REPORT #652

TAX SECTION

New York State Bar Association

COMMITTEE ON NEW YORK STATE MATTERS
REPORT ON CERTAIN TAX BILLS INTRODUCED BY THE GOVERNOR

March 27, 1990

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March 27, 1990

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

Re: 1990 Budget Bills

Dear Mr. Boyle:

Thank you for forwarding to us copies of the Governor's Budget Bills for our review. Enclosed is our Report on certain portions of the Bills which we believe to be significant.

Although we understand that the budget process has resulted in changes to the original bills, we hope our comments will be useful since, we assume, many of the concepts and much of the proposed statutory language of the original bills have been incorporated in later versions.

I hope this report proves useful to you.

Very truly yours,

Arthur A. Feder
Chair

Enclosure

CC: The Honorable Mario R. Cuomo
Governor
State of New York f
The Capitol
Albany, New York 12224

Evan Davis, Esq.
Counsel to the Governor
The Capitol
Albany, New York 12224

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

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

The Honorable Ralph J. Marino
Senate Majority Leader
The Capitol
Albany, New York 12224

The Honorable Melvin Miller
Speaker of the Assembly
The Capitol
Albany, New York 12224

The Honorable Tarky Lombardi
Chairman, Senate Finance Committee
The Capitol
Albany, New York 12224

The Honorable Roy Goodman
Chairman, Senate Committee on Investigations,
Taxation and Government Operations
The Capitol
Albany, New York 12224

The Honorable Saul Weprin
Chairman, Assembly Ways and Means Committee
The Capitol
Albany, New York 12224

Dean Fuelihan
Deputy Secretary
Assembly Ways and Means Committee
The Capitol
Albany, New York 12224

Abraham Lackman
Director, Fiscal Studies
Senate Finance Committee
Empire State Plaza – Agency Building #4
Albany, New York 12233

Tax Report #652

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON NEW YORK STATE MATTERS

REPORT ON CERTAIN TAX BILLS INTRODUCED BY THE GOVERNOR

March 27, 1990

Introduction

The report consists of a series of reports addressing certain tax bills introduced by the Governor. Because of the very tight time frame imposed by the State's legislative process, the reports are generally limited to major substantive issues and do not provide detailed technical commentary.

The subjects addressed are:

Topic	Section
Sales Tax	A
Corporate gross Receipts	B
Gains Tax	C
Partnership Withholding	D
Estate and gift taxes	E
2 Percent "S" tax	F
Insurance companies	G

COMMENTS ON CERTAIN TAX PROVISIONS
OF THE GOVERNOR'S BUDGET BILL

SALES AND USE TAX PROVISIONS*

The Bill makes a number of changes to the sales and use tax laws in a manner projected to increase revenues. The changes fall into three basic categories which, in summary, are as follows: (1) removal of the credit against sales tax for trade-ins of automobiles, boats, non-commercial airplanes, all-terrain vehicles and snowmobiles; (2) acceleration of sales tax on long-term leases of automobiles, boats and non-commercial aircraft; (3) expansion of the definition of “vendor” to include persons who retain an owner hip interest in property which is subsequently brought into New York State for use in the trade or business of the buyer/lessee or at a time when the buyer/lessee is a resident of New York State.

The following is a summary of our comments on these provisions:(1) The removal of the trade-in credit represents a change in policy against double sales taxation on the residual value of trade-in property. We conclude that this change in policy to conform the treatment to private exchanges of property not intended for resale is a matter of legislative prerogative. We do note, however, that absolute uniformity has not been achieved in this area since trade-ins for resale of property other than in the five categories affected will still be allowed the trade-in credit.

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* These comments were prepared by Sherry S. Kraus. Helpful comments were received from Arthur A. Feder, E. Parker Brown, William M. Colby, Sherman F. Levey, Randall K. Kau and Robert E.

(2) We have a number of problems with the legislation proposed to accelerate sales and use taxes on long-term leases. The stated basis for the change in law is that long-term leases of certain property are equivalent to installment sales and should be treated similarly for sales tax purposes. This assumption does not take into account the extensive body of law in the income tax area on recharacterization of leases as installment sales. Because we generally encourage conformity in sales tax concepts and income tax concepts unless good reasons exist for differing treatment, we do not favor a change in the sales tax law based on this assumption of equivalence without regard to whether the lease would similarly be treated as a sale for income tax purposes. We also note that since the accelerated sales tax payable on a long-term lease is based on gross rental payments, which includes the lessor’s built-in interest charge, the tax is likely to exceed the sales tax payable upon an installment purchase of the same property. To reconcile this disparity, we recommend that the accelerated sales tax payable on long-term leases be based either on the discounted present value of the lease payments or that a ceiling be imposed on the sales tax so that it would not exceed that payable had the property been purchased outright. We also recommend that the leases affected by this law be extended from a term of one year or more to a term of thirty months or more since shorter term leases bear less similarity to installment sales.

(3) We have serious questions as to the constitutionality of the amendments which expand the definition of vendor and property subject to New York State use tax to include certain property sold or leased outside the state which is subsequently brought within New York State. These concerns result from the absence of any “nexus” requirements for the “vendor” with New York State to support imposing the burden of collecting New York State's use taxes in the circumstances provided. We further question the fairness of imposing vendor status in situations where there may be little likelihood that the vendor would know that the property sold or leased was being used in New York in a manner which would subject the property to New York use tax. The provisions also need clarification as to their scope and, if the provisions are intended to apply to sales as well as leases, more statutory guidance is needed on the meaning of a retained ownership interest. We recommend that this category of amendments be withdrawn for further study to address these concerns.

The following represents a detailed discussion of each category of amendments.

A. Removal of Trade-In Allowance.

The Bill would amend the definition of “receipt” in Section 1101 of the Tax Law to disallow the credit against the base on which sales tax is imposed for certain properties accepted in part payment and intended for resale. The properties are (1) motor vehicles, as defined in Section 125 of the Vehicle and Traffic Law, with a gross vehicle weight of 10,000 pounds or less, (2) vessels, as defined in Section 2250 of the Vehicle and Traffic Law (including trailers with such vessels); (3) non-commercial aircraft having a seating capacity of less than 20 passengers and a maximum payload capacity of less than 6,000 pounds; (4) all-terrain vehicles; and (5) snowmobiles.

Current law excludes from the definition of “receipt” the credit given by a seller to a buyer for tangible personal property accepted in part payment where the property is intended for resale by the seller. The proposed amendment to the definition of “receipt” will eliminate the current “trade-in” exclusion for the above properties and require the buyer to pay sales tax on the full purchase price of the property rather than on only the difference between the purchase price of the property and the trade-in value allowed him by the vendor. A similar amendment is proposed to the use tax provisions of Section 1110 of the Tax Law to disallow the trade-in credit against use tax for the above-described properties.

The Memorandum in Support of the Bill states that the proposed elimination of the trade-in allowance will conform the treatment of such transactions to private sales (i.e., traded-in property not intended for resale). The proposal changes a long-standing policy which generally had the effect of exempting the residual value of trade-in property from double sales taxation.[*]

[*] Under current law, for New York purchases, sales tax is payable on the full value of property acquired. Upon a later trade-in of the property for resale, the newly acquired property is exempted from sales tax to the extent of the residual value of the old property received in the trade. Since sales tax generally had been paid on that residual value at the time of original purchase, credit to that extent was applied to subsequent purchase.

The proposed elimination of the trade-in credit from the sales tax base will have the effect of adding to the sales tax liability of the purchaser, but will not impact on the taxability of the exchange for the vendor so long as the trade-in is sheltered by the resale exclusion. The provision should also have no impact on private sales where the trade-in is accepted as part payment for the property purchased without the intention of resale. As under current law, the private exchange will still be viewed as two sales, each subject to sales tax on the value received.

While the elimination of the trade-in credit will likely raise protest from the automobile retail industry and other affected industries in New York, we regard this change in policy as a legislative decision on which we have no comment. We do note, however, that while the change will conform the law to private exchanges of property not intended for resale, the law will still not be totally uniform since the trade-in exclusion will continue for properties intended for resale which are not in the included categories of the proposal (i.e., motor vehicles, vessels, non-commercial airplanes, all-terrain vehicles and snow-mobiles).

B. Acceleration of Sales or Use Tax on Long-Term Leases.

The second major provision of the Bill would add a new subdivision (i) to subdivision (c) of Tax Law Section 1111 with the effect of accelerating sales tax payable on long-term leases of motor vehicles, vessels and non-commercial aircraft described in Part A. The leases to which the provision applies are those with a term of one year or more, defined to include a lease for a shorter period which may be extended to a year or more by exercise of an option or other similar provision. Any additional consideration payable on the lease for excess mileage charges will continue to be subject to sales tax under existing law and thus not be subject to tax until paid or due.

The Bill further provides that if the property is originally leased outside the state and brought by the lessee for use within the state and the lessee is either a resident of New York or subsequently became a resident while the property is used within the state, the lease will be subject to the above provision and any remaining lease payments due after the property is brought into the state will be subject to the accelerated tax. The Bill provides for a crediting against the tax for any sales or use tax paid by the lessee to another jurisdiction before the lessee brought the property into New York State.

The Memorandum in Support of this provision states that the loss of the income tax deduction for sales taxes under the 1986 federal tax law changes has resulted in an increased popularity of long-term leasing, particularly of vehicles, which has resulted in a drain on sales tax revenue to the State. The Memorandum states the view that long-term leasing is very similar to an outright purchase of a vehicle in terms of the period that the vehicle is retained, vehicle registration and insurance requirements. While lease payments for the use of tangible personal property are, under current law, subject to sales tax, the payment (and collection) of sales tax is made separately with each lease payment over the term of the lease. The objective of the Bill is to treat long-term leases in the same manner as installment purchases of property, with full payment of the sales tax obtained in the first installment payment.

We have several comments on this proposal. First, we note that the question of whether a long-term lease is economically equivalent to a sale has long been the subject of review under income tax laws. The provisions of Section 7701(h) of the Internal Revenue Code reflect the efforts of Congress to provide some guidance as to when an automobile lease should be treated as a lease, as opposed to a sale, for income tax purposes.

Just as we generally encourage conformity of New York State income taxes to federal income taxes, we also encourage conformity in concepts underlying New York State sales taxation to similar concepts underlying New York State income taxation. For this reason, if a lease would be respected as such under New York State and federal income tax laws, we do not favor any change in the sales tax laws predicated on a recharacterization of a lease as equivalent to an installment sale where such recharacterization would not occur under the income tax laws.

As further development of this point, we question whether leases having a term of as little as one year are comparable to an installment purchase of property. While we not have access to specific industry statistics, it is our understanding that the typical installment payment period for the purchase of an automobile is three years. Since the justification for the change in law is to achieve parity between transactions that are economically equivalent, we recommend that the minimum lease term for purposes of triggering the acceleration provision be no shorter than thirty months.

As further comment on this provision, we note that the statutory language does not address the situation in which there may be an automatic renewal of the lease such as from month-to-month or year-to-year unless the lessee or lessor gives advance notice of termination. While we understand that this type of option is not characteristic of options to renew in the automobile leasing industry, such an option could arise in the case of a related party or other non-commercial lease arrangement. In such a case, there probably should be a presumed period of lease (e.g., thirty months) for purposes of determining the sales tax payable. Such a presumption, however, should only apply in cases where the lease is a “disguised” long-term lease rather than an arms-length lease where there is no guarantee that the lease will extend for more than the minimum period in the absence of a formal lease arrangement. Notwithstanding this observation, we suggest no specific statutory language to deal with this situation since regulations would likely be the preferable means for addressing this concern.

Since parity in treatment to installment purchases is the stated goal of the proposal, we note a further problem in the proposal. This results from the fact that the proposed tax base for acceleration of sales tax on the lease consists of the gross lease payments on the longest possible term of the lease (assuming exercise of all options to renew) and, as such, will include interest charges built into the lease payments. Had the property been purchased rather than leased, the sales tax base would be the purchase price of the vehicle, not the gross amount of the installment payments, including interest. Under the proposed change, the sales tax payable under lease could exceed the sales tax payable had the automobile been purchased outright.

For example, compare the results of a lease as opposed to a purchase of an automobile with a list price of $16,400. Were the automobile purchased outright for its list price, there would be $1,148 of sales tax payable (assuming a 7% sales tax rate). Had the automobile been leased instead for a four year period, the lease payments would be in the range of $365 per month with a sales tax payable in the first rental installment of $1,226. If the lease were for five years, the lease payments would be $332 per month with a sales tax payable of $1,394. Because, in most instances, an automobile can be purchased for less than its list price, the potential disparity in sales tax is even greater than shown in the above example.*

We believe that any revision to the law which results in a sales tax payable on a lease which could exceed the sales tax payable on an outright purchase of the property does not achieve the stated legislative objective of parity. We recommend, therefore, that the provision, if retained, be modified either to base any accelerated sales tax on the discounted present value of the lease payments over the term of the lease or to place a ceiling on the sales tax payable at the amount which would have been payable had there been an outright purchase of the property.

C. Expansion of Definition of Vendor and Properties Subject to Use Tax.

The third major provision of the sales tax portion of the Bill adds a new clause (F) to expand the definition of "vendor" in Section 1101 of the Tax Law to include any person making "sales" of tangible personal property subject to New York use tax where such person "retains an ownership interest" in such property and the property is brought into New York by the person "to whom such property is sold" and that person is or becomes a resident of New York State or uses such property within New York in carrying on any employment, trade, business or profession. A related amendment to Section 1131 expands the definition of property and services subject to the use tax. The effect of this provision is to subject to New York use tax any property sold by persons to buyers described in proposed clause (F) of Tax Law

* Lease payments are generally based on list price.

Section 1101, whether or not the sale is made within New York State. A further related provision amends Section 1134 of the Tax Law to require any person who becomes a “vendor” by reason of clause (F) of Section 1101 to register as a vendor within thirty days after the date on which the tangible personal property in which the vendor retains an ownership interest is brought into the state by the person to whom such property is sold.

The Memorandum in Support of the Bill implies that the primary targets of this provision are out-of-state lessors which lease property which eventually is used within New York State by residents or by non-residents pursuing a trade or business. Notwithstanding this description in the Memorandum and the fact that Tax Law Section 1101(b)(5) includes leasing arrangements within the meaning of the term “sale,” the proposed statutory language gives little hint that the primary focus of the provision is out-of-state leasing.

As further masking of the leasing focus of the law, the related change to Section 1131, which enlarges the definition of property subject to use tax, extends the law to

> “all property sold by a person making sales described in clause (F) of subparagraph (i) of paragraph (8) of subdivision (b) of Section 1101 of this article to a person described in such clause (F) who <u>purchases</u> such property <u>at retail</u>, whether or not the <u>sale</u> is made within the state.” Emphasis added.

The statutory revisions to the definition of vendor do not define the meaning of a retained ownership interest in the property sold. This fact, in combination with the absence of any statutory language suggesting that the provision is primarily intended to apply to leaving situations, will likely create confusion as to the scope of the provision. For example, assume an out-of-state sale of property with respect to which the seller retains a security interest in the property or a right to reclaim the property upon default of payment. Is this a retained ownership interest subjecting the “vendor” to collection of New York State's use tax should the property subsequently become subject to use taxes? Further, if the statute is intended to extend to sales as well as leases, does it repeal in part the provisions of Section 1118 which exempt from New York use tax any non-trade or business property purchased by the user while a non-resident which is subsequently brought within the state? Similar questions could arise with respect to whether the scope of the law extends to the sale of a partial interest in property where the non-resident seller retains an undivided interest in property brought by his joint tenant into New York State and used in a manner subjecting the property to our use tax.

If, as suggested by the Memorandum, the targets of the provisions are out-of-state leasing transactions which become subject to use tax in New York, we recommend that the language specifically so provide and that terms such as “sale,” retained “ownership interests” and “retail sales,” which suggest a broader application, be removed. If, on the other hand, the provision is intended to include sales, an effort should be made to define the type of retained ownership interest which will trigger liability as a vendor.

As further commert on these provisions, it should be noted that they are broader in scope than needed to assist New York State in collection of the use tax resulting from the lease amendments proposed and described in Part B. In contrast to proposed Section 1111(c)(i), the properties subject to these provisions are not limited to motor vehicles, vessels and non commercial aircraft. The provisions apply to any tangible personal property, the use of which would be taxed under New York State's use tax laws. By way of demonstration, the amendments could apply to an out-of-state lease of computer equipment brought into New York State for use in the lessees' trade or business or after the lessee becomes a resident of the state. While computer leases would not be subject to the accelerated payment of use tax revisions to Section 1111, the out-of-state lessor would have a continuing obligation to collect and pay over to New York the use tax payable on each installment of rent received after the property is brought into New York State.

The provisions could also apply to a transaction as commonplace as an out-of-state installment sale of a refrigerator where the refrigerator is subsequently brought by the buyer into New York State after the buyer became a resident of New York. While sales tax. usually will have been paid on the installment purchase of the refrigerator in the jurisdiction of sale, it appears that there is no mechanism for relieving the vendor from its obligation of collecting use tax for New York State since it would be up to the buyer to claim the credit for any sales tax paid in the other jurisdiction.

The broad and uncertain scope of the statute also presents problems in registration as a vendor. Anyone coming within the definition of vendor, as proposed, is required to register for collection of use taxes within thirty days after the date on which the tangible personal property is brought into the state by the person to whom the property is sold (or leased) and becomes subject to use tax. For property such as computers or refrigerators, where there is no state law registration requirement to ensure notification to the lessor or seller, it is highly probable that many lessors/sellers will not be able to comply with this provision. Nor is it an answer to observe that the lessor/ seller is likely to know about a change of address into New York State since he is continuing to receive payments from the lessee/purchaser. First of all, the new provisions would apply in the case of property used in the trade or business of the lessee/buyer even if the lessee/buyer remained a resident of the other jurisdiction and had no change in address. Secondly, in many cases, installment sale or lease payer of this type is assigned to banks or finance companies who are then responsible for collection of the payments. In that case, the lessor/seller may have no; reasonable means of knowing that the lessee/buyer has moved to New York State.

The above comments represent only a few of the many problems which we anticipate in connection with these proposed revisions. By far the most serious of our objections is the question of whether the expansion of the definition of vendor will be found to be in violation of the Due Process and/or Commerce Clauses of the federal constitution. In contrast to the expanded definitions of vendor made in the 1989 “anti-National Bellas Hess” legislation, there is no requirement here that the vendor be doing business in the state, have regular or systematic contacts with the state or satisfy any other recognized constitutional nexus requirements.* Furthermore, in the case of property where there is no state registration requirement to alert the lessor to the fact that the property is being used in

* It should be noted that the provisions could also apply to an in-state vendor who leases property to an out-of-state resident who subsequently becomes a resident and brings the property back into the state for use within the state. The above-stated constitutional objections would not apply in that case since the lessor would be a domiciliary of New York State.

New York State, there is a real question of fairness in imposing such a liability.

While we are sympathetic to the difficulties encountered by New York State in collecting its use taxes, we believe that this extension of jurisdiction will be found to be unconstitutional unless revised substantially to limit the scope of the law to situations where the recognized nexus requirements have been satisfied by the “vendor.”

Beyond the constitutional question, however, is the further question of fairness in imposing vendor status upon lessors/sellers in situations where there is little likelihood that the lessor/seller will know that the property has become subject to New York's use taxes. This problem has not existed in previous New York anti-National Bellas Hess legislation since the vendor can reasonably assume taxable use of the product in the state of delivery to the buyer. In the case of the leasing or installment sales governed by these proposals, the transaction is likely to have no contacts with the State of New York at the outset. This raises a significant question as to the fairness and administrability of a law which assumes that the lessor/seller will be able to monitor over the entire term of the lease/ installment sale (a) whether the property is being used in the lessee's/buyer's trade or business, (b) the place of use of the property and (c) the legal residence of the lessee/buyer. While in automobile leasing, there exists state law registration requirements which normally will ensure that the lessor, as owner of the vehicle, will at least have notice of the change in location of the use of its automobile, the proposals are not limited in application to registered properties.

For the above reasons, we recommend that this category of amendments be withdrawn for further study to address the likely constitutional deficiencies outlined above and to give further consideration to the scope and fairness of the proposals.

SECTION B

ALTERNATIVE FRANCHISE TAX ON GROSS RECEIPTS*

The Bill would impose a new alternative franchise tax on the gross receipts of corporation subject to the Article 9-A franchise tax. The gross receipts tax would apply if it results in a higher tax than the tax computed using the net income, capital or minimum tax base. “Gross receipts” is defined to mean the sum of all receipts included in the computation of gross income without deduction for any expense, cost, basis, loss or otherwise with two exceptions. Receipts from the sale of stock in trade or inventory can be reduced by 65 percent of “the cost of materials or purchases for resale with respect to such property.” The Memorandum in Support indicates that only direct material costs are eligible for this reduction. No reduction is allowed for costs such as labor and overhead. In the case of taxpayers principally engaged in the business of lending funds or purchasing or selling debt instruments, interest income is reduced by any interest expense directly or indirectly related to such loans or debt instruments.

The gross receipts tax would be imposed on gross receipts allocated to New York using the taxpayer's business and investment capital allocation percentages to the applicable receipts. Gross receipts from business income are reduced by $1,000,000 before application of the business allocation percentage. The tax on gross receipts would be 0.5 percent in 1990, 0.55 percent in 1991 and 0.6 percent in 1992 and thereafter.

We believe that the new alternative tax based on gross receipts is bad tax policy. The Tax Section has consistently

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* These comments were prepared by Robert E. Brown and James A. Locke. Helpful comments were received from Arthur A. Feder and Arthur R. Rosen.

urged New York to adopt income-based taxation whenever feasible. The imposition of this new tax would be contrary to the general movement in New York to eliminate the Article 9 gross receipts taxes, a movement supported by the Tax Section. The franchise tax has primarily been a tax on net income, based upon a taxpayer's ability to pay. The current alternative tax on capital and the minimum tax is designed to insure that all corporations make at least some payment for the privilege of conducting business in New York. The gross receipts tax will result in uneven and arbitrary tax results that may make some New York businesses uncompetitive with their out-of-state competitors.

A corporation which has incurred a loss for tax purposes would be subject to the gross receipts tax which could be substantially higher than the current capital or minimum tax Moreover, a corporation which purchased real property in New York for investment purposes and subsequently sold the property for a loss could be subject to the gross receipts tax on the entire sale price of the property, even though it had an economic loss. This is an addition to the real estate transfer tax that would be imposed. Clearly, such an example illustrates the problems with the proposal; it does not appear to be good tax policy.

The gross receipts tax would likely produce distorted and unfair results for certain high volume, low margin businesses. Retail food markets and the securities industry are two such examples. For example a large corporation in the retail food business (for whom the $1,000,000 exemption is de minimis) may have a 1 percent profit margin on its sales. Even if the 65 percent reduction for the cost of materials applied to all of the corporation's costs (which clearly will not be the case), the gross receipts tax will be 21.39 percent of net income * In the

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* In the event that this Bill is enacted, we suspect that New York City

case of a securities dealer, the gross receipts tax would apparently be applied to the gross proceeds from securities underwritten or otherwise sold by a dealer which is clearly inappropriate.

Some businesses which have historically “run-through” client expenses could escape the gross receipts tax base. For example, an advertising business could bill its clients for expenses for ad placements as disbursements, although it is not free from doubt that such reimbursements would be excluded from gross receipts. However, other low margin businesses, would not possibly be able to escape the impact of the tax by these means. Because the proposed gross receipts tax does not reflect accurately the net economic benefit of a business from its activities, this proposal is inappropriate as a franchise tax measure and should be eliminated from the Bill.

It should be noted further that none of the major commercial states use a gross receipts type of franchise tax. Moreover, while this type of tax historically has been used for utilities subject to tax under Article 9,* we do not believe it is an appropriate measure of tax under Article 9-A. While gross receipts taxation may be appropriate for government-sanctioned monopolies, it is wholly inappropriate for competitive businesses.

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will seek to make a similar change to the New York City franchise tax which would further increase this tax burden.

* During the period 1934 to 1966, New York City imposed a franchise tax on gross receipts. This tax was replaced by the current franchise tax on net income due to some of the same problems which we anticipate this tax will create

SECTION C

REAL PROPERTY GAINS and TRANSFER TAXES*

The Bill relating to the 10 percent real property gains tax and the 0.4 percent real property transfer tax generally proposes amendments in seven different areas:

1. Leasing transactions;
2. Convertible mortgages;
3. Purchase money mortgages;
4. Partial and successive transfers;
5. Townhouses;
6. Entity-level reporting;and
7. Persons responsible for tax.

1. Expanded Taxation of Leasing Transactions.

The gains and transfer taxes currently apply to the grant of a lease in two situations -- leases with options (which are not affected by the proposal) and certain long-term leases. Specifically, the grant of a long-term lease is taxable if the term of the lease including renewal options exceeds 49 years, the lease covers substantially all (90 percent or more) of the premises, and substantial capital improvements are made or may be made by or for the benefit of the lessee. The existing statutory provisions treat these leasing transactions as if they constitute current sales, without any analysis of whether the benefits and burdens of ownership have in fact shifted. Essentially, therefore, the gains and transfer taxes are imposed on rental income from these leases whether the transaction is a true lease

* These comments were prepared by Carolyn Joy Lee Ichel. Helpful comments were received from William M. Colby, Arthur A. Feder, Thomas V. Glynn and James A. Locke.

or a disguised sale. The amount of the consideration for a taxable lease is the present value of the net rental income.

The Bill includes two changes that would significantly expand the scope of the tax on long-term leases. First, the Bill deletes the requirement that a lease cover substantially all of the premises and contemplate substantial capital improvements. Thus, the only condition for taxing the grant or a lease would be its term. Second, the Bill proposes that gains and transfer taxes apply to any lease if the term of the lease, exclusive of any renewal options “priced at fair market value,” is from 30 to 49 years. It is not clear whether the lease must actually provide that renewal term rents will be at fair market value, or whether a formula designed to approximate fair market rentals will suffice to exclude renewal terms from the 30 to 49 year) calculation.

Under the Bill, therefore, a landlord who leases one floor of a building for 10 years with two 10-year renewal options at rents other than “fair market value” will be taxed as if he sold that floor to the lessee.

There is no sound basis for assuming that long-term leases are always disguised sales. The Bill would impose tax on even more leasing transactions and is both unjustified and unwise. It is overly simplistic to assume that a 30-year lease is economically equivalent to a sale.* Moreover, in the current economic environment it may well prove counterproductive to encourage short-term space leases over longer-term commitments to investment in New York, and to burden lessees, who represent the one segment of New York's real estate industry that is capable of moving, with the need to analyze the gains and transfer tax treatment of their leases, and with the potential for another tax that effectively increases occupancy rates. Threatening the attractiveness of New York rental property with another set of taxes and another level of complexity sends a clearly negative message to the industries who would lease property in New York.

If the legislative intent is to tax leases which effectively transfer the value of a property for a substantial period, perhaps the 90% test under current law could be reduced. We do not believe, for example, that a lease of less than two-thirds of a building can be used as an effective substitute for the sale of real property; thus, reducing the 90% test to, say, 67% would be an effective tool in closing the perceived “loopholes”. Another alternative is a rule that leases of 30 years would be a transfer only if the lessee and its affiliates

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* The regulations under Section 1031 of the Code state that a leasehold interest for a term of 30 years or more is of “like kind” with a fee interest. Treas. Reg. § 1.1031(a)-1(c). This means that a lessee's assignment of a 30-year leasehold interest in real property can qualify for nonrecognition of gain if the lessee receives another real property interest in exchange. The treatment of the lessee's long-term leasehold interest as “like kind” to a fee is however, quite different from treating the lessor's grant of that lease as a current sale. There is no federal income tax rule providing that the <u>grant</u> of a 30-year lease is the equivalent of a sale. To the contrary, in the same “like kind” exchange context the authority makes clear that a <u>lessor</u> of a long-term lease cannot qualify for “like kind” exchange treatment, precisely because the grant of the lease is not a disposition of the property but instead is simply a lease that gives rise to rental income. <u>See</u> Rev. Rul. 66-209, 1966-2 C. B. 299.

does not physically occupy some specified percentage (5% to 50%) of the entire premises subject to lease.

2. Taxation of Convertible Mortgages.

a. Fundamental Questions.

The Bill would impose gains and transfer taxes on the creation of convertible debt instruments that, over a three-year aggregation period, reflect a right or option to acquire a 50 percent or greater interest in New York real property (either directly or through an entity that owns New York real property). This proposal to impose tax on the creation of convertible debt instruments presents several technical questions, as well as more fundamental questions about the propriety of assuming that a “convertible debt instrument” should be taxed as a disguised sale.

The automatic treatment of certain borrowing transactions as currently taxable sales is unjustified. The essential nature of these transactions is a borrowing. The property owner remains liable as a borrower, and must either repay the debt or lose the property through foreclosure.

The fact that a lender has an option to convert a loan into an equity position is not in itself evidence of a current sale. That analysis requires a more detailed evaluation of the value of the property and the amount the lender must pay (in the form of surrendering the right to collect the debt or by collecting the debt and using those proceeds to purchase an interest) to acquire the equity interest in the property.

We believe that the enactment of statutory provisions treating all 50 percent level convertible debt instruments as disguised sales is both economically and theoretically flawed. Substituting overly simplistic assumptions for thoughtful tax analysis results in inequities and distortions of economic behavior. Moreover, if convertible debt instruments become subject to gains and transfer taxes it is likely property owners will simply stop granting convertible mortgages. The amendments would therefore simply foreclose New Yorkers' access to certain kinds of financing, and may prove to be particularly unreasonable in difficult financial times.

The proposal to subject convertible mortgages to gains and transfer taxes also reflects a fundamental inconsistency in the characterization of such instruments. For mortgage recording tax purposes these instruments generally would be subject to tax as mortgages, yet for transfer tax purposes the Bill proposes to tax them as sales. This promotion of inconsistent analysis to exact duplicative taxes clearly will be perceived as unfair and purely revenue-driven. Moreover, if the effect of the current proposals is to reduce the volume of lending transactions or change property owners' methods of financing, there may be a fall off in the revenues currently derived from the mortgage recording tax.

It is possible that the Bill did not intend to usurp the traditional inquiry into whether a convertible loan in fact achieves the economic equivalent of a sale, but was intended simply to provide clear statutory support for analyzing the substance of a transaction rather than its form. Thus, in the proposed amendments to Sections 1440.7 and 1401(e), the use of the word "transfer" might suggest that the creation of a convertible debt instrument is intended to be taxed only if the transaction in fact effects a transfer of a 50 percent or greater equity interest. Under such an interpretation, a true loan, where the convertible debt structure is not being used to disguise a current sale, would not be subject to gains and transfer taxes because it does not currently effect a transfer of an equity or other ownership interest in the underlying property. In this posture, the convertible loan proposals would not be unreasonable. It is, however, difficult to know whether this was the intended scope of the Bill. Moreover, even if this is the intent of the statute, the proposed language is sufficiently confusing to present a serious risk that the provisions will come to be interpreted as applying to all grants of convertible debt instruments (once the 50 percent mark is reached).

We believe it is unsound to tax all 50 percent convertible debt instruments as sales. We therefore recommend that either the proposed amendments be dropped altogether, or that it be clarified that the amendments apply only to transactions that effect a current transfer of beneficial ownership.

b. Technical Issues

Apart from the fundamental question of the scope of the proposal, several technical questions are raised by the amendment. The definition of a convertible debt instrument is quite broad. It includes any option or right to acquire an equity or other ownership interest in real property or in an entity that owns real property (an “Entity Interest”) if such option or right is granted simultaneously with or in connection with any loan. As a result, even if the option requires the lender to pay an amount in excess of the loan proceeds to acquire the equity interest, and even where the loan (or a portion of the loan) remains outstanding after the option is exercised, the proposed amendments would treat the borrower as if it had made a current sale of the property at its fair market value. This can result in the borrower being currently taxed on more than it receives. Particularly if the convertible loan provisions are applied to bona fide loans that are not disguised sales, the amount of taxable consideration should be limited so that the borrower is only taxed on the portion of the loan proceeds that would ultimately be applied (directly or indirectly) to acquire the equity interest.

To avoid the imposition of duplicative gains taxes, the statute should specify that, following the taxation of a convertible debt instrument, the original purchase price for the property will be increased to reflect the amount of taxable consideration received by the property owner. This would be similar to the current provision regarding taxable grants of leases in Section 1440.5(e), and is consistent with the Bill's proposed credit for transfer taxes paid on convertible debt instruments.

Under existing law the last sentence of Section 1440.7 and the last sentence of Section 1401(e) provide that a number of transactions involving mortgages are not subject to gains and transfer taxes. Assuming that certain convertible debt instruments will now become subject to tax in certain cases, some modification of these provisions is necessary. However, both the proposed gains and transfer tax amendments place the exceptions for convertible debt instruments in the wrong part of the statute. As a result, the proposed transfer tax amendment appears to provide not only that the creation of a convertible debt instrument can be taxed, but also that any document evidencing a severance, assignment, satisfaction, etc. of a convertible debt instrument is subject to the transfer tax. Presumably this is not intended since the definition of taxable conveyances refers only to “creation”. Similarly, the proposed gains tax amendment provides that any instrument given to perfect or record a convertible debt instrument is a transfer of real property for purposes of the gains tax. Obviously this is not the intent. To eliminate this confusion, the words “other than a convertible debt instrument” should be inserted immediately after the word “creation” in the amendments to Sections 1440.7 and 1401(e).

Given the intention of the convertible loan provisions to deal with abusive transactions that seek to take advantage of a perceived loophole in the tax, it seems inappropriate, and overly intrusive, to apply the convertible debt instrument rules to the issuance of publicly-traded convertible securities of entities whose assets are not predominately New York real estate. Those simply are not the kinds of transactions where a conversion feature is used to effect a disguised sale. We therefore recommend that there be a specific exception for the issuance of publicly-traded convertible debt instruments unless more than 50% of the gross value of the entity's assets consist of interests in New York real estate. This will greatly alleviate the compliance responsibilities of public companies without opening any significant loopholes.

3. Interest Rates on Purchase Money Mortgages.

The Bill proposes to amend Section 1401(d) of the transfer tax and Section 1440.7 of the gains tax to treat interest on a purchase money mortgage that is imposed at a rate in excess of two percentage points over the applicable federal rate (“AFR”) as additional consideration.

We question the assumption that an interest rate equal to AFR plus two percentage points is excessive. For example, the currently quoted rates for <u>federally insured</u> mortgages is approximately two points over the AFR. Surely it is not “excessive” to impose a higher rate of interest for real estate loans without a federal guaranty. We believe that either the Bill should use a considerably higher safe harbor, or further study be undertaken to select the appropriate rate. If it is considered necessary to include a specific rate in the current legislation, we suggest that a safe harbor of at least 5 percentage points over the AFR is more appropriate. See <u>e.g</u> Code Section 163(i).

The wording of the amendments creates a technical problem. Currently, these sections of the gains and transfer taxes provide that consideration includes “the amount of any ... purchase money mortgage.” The proposed amendments provide that, in the case of a purchase money mortgage with “excess” stated interest, consideration includes the amount which would have been principal had interest been stated at a rate equal to the AFR + two percent. This technically results in a double counting of the stated principal amount of the mortgage, which is incorrect. The amendments should instead provide that, in the case of any mortgage with “excess” interest, consideration includes, <u>in lieu of the stated amount of the purchase money mortgage</u>, an amount which would have been principal if the prescribed interest rate were used.

We note that the legislation does not specify the relevant date for determining the AFR applicable to a particular transaction. Presumably, it should be the date of contract. <u>Compare</u> Code Section 1274(d)(2)(B). This should be clarified in the statute.

Furthermore, the amendments provide that the relevant AFR is to be determined by reference to the AFR for the first month of the immediately preceding calendar quarter. This represents a time delay of as many as five months between the interest testing date and the contract date. A seller will not be able to satisfy the AFR plus two percent test to the extent that interest rates increase at all in the intervening period. Correspondingly if interest rates drop the seller may be able to state inappropriately high interest. It would therefore make sense to use a more contemporaneous interest rate, and it would be fairly simple to adopt the federal rule, which permits the parties to use the AFR applicable for the month of contract or for either of the two preceding months.

4. <u>New Aggregation Rules Respecting Partial and Successive Transfers</u>.

The Bill proposes to amend Section 1440.7 of the gains tax to provide that a transfer of real property includes partial or successive transfers if such transfers are made pursuant to a plan or if such transfers occur within a three-year period. Presumably, this amendment is intended to apply to a series of transfers of contiguous or adjacent parcels where each sale is below the $1 million dollar threshold. The proposal thus would appear to provide an administratively manageable approach to aggregating seriatim transfers. It would be useful, however, to clarify that this is the intended effect of this provision. Specifically, it is unclear whether the proposed statutory aggregation rule is intended also to apply to aggregate transfers for purposes of the controlling interest provisions, thus codifying the existing regulations. It does not appear that this result is intended, but it would be useful to make that clear.

As a substantive matter, in establishing any bright-line text of taxability it is always difficult to know whether the chosen cut-off is appropriate. We do not have sufficient information to comment on the propriety of the three-year period. We note, however, that it generally corresponds to the gains tax and federal and state income tax statutes of limitations, and this kind of consistency is commendable. We also note that auditing and litigating cases involving the $1 million exemption has commanded a great deal of administrative attention, and it would appear reasonable to adopt some method for streamlining this area of the gains tax. The application of automatic aggregation rules for sales of contiguous and adjacent parcels that occur within a prescribed time period may therefore be useful in enabling the State to turn its attention to other issues.

5. Taxation of Townhouse Developments.

The Bill proposes to impose gains tax on townhouse developments in the same manner as co-op and condominium developments currently are taxed. This reflects a determination that townhouse developments are more similar to co-ops and condos than to single-family homes. It is difficult to understand, however, the continued tax bias against multi-family housing as compared to single-family housing.

Moreover, as the Tax Section has noted in the past, the existing taxation of cooperative and condominium developments is deficient in many respects. Numerous types of costs incurred in connection with such developments are not taken into account in computing taxable gain. As a result, in many projects the amount of taxable gain is significantly overstated. It does not seem reasonable to extend the gains tax to another form of development without also addressing the existing inequities in the application of the tax.

6. Reporting Requirements for Entity Interests.

The Bill proposes a new provision that would permit the Commissioner to require corporations, partnerships and other entities with New York real property worth at least $2 million to report transfers of Entity Interests when the percentage interest transferred over a three-year period is 30 percent or more. Currently because the transferor and transferee do not file returns unless they determine that a 50 percent or greater Entity Interest has been transferred or acquired, the Commissioner is apparently encountering difficulties in determining whether a taxable transfer of a controlling Entity Interest has occurred.

The imposition of reporting requirements for changes in 30 to 50 percent Entity Interests over a period of time appears a reasonable method for enhancing the Commissioner's ability to identify taxable transfers of Entity Interests. However, the requirement that the entity file annual reports raises a number of complexities. For example, it will be difficult for entities to monitor changes of ownership interests in upper-tier entities, and in many situations it will be difficult for entities even to; know whether there has been a transfer of an Entity Interest in the entity itself. It seems easier, and just as effective, to require reporting by transferors and transferees who, alone or in concert with others, transfer or acquire a 30 percent or greater Entity Interest. Just as the gains tax currently requires pre-transfer audit filings for transactions between $500,000 and $1 million, filings could be required for transfers in the 30 to 50 percent range. The application of the pre-transfer audit procedures seems fairer to the parties, for it would enable a transferee to ascertain prior to closing whether the Commissioner views a sale as taxable. It also seems that this method would be considerably less burdensome than entity-level reporting.

If entity-level reporting is retained, we would suggest that the reporting requirement only be imposed where New York real estate constitutes a significant portion -- say 50 percent -- of the book value of the entity's assets. As written, the Bill would require reporting by a billion dollar corporation that has only a $20 million factory in New York, or even a significant office lease that has appreciated in value. If reporting is required in such cases it will be viewed as one more annoying bureaucratic burden associated with doing business in New York. Accordingly, given the burdens of an entity-level reporting requirement, its application should, at the least, be limited to cases where the tax avoidance potential is significant.

7. Change in the Definition of Person Responsible for the Tax.

The Bill appears to make entities responsible for the gains tax if the transferor and transferee of a controlling Entity Interest fail to pay tax. Given the current gains tax structure, this approach can have inequitable consequences for the non-transferring owners of the entity. For example, if shareholder A sells a 60 percent Entity Interest to B, but neither A nor B pays the tax due, the proposal would appear to permit the Commissioner to proceed against the entity and therefore collect the tax out of all of the assets of the entity, including the share which is indirectly the property of the nonselling shareholders who own the remaining 40 percent of the corporation's stock. Moreover, if the entity is a partnership the Bill would appear to permit the State to proceed against the personal assets of general partners, even though they had no involvement in the taxable transaction.

In certain transactions, particularly those involving acquisitions of widely-held entities, the parties may wish to have the forms filed and gains tax paid by the entity. It would be useful to have statutory support for this kind of voluntary departure from the usual procedures. As drafted, however, this proposal appears to go beyond that situation, and we are concerned that it could result in imposing gains tax on persons who have no involvement in, no control over, and no benefit from the taxable event.

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SECTION D

WITHHOLDING TAX ON NONRESIDENT PARTNERS AND SHAREHOLDERS OF S CORPORATIONS*

The Bill would add Section 679 to the Tax Law which would impose a “withholding” tax on the portion of the New York source income of a partnership or a New York S corporation (“PassThrough Entity”) that is allocable to an individual partner or shareholder who is a nonresident of New York (“Nonresident Member”). Similar changes would also be made to the New York City tax law. Its provisions are roughly analogous to Section 1446 of the Internal Revenue Code of 1986 (“Code”).

Although Section 679 is referred to as a “withholding tax”, it actually requires a PassThrough Entity to make estimated tax payments on behalf of its Nonresident Members. These payments are not based upon actual distributions by the PassThrough Entity. The amount of the required payment on behalf of a Nonresident Member is an amount equal to the product of the New York source income allocable to the Nonresident Member and the highest rate of New York tax imposed upon individuals. The tax is paid in four annual installments corresponding to the four estimated tax payments required to be made by individuals except that the fourth installment would be due in December rather than January. The methods for computing the required payments are based upon the annualization methods used by individuals to compute their estimated tax payments. A PassThrough Entity with fails to make required estimated tax payments on behalf of it Nonresident Members may be liable for the tax which should have been withheld plus penalties.

Collection of taxes due from Nonresident Members is apparently a significant administrative problem for the Department of Taxation and Finance. Nevertheless, we believe that the Bill raises a number of significant problems and impose unfair compliance burdens on PassThrough Entities and should be enacted in its current form. If additional enforcement measures are required to insure compliance by Nonresident Members, we recommend that a true withholding tax based upon actual distributions of taxable income be enacted to insure compliance. Since we understand that the principal noncompliance problems arise in connection with personal service partnerships in law, accounting and investment banking activity withholding based upon distributions of taxable income should solve these compliance problems. Moreover, we further suggest that to ease compliance burdens, a PassThrough Entity could I allowed to elect to not withhold with respect to Nonresident Members if the PassThrough Entity agreed to be directly liable a Nonresident Member did not file required New York returns and pay the taxes due attributable to income from the PassThrough Entity. This would reduce the compliance problems for those Entities where all Members are complying with their New York tax obligations.

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* These comments were prepared by Franklin L. Green. Helpful comments were received from John A. Corry, Arthur A. Feder, James A. Locke and Arthur R. Rosen.

Some of the problems with the current Bill are as follows:

1. The Cost and Disruption of the Withholding Proposal Would Far Exceed Its Revenue Gains

The Memorandum in Support of the Bill indicates that the total annual revenue gain for the 1990-91 budget year is $7 million. This figure presumably includes the benefits not only from the withholding proposal but also from other information reporting aspects of the Bill. Albeit without empirical evidence, we believe that the resulting burdens, costs and disruption to taxpayers complying with the withholding provisions would equal if not vastly exceed the anticipated revenue increase.

The withholding proposal does not impose a new tax; it simply is designed to collect tax from noncompliant nonresident taxpayers. However, the substantial costs and burdens of figuring out how much to withhold under an estimated tax regime, filing the required returns and forms, dealing with the loss of fungibility of partnership units and S corporation shares, and seeking accounting and legal advice with respect to all of these matters, would have to be borne by all the Members in PassThrough Entities which have Nonresident Members. The implementation problems in the case of publicly traded partnerships is particularly severe since such partnerships may not know who their partners are, much less whether or not they are residents of New York.

2. Disruption to Commercial Arrangements

The estimated tax payments required of PassThrough Entities with Nonresident Members will have far greater application than the Section 1446 withholding requirements since PassThrough Entities with members who are nonresidents of New

York are significantly more common than partnerships with nonresident alien partners. We believe that the estimated tax system has significant potential to disrupt commercial arrangements among Members of PassThrough Entities and between the PassThrough Entity and third parties. This upset would result largely because tax would be required to be paid by a PassThrough Entity on behalf of some of its Members but not others ("Preferential Payments").

Whenever Prefrential Payments would be required with respect to a Nonresident Member, he would be benefited because he could either apply the payments against his New York tax liability or, if appropriate, obtain a tax refund. Generally, resident Members would have to receive comparable "make-up" distributions from the PassThrough Entity in order to be made whole. Failure to make immediate "make-up" distributions obviously would be unfair to resident Members. On the other hand, "make-up" distributions may not be authorized under a partnership or shareholder agreement, may impose liquidity problems on the PassThrough Entity and may be violative of various contractual obligations of the PassThrough Entity under its debt, lease or other agreements. Indeed, making estimated payments may be violative of the terms of such agreements restricting distributions to Members. Moreover, withholding may be required where no cash is available in the entity required to withhold -- for example, where "phantom" income is generated by a sale of property subject to a mortgage.

There is no facile means for dealing with these practical problems, especially in the case of existing PassThrough Entities. A PassThrough Entity might seek to be reimbursed by a Nonresident Member for the estimated payment made on his behalf. However, the Nonresident Member with or without reason night choose to refuse to make the payment -- for example, the Nonresident Member may have New York source losses from other activities and would not himself owe tax or estimated tax for the year. In addition, the PassThrough Entity might attempt to treat the estimated payment as a loan to the Nonresident Member on which interest could be charged and might attempt to collect this deemed loan by offsetting it against future amounts to be distributed to the Member. However, the PassThrough Entity's rights to create a deemed loan and to offset it against distributions (especially if the Nonresident Member in the interim has transferred his interest to a third party) are problematic as a legal matter in the absence (as heretofore has been typical) of specific authorization in tie PassThrough Entity's agreement. In any event, this proposed solution does not address the problem of contractual restrictions in debt or lease instruments on a PassThrough Entity's right to make distributions or even loans to its Members. Furthermore, any solution is likely to be cumbersome and burdensome, especially for any PassThrough Entity with numerous Nonresident Members or substantial transfers of interests.

The recordkeeping burdens for larger PassThrough Entities (especially public partnerships which are not treated as corporations) whould prove to be immense. Moreover, the fungibility of PassThrough Entity units would be destroyed since only some units would be entitled to make-up payments; it would be necessary to keep track of the unrecouped Preferential Payments, if any, made with respect to each unit even after the unit had been transferred by a Nonresident Member to a resident of New York. Furthermore, the Bill would prevent publicly traded partnership units to be held through a central security depository which is important to the ability to trade such units.

Finally, a Preferential Payment on behalf of some but not all of the shareholders of an S corporation and the need for mechanism to provide for “make-up” distributions might raise a question as to whether the corporation could continue to meet the federal S corporation requirement that it have only one class of stock.

A far simpler and less costly and burdensome (but less precise) alternative for dealing with noncompliant partners and S corporation shareholders would be to require withholding from actual distributions to nonresidents, to the extent such distributions relate to New York source taxable income. Under Section 10 of Revenue Procedure 89-31, 1989-1 C.B. 895, this actual withholding alternative is allowed in certain circumstances for purposes of section 1446 of the Internal Revenue Code. We believe that such withholding, at least as an elective alternate method, would solve many of the problems we perceive but yet help to improve taxpayer compliance. Although a withholding system based upon distributions may be subject to abuse through the timing of distributions, we believe that such abuse is not likely to be a significant problem. For example, distributions could be deemed to be out of New York source income relating to post 1989 years. That would reduce much of the incentive to delay distributions. Moreover, for a great many PassThrough Entities, our suggestion that the Entity have an election to forego withholding and assume liability for the New York tax of their Members would solve the timing problems for electing Entities.

3. Suggested Modifications

For the reasons, discussed above, we believe an estimated tax regime should not be adopted. If, however, passage of the Bill is to be pursued, a number of modifications should be made.

a) Minimum Exemption

Partnerships, especially those with a substantial number of partners, should not be put to the burden of complying with the withholding rules and dealing with the resulting disruptions where the amount of the estimated tax payments would be minimal. We suggest that a de minimis rule be added exempting withholding with respect to a nonresident where the amount that would be paid would be less than $100 (or perhaps an even higher amount) for the year and exempting a partnership or S corporation where the amount that would be paid by it for all its partners would be less than $5,000 (or perhaps an even higher amount).

b) Expansion of Safe Harbor

Normally, an estimated tax system relates to the payment by a taxpayer of his own tax liabilities, whereas the Bill creates vicarious liabilities and obligations to make parents on behalf of third parties. Accordingly, the Bill should in all circumstances provide a withholding agent with a clear safe harbor, for the avoidance of penalties.

In particular, it is inappropriate for the Bill to disallow the prior-year safe harbor where New York income was less than 50 percent of the current year's New York income. The taxable income of many enterprises is not knowable until year-end as the result of commercial or perhaps other uncontrollable factors. The 50 percent rule means the prior-year safe harbor for many, if not most, withholding agents will not be reliable. Accordingly, PassThrough Entitys will be forced to undertake to annualize current year's income -- a much more difficult and costly calculation.

c) Special Partnerships

Under current law nonresident individual partners of a New York partnership whose sole activity is trading in securities are exempt from New York tax on their share of partnership income. Likewise, many public regulated investment companies are now organized as partnerships rather than corporations and their nonresident partners are not subject to New York tax on income earned by these partnerships. These types of partnerships should be exempted from the new withholding tax rules. Since otherwise, their partners will have to file refund claims each which will have two effects. First, it will needlessly add to the Department's administration costs and second it will lead to pressure to move these entities out of New York with attendant loss of New York employment.

d) Transitional Period Issues

We believe withholding agents will need some time to acclimate themselves to the withholding requirements and to attempt to arrange to deal with the loss of fungibility of their partnership units and S corporation shares. We suggest that no penalties or interest be imposed on a PassThrough Entity for the first year it is subject to the withholding regime as long as it and/or its Nonresident Members have paid the required amount by the time the withholding agent's annual withholding tax return is due.

Clarification is also needed as to the effective date of the provision. It appears that a full year's estimated payments may be required for calendar 1990 even though the first payment is not due until September 15.

It would be particularly helpful for the first year that the regime becomes applicable to a withholding agent (and for 1990 generally) for the prior-year safe harbor to be made available on a pro-forma basis. Accordingly, PassThrough Entities should be allowed to pay for 1990 the amount which they would have had to pay for 1989 if the estimated tax system had then applied.

e) Audit Adjustments

If it is not already clear, it should be clarified that changes in taxable income on audit either in the current year or the prior year should not be relevant for any purposes of the estimated tax regime.

f) Miscellaneous

The reference to tiered partnerships in proposed new Section 679(f) appears inconsistent with the general rule that withholding is required only with respect to partners who are nonresident individuals.

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SECTION E

TRANSFER TAXES*

I Generation-Skipping Transfers

The Bill imposes a tax on generation-skipping transfers designed to take advantage of the credit for state generation-skipping transfer tax under Section 2604 of the Code. Under the Code, a credit is available against State generation-skipping transfer taxes imposed in connection with transfers, other than direct skips, occurring at the same time and as a result of the death of an individual. Such credit is limited to 5 percent of the Federal tax. The Bill imposes a New York tax in the amount of the maximum credit times a fraction, the numerator of which is the value of the "New York property" included in the transfer and the denominator of which is the value of all property included in the transfer. For these purposes, the numerator includes not only real and tangible property having an actual situs in New York but also intangible personal property where the original transferor was a resident of New York at the time of the original transfer. Thus, the Bill would purport to impose the tax even where neither the property nor any of the individuals involved has any connection with New York at the time of the generation-skipping transfer. For example, assume a New York resident creates a trust for the benefit of his child and more remote descendants and assume further that at the time at the child's death neither the trustee, the child nor any of such descendants are residents of New York and that all of the property held in such trust is intangible personal property. In this example, if the death of the child constitutes a taxable termination giving rise to

* These comments were prepared by Beverly F. Chase and Sherman F. Levey. Helpful comments were received from Arthur A. Feder and James A. Locke.

Federal generation-skipping tax, the Bill would impose a New York tax at such time equal to the entire amount of the Federal credit.

This result gives rise to due process concerns under the Fourteenth Amendment. As the Court of Appeals has held in the state income tax context, a state may not levy taxes beyond its borders without being in violation of due process. Mercantile-Safe Deposit & Trust Company v. Murphy, 15 N.Y.2d 579, (1964), aff'g 19 A.D.2d 765 (3rd Dep't 1963), citing Safe Deposit & Trust Co. of New York c. Virginia, 305 U.S. 19 (1938). The Mercantile case involved New York's lack of jurisdiction to tax income accumulated in a trust created by a New York domiciliary, which was administered in Maryland by a Maryland trustee, even though the life beneficiary was a New York resident. Cf. New York Income Tax Regulations Section 102.4. Applying the result in the Mercantile case to the proposed generation-skipping transfer provision, the same lack of nexus between the property to be taxed and the taxing jurisdiction potentially exists. This constitutional infirmity is particularly troubling in view of the failure of the proposal (as described below) to provide an effective cap on the New York tax when aggregated with similar taxes imposed by other states, including those having a superior constitutional right to impose such tax.

In addition, there is no mechanism in the Bill designed to ensure that the New York generation-skipping tax, when combined with similar taxes imposed by other states, will not in the aggregate exceed the 5 percent credit. This is so notwithstanding a statement in the Memorandum in Support to the effect that this provision would not increase the tax burden on particular taxpayers. At a minimum, the Bill should contain a mechanism for compromising the amount of generation-skipping transfer tax with other states, such as the provision dealing with disputed domicile contained in Section 249-o of the Tax Law in connection with New York estate tax (as the same is proposed to be incorporated in new Section 978 of the Tax Law).

Finally, although the Bill purports to impose administrative provisions which are in conformity with Federal law, it nevertheless requires the payment of tax in connection with generation-skipping transfers occurring in 1990 by March 15, 1991, rather than April 15, 1991 (the Federal due date), solely in order to create 1990-1991 receipts for budget purposes. This is so notwithstanding that the entire estimate for 1990-1991 receipts from this provision is a mere $2 million. In our view, the burdens imposed by such lack of conformity outweigh this questionable benefit.

The *de minimis* budget implications of this tax, when viewed in relation to the costs and difficulties of enforcement and the negative impact such a bill could have on wealthy individuals considering a change of domicile, argue in favor of either rejecting the generation-skipping provisions of the Bill or, or a minimum, narrowing such provisions in order to (1) to eliminate the extra-territorial application of the tax, (2) to limit the aggregate tax imposed by New York and other states to the maximum Federal credit and (3) to conform the administrative provisions with respect to 1990 to the Federal provisions.

II. Estate and Gift Tax Conformity to Federal Law

A. Non-citizen spouses

The Bill would deny any marital deduction for a transfer for the benefit of a non-citizen spouse to a qualified domestic trust under Section 2056A of the Code. The Bill would also negate for New York purposes the increase from $10,000 to $100,000 in the annual gift tax exclusion available under the Code for gifts to a non-citizen spouse.

While the denial of the marital deduction for transfers in trust to non-citizen spouses may be rationalized in view of perceived enforcement difficulties, there is no reason why New York should not provide for a “qualified domestic trust” structure similar to the federal provision under Section 2056A, but requiring that a “New York situs trust” be used in order to qualify for the New York marital deduction. The use of such a qualified New York trust would both enhance the concept of maintaining conformity with the comparable federal rules, and would protect the revenue on a long-term basis since it would assure collection of the appropriate estate tax on the death of the surviving spouse and the termination of the qualified New York trust.

Since it is likely that most decedents having alien spouses will very likely establish a “qualified domestic trust” for federal purposes, the State's concern about the possible avoidance of the New York estate tax can be met by merely requiring that the trust also qualify for New York purposes as well. It would also appear that this would be better policy since the creation of a dichotomy between marital deduction treatment for federal and State purposes would merely serve as a further inducement for wealthy individuals with alien spouses to more seriously consider a change of residence in order to avoid the “non-conformity” and acceleration of estate tax which would be imposed by the proposed New York rule. Thus, for both procedural and policy reasons, conformity by use of a qualified New York situs trust appears to be a better solution.

The denial of the increased annual exclusion for transfers to non-citizen spouses appears to be extremely difficult to justify on any basis other than as a “pure revenue raiser”. It departs in a significant manner from the federal arrangement, and again not only creates a present “nonconformity” problem, but presents an immediate inducement for the wealthier mobile taxpayer to seriously consider a change in tax residence. Thus, for both policy reasons -- conformity and not creating tax incentives for relocation -- use of the federal $100,000 annual gift tax exclusion should be maintained in the New York structure.

B. Valuation Freezes

The Bill would add the provisions of Section 2036(c) of the Code to the New York estate tax. These provisions deal with the federal estate and gift tax treatment of certain “valuation freezes” and other transactions designed to limit appreciation of assets in the decedent's estate. However, few tax provisions in modern times have been as vigorously criticize, as Section 2036(c), and its repeal appears to be virtually certain at the federal level.[**] Accordingly, while we continue to support the concept of conformity, in view of the very likely retroactive repeal of the present Section 2036(c), it would appear to be more

[**] We note that on March 23, 1990, Chairman Rostenkowski of the House Ways and Means Committee released a proposed discussion draft of a bill which would replace and retroactively repeal Section 2036(c) in its entirety.

practical for New York to defer enactment of any comparable provision in view of the administrative difficulties that would attend trying to interpret a federal provision which contains substantial ambiguity, and which is likely to be repealed and revoked. It is likely that some other provision will be enacted in place of Section 2036(c) and at that time we would very probably urge enactment of a comparable New York State provision, with identical effective dates.

Further, as a very practical matter, given the confusion and uncertainty that the present Section 2036(c) has visited, any revenue loss to New York by reason of a delay is probably nonexistent because taxpayers generally have been prevented from taking any action which might bring them within the very broad sweep of the present Section. Thus few, if any, transactions are now taking place which would escape the revenue net of a comparable State provision.

Lastly, as a purely alternative technical comment, if the provision is enacted, care should be given that the effective dates (i.e. both the original enactment and subsequent modifications) are identical with the federal provisions. Again, however, we would urge that New York delay any enactment of a comparable provision in view of the likelihood of repeal and retroactive revocation at the federal level.

III. Administrative Reform

The administrative reform provisions of the Bill are sweeping. Generally, the Bill would replace the New York estate tax proceeding in Surrogate's Court with a return procedure under the jurisdiction of the Tax Commissioner. The return would be required to be filed at the same time as the Federal return, except that gross estates of less than $100,000 would be relieve of any return requirement. While certain of the existing administrative provisions have been retained, several provisions have been changed in a manner which will have significant substantive, rather than merely procedural, consequences.

A. Final Federal Determination

One such provision would alter the existing rule that a Federal closing letter constitutes a binding final Federal determination. Under the Bill such a closing letter would not be binding in New York unless it was issued after an audit by the Internal Revenue Service. Such a rule would provide great latitude to the Commissioner to audit estates and make an independent determination of issues deemed resolved for Federal purposes. Thus, for example, estates could emerge from administration having different tax cost bases from Federal and New York purposes as a result of variations in the valuation of assets in the two jurisdictions. It may be anticipated that in many estates where a Federal closing letter would be likely without an audit, the executor will seek a Federal audit in order to provide the consistency and certainty which are desirable.

B. Tax Liens

The Bill would impose a modest fee of $10 as the cost of a obtaining tax waiver. It would also liberalize the tax waiver and tax lien provisions in respect of certain transfers to spouses so that, for example, an interest in real property held by the decedent and surviving spouse as tenants by the entirety would be divested of the estate tax lien. The changes proposed in this area are practical and should streamline the administration of estates.

C. Extensions of Time

One change which is not discussed in the Memorandum in Support relates to the provisions for extensions of time. Although the Memorandum in Support suggests that the provisions allowing extensions of time for hardship are retained, the existing rule providing for an automatic extension of time in the event that the New York estate tax exceeds 5% of the net estate appears to have been deleted. Because the existing provisions imposing interest on estate tax which is not paid within six-months from the date of death have been retained in the Bill, eliminating the automatic extension of time effectively increases the burden on estates currently eligible for the automatic extension. This is especially so in view of the proposed changes, described below, in the way New York estate tax is to be computed, which will have the effect of increasing the New York estate tax in many estates. We would propose that if conformity with the Federal regime is the focus of the Bill, no interest should be imposed in connection with New York estate tax for any estate in which the tax is paid by the nine-month date. In the absence of such conformity, the automatic hardship extension for estates in which the New York estate tax exceeds 5 percent of the net estate should be reinstated.

IV. Computation of Estate and Gift Taxes

The Bill would increase the tax rates for each existing bracket by 1 percentage point and would increase the New York unified credit against transfer tax such that the exemption equivalent would be increased from approximately $108,000 to $125,000, and would eliminate the $500 minimum unified credit. While the increase in the exemption equivalent is welcome, it falls far short of conformity with the Federal exemption equivalent of $600,000. In fact, after giving effect to the increased tax rates and the elimination of the $500 minimum credit, the New York estate tax burden on a $600,000 estate would be increased from $25,500 to $32,000. The Bill will increase rather than decrease the incentive for taxpayers to relocate to e jurisdiction imposing less burdensome estate taxes, with the obvious loss of tax revenues for New York State. We believe this large an increase in the tax on relatively small estates should be reconsidered.

The Bill would also provide for a new method of computing New York estate tax. Under the proposed method, the tentative tax for a resident would be based on all of the decedent's property wherever located, so that the tentative tax imposed on estate of similar size will be computed at the same, highest marginal rates. Only after the tax has been computed at this level will the actual tax imposed be adjusted to reflect property included in the estate for purposes of such computation which is actually situated outside of New York. Under the existing scheme, the New York estate tax for a resident decedent is computed in the first instance without regard to property situated outside of New York.

The change in the manner of computing estate tax for resident decedents would be parallelled in the computation of estate tax for nonresident estates, so that the tax would be computed initially as if (as under current law) the nonresident decedent were a New York resident. That is, the only difference in the computation for New York resident decedents as contrasted with nonresident decedents would be that intangible personal property would attract its allocable portion of the tentative tax for resident decedents only.

While the change in the manner of computation for residents has the appeal of imposing New York tax at the same effective marginal rate for similarly sized estates, it perpetuates, and even exacerbates, the following flaw in the existing scheme for nonresidents. In the event that an estate contains New York property which is specifically devised to charity, the New York estate tax computation in effect spreads the value of the charitable deduction across all of the property included in the decedent's estate for purposes of computing the tentative tax. Thus, for example, if all of the decedent's New York property were left to charity, and only the property located outside of New York were left in a taxable manner, a New York estate tax would nevertheless be imposed with respect to the non-New York property based upon the relative value of the New York property to all of the property includible in the decedent's estate for purposes of the tentative tax. This result is particularly egregious in the case of nonresident estates and has the undesirable effect of discouraging charitable donations of New York sitused property. The provision will also encourage a change in residence by elderly individuals of wealth who have substantial property situated outside New York, especially if they are charitably minded.

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SECTION F

ADDITIONAL FRANCHISE TAX ON S CORPORATION*

The Bill would impose a 2 percent franchise tax on allocated net income of S corporations which have elected S status for New York tax purposes. This additional tax is reduced by the $325 tax imposed on all S corporations. Net operating losses and tax credit carryovers arising from C corporation years cannot be used to offset the additional franchise tax imposed on S corporations.

We do not question the wisdom of this new tax in as much as that is a policy matter, other than to note that California and Illinois at least, impose similar taxes.

The Bill does make some helpful amendments to conform the New York S corporation rules to the Federal S corporation rules. We support these changes to bring greater conformity to this area. Perhaps this would also be the appropriate time to adopt further conforming amendments -- e.g., consistently applied basis concepts and allowance of the resident credit to a shareholder for corporate taxes that are based upon net income paid by an S corporation to other states by the S corporation. Moreover, since the tax policy of New York towards professional corporations has always been revenue neutral (i.e., the federal tax benefits of professional corporations were not available for New York tax purposes), it may not be appropriate to impose the additional franchise tax on such corporations.

We also suggest that the following technical changes be made to the Bill:

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* These comments were prepared by Mark E. Berg and James A. Locke. Helpful comments were received from Arthur A. Feder, Gordon D. Henderson and Arthur R. Rosen.

1. Section 1.

The last three words should be replaced with “within the meaning of Section 1362(e)(4) of the Internal Revenue Code”.

2. Section 2.

The reference to “tax commission” should be changed to “commissioner”.

3. Section 15.

The words “an S corporation (other than an S corporation which is a New York C corporation)” should be replaced with “a New York S corporation”. In addition, conforming changes should be made to the actual modification provisions to which Tax Law Section 617(a) refers -- i.e., Tax Law Sections 612(b)(18), (19), (20); 612(c)(22); 612(e); and 612(n). For example, Tax Law Section 612(b)(18)(A) should begin “that is a New York S corporation”; Tax Law Section 612(b)(19)(A) should begin with the words “that is a New York C corporation”; and Tax Law Section 612(e) should be amended to conform with Tax Law Section 617(a), as amended.

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SECTION G

INSURANCE TAX PROVISIONS*

The Bill would significantly alter the taxation of insurance companies doing business in New York. Under current law insurers are taxed on a two-part basis: the first is a franchise tax on net income, and the second is an additional franchise tax on gross premiums. The combination of the two taxes is subject to a “cap” of 2.6 percent of gross premiums. Under the Bill the two-part system will be replaced with a single tax on gross premiums at the rate of 2 percent. The Memorandum in Support of the Bill states that this change will produce, approximately $100 million in additional revenues, and will produce a more regular and predictable stream of revenues from the insurance industry. It also points out that a majority of states now tax insurance companies on the basis of premiums. The Memorandum states that “most” states impose a tax at a rate higher than 2 percent, and approximately 40 percent of the states impose the tax at the 2 percent rate.

It is the policy of the Tax Section to refrain from commenting on the potential revenue impact of a tax proposal, and we do not do so here. We have consistently stated our belief that a corporate franchise or income tax system should be based primarily on the concept of profitability; i.e., net income, computed as gross income minus necessary expenses, is a fairer basis of taxation than is gross receipts. In particular, the gross receipts tax will be imposed equally on enterprises, that whether they are making money or losing money, without differentiation. Moreover, when the company subject to the gross

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* These comments were prepared by Hugh T. McCormick and Irving Salem. Helpful comments were provided by Arthur A. Feder, James A. Locke and Arthur R. Rosen.

receipts tax is in competition with other enterprises that are taxed on a net income basis, as can occur when insurance companies are in competition with banks, there is a potential for significant tax inequality at the company level.

Finally, we note that this proposal seemingly repudiates a statement made by the Division of the Budget in connection with a 1974 change to the Tax Law that eliminated a prior tax system which was based totally on premiums, and instead imposed the current tax system. The Memorandum in Support of the 1974 Legislation stated that “the traditional premiums tax base has become increasingly obsolete as a fair and adequate measure of insurers' ability to pay ....”

The Bill would be effective for taxable years beginning on or after January 1, 1990.

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