Mutual Life Insurance Company, 1988-1 N.Y. Tax Cases T-181 (August 4, 1988) That case held that a corporation eligible to qualify for the business facility tax credit established under the Job Incentive Program continued to be eligible for the credit although it experienced a decrease in employment. Once again, the Bill's effective date section states

that it applies to all determinations of eligibility not finally and irrevocably fixed. Thus, a corporation with an appeal pending will be denied a credit after it has made a major business decision premised in part upon the law as the Columbian Mutual case tells us it existed at the time of the decision.

Again we object to the retroactive feature of this Bill.

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These retroactive bills may violate constitutional guarantees of due process, particularly as to those taxpayers who have pending appeals. However, aside from the question of due process, retroactive amendment of the Tax Law to impose tax is poor tax policy. Tax policy requires fairness, which implies that taxpayers should be able to plan their affairs confident that the law in effect when they make their decisions is the law that will apply to those decisions.

Public fear that taxes may in effect be imposed retroactively, will chill economic activity in this State. Such certainty leads to market inefficiency in the and higher transactions costs.

We therefore urge that both bills be amended so that, if enacted, they do not apply to taxable years before 1991.

We realize that these two bill proposals may in part be prompted by the Department of Taxation and Finance's frustration over its inability to appeal adverse decisions of the Tax Appeals Tribunal. We continue to support amendment of the Tax Law to permit such appeals. However, the solution to that continuing problem does not lie in retroactive legislative reversals of the Tribunal's decisions, which can only undermine the importance of the Tribunal in the State's tax system.

Very truly yours,

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Chair

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