REPORT #827

TAX SECTION

New York State Bar Association

Report on Governor's 1995-1996 Budget Proposals

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March 17, 1995

Hon. Michael H. Urbach
Commissioner
Department of Taxation and Finance
State of New York
Building 9, State Campus
Albany, NY 12227-1215

Re: 1995-1996 Budget Proposals

Dear Mr. Urbach:

Enclosed please find a report commenting on certain Budget Bills currently under consideration by the New York legislature.

Please call me if you would like to discuss this further.

Very truly yours,

Carolyn Joy Lee
Chair

cc: Hon. Sheldon Silver
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Albany, NY 12247

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Tax Report #827

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Governor's 1995-1996 Budget Proposals

Governor Pataki's budget proposal for 1995-96 contains several tax initiatives, including an extension of the tax on banking corporations, a revision of the method for taxing the telecommunications industry, a new child day care facility credit, and several procedural and substantive amendments to various taxes.

This report was prepared by the Committees on New York State Franchise and Income Taxes, New York State Sales and Miscellaneous Taxes, Multistate Tax Issues and New York City Taxes (the “Committees”).[1] It focuses on the proposals that these Committees believe warrant comment because of technical, administrative, or conceptual issues they raise.

[1] This report was drafted by Robert E. Brown, Maria T. Jones, James A. Locke, Robert Plautz, Arthur R. Rosen and Joanne M. Wilson. Helpful comments were received by E. Parker Brown II, Paul Comeau, Roger Cukras, Craig Fields, Mark Klein, Carolyn Joy Lee, Robert J. Levinsohn, Robert Plattner, Richard L. Reinhold and Michael Schler.

1. S.1826/A.3126 - Amendment to Tax Law §171-a requiring information reports on new employees.

This bill would amend §171-a of the Tax Law to require that employers submit a report to the Department of Taxation and Finance (the "Department") identifying employees who have been newly hired or rehired within fifteen (15) days of the hiring or rehiring date. According to the Memorandum in Support, the purpose of this bill is to facilitate accurate calculation of child support obligations.

The Tax Section takes no position on the policy objectives sought to be achieved by this proposal. We do believe, however, that imposing the burden of collecting such forms on the Department is an unwarranted diversion of the resources of the Department from the administration and collection of taxes. It is the belief of the Tax Section that if such reports are worthwhile they should be made directly to those agencies responsible for taking action with regard to the intended social policy.

2. S.1830/A.3130 - Amendment to the Tax Law and the Administrative Code of the City of New York repealing certain provisions relating to the treatment of corporate mergers, consolidations and acquisitions.

The Tax Section strongly supports the passage of this bill, which would repeal certain provisions in the Tax Law and the Administrative Code of the City of New York relating to corporate mergers, acquisitions, and consolidations (the "M & A provisions"). The M & A provisions impose various sanctions (i.e., loss of certain tax benefits) on corporations that engage in certain kinds of corporate transactions, and also impose additional sanctions on such activities when they are "highly leveraged."

In our letters to former Governor Cuomo and various legislative leaders, dated April 14, 1989 and June 9, 1989, the Tax Section expressed deep concern over the passage of the M & A provisions, on both technical and policy grounds. In the nearly six years since signed into law, the M & A provisions have served mainly as a trap for -- at most -- a few unwary corporations that do business in New York State. Due to both the complexity and the scope of the M & A provisions, they have been a source of concern for tax practitioners, and it seems likely that they have been difficult for the New York State and City tax administrators to audit and to enforce. According to the Memorandum in Support, these provisions were inapplicable to a large number of transactions, and repeal of these provisions will have a minimal impact on tax revenue.

The Tax Section strongly supports the repeal of these ill-advised provisions through prompt passage of this legislation.

3. S.1842/A.3142 - Extension of the expiration date of amendments to the Tax Law and the Administrative Code of the City of New York relating to banking corporations.

This bill extends the expiration date of the amendments made to Tax Law, Article 32, the Franchise Tax on Banking Corporations, and the comparable provisions of the Administrative Code of the City of New York (the “Administrative Code”) from January 1, 1995 to January 1, 1999. In 1985, the Legislature made significant modifications to Article 32 and the comparable provisions of the Administrative Code. These changes were to expire on January 1, 1990. A temporary state commission was to be created to study the new tax and alternatives and to propose permanent legislation. In 1989, the Legislature extended the expiration date until January 1, 1992. In 1992, this expiration date was extended until January 1, 1994, and in 1994, it was extended to January 1, 1995. While the Tax Section does not object to the further extension, a permanent resolution of the tax structure for banking corporations should be an important legislative goal. In view of the recent changes in the interstate banking rules in the Riegle-Neal Interstate Banking and Branch Efficiency Act of 1994 and the recent Multistate Tax Commission Report on allocation of banking income, the temporary state commission should be reinvigorated and should complete its work in a timely fashion.

4. S.1822/A.3122 - Amendments to the Tax Law relating to the establishment of a child day care facility credit.

This bill would provide a tax credit to businesses that offer child day care facilities for their employees' dependents. The eligibility requirements, recapture provisions and other features of the proposed child day care facility credit are patterned on existing investment and other tax credit provisions contained in the Tax Law. As such, the proposed credit, to a large extent, keys into a pre-existing, well-developed pattern of determining credit eligibility, computation and recapture. However, a comparison of the proposed child day care facility credit provisions and the existing investment and other tax credit rules highlights certain differences in the statutory approach upon which we furnish the following comments and suggestions.

Certain of the existing tax credits, such as the economic development zone (“EDZ”) investment tax credit contained in the Tax Law § 210.12-B, provide, in general, that (i) the credit may not reduce a corporation's franchise tax liability to an amount less than the higher of the tax on minimum taxable income or the fixed dollar minimum tax, (ii) any such credit that cannot be used to reduce the current year's tax liability may be carried over to the following tax years without any specified expiration date, and (iii) no amount of the credit will be refunded. In contrast, other tax credits, such as the investment tax credit contained in Tax Law§ 210.12, although similarly providing that the credit may not reduce a corporation's franchise tax liability to an amount less than the higher of the tax on minimum taxable income or the fixed dollar minimum tax, provide that unused credits may be carried over for a specified number of years and provide for certain refund rights. For example, the investment tax credit provisions contained in Tax Law § 210.12(e)(1) permit a new business to receive a tax refund in lieu of carrying over excess credits to subsequent tax years. [1] Another incentive option which could be included if compatible with the legislation's policy goals is a refund alternative for new businesses and/or an unlimited carryover period.

In order to qualify for the proposed child day care facility credit, the tangible property acquired by purchase and placed in service in New York by the taxpayer must be used, whether by the taxpayer or another person, exclusively in the provision of day care services for the benefit of the taxpayer's employees. These provisions clearly contemplate that the taxpayer who acquires and places in service the tangible property need not actually use or operate the day care facility as long as it is being used and operated exclusively in the provision of day care services for the benefit of the taxpayer's employees. Thus, the terms of any leasing arrangement involving the property would be irrelevant as long as such leasing arrangement does not convey tax ownership to the lessee. Moreover, the proposed amendment does not regulate the financial terms on which day care service is provided for the employees' dependents. It is presumed that this expansion in the ability of a taxpayer to lease facilities and still have those facilities qualify for the day care facility credit is necessitated by the fact that taxpayers are likely to seek tenants experienced and licensed in the provision of day care services to operate such a facility. Also, because of liability concerns, it is likely that the taxpayer may use a

1 Interestingly, the refund provision is noted as an exception to the general carryover rule utilizing the same language, i.e., "[e]xcept as otherwise provided in this paragraph," as contained in new paragraph (D) of subdivision 22 of Section 210 of the Tax Law. We question the use of this phrase in this paragraph since an exception to the general carryover rule is not contained in this paragraph.

separate subsidiary or other entity to own and/or operate the day care facilities. We question whether the objective of the proposed credit--to “enhance the viability of families with working parents”--is adequately addressed by the proposal's absence of parameters on the taxpayer's profit potential from leasing activities and day care charges, or whether market forces and the need to attract employees' dependents as day care recipients will sufficiently regulate this activity. If enacted, it may be useful to provide technical guidance on the qualification and allocation of the day care facility credit base and credits through joint venture ownership by the taxpayer and a licensed day care service provider.

We also note that as drafted the credit is available only if the property is owned by the employer. This approach means, for example, that space leased by the employer is not eligible for any credit even if the leased property is used to provide the targeted care.

While the Tax Section does not oppose the enactment of this credit, we note that, in general, investment or employment credits increase the complexity of the tax laws and frequently benefit only a narrow group of taxpayers. The social policy goals that the Legislature is seeking to achieve through this legislation should be weighed against these possible drawbacks.

5. S.1834/A.3134 - Procedural Amendment to the Tax Law relating to notice and demand for payment.

The Tax Section opposes enactment of this bill as currently drafted. This bill would add a new section to the Tax Law, Section 173-A, which would specifically deny taxpayers the right to a prepayment hearing to contest amounts sought pursuant to a “notice and demand for payment” issued by the Department. The bill is intended to overrule the Appellate Division's decision in Meyers v. Tax Appeals Tribunal, 201 A.D.2d 185, 615 N.Y.S. 2d 90 (3rd Dept. 1994) in which the court held that Tax Law §2006(4) gives taxpayers the right to a hearing in the Division of Tax Appeals before the payment of an amount asserted to be due in a notice and demand.

In general, two methods are used by the Department to notify taxpayers that an additional amount of tax, interest or penalty is due: (1) a “notice of deficiency” or “notice of determination” from which a taxpayer may contest the amount asserted to be due through a prepayment hearing before the Division of Tax Appeals, and (2) a “notice and demand” from which, until the Meyers decision, it was the Department's position that a taxpayer was entitled to a hearing only by first paying the amount asserted to be due and then filing a refund claim (if available pursuant to a specific statutory provision). The Department generally issues a notice and demand when, in the Department's view, the amount asserted to be due has been “self assessed” but not paid by the taxpayer (i.e. when the amount of tax due as reflected on the return submitted by the taxpayer exceeds the amount remitted by the taxpayer or where the tax return contains a mathematical error) or when the amount due is readily ascertainable from the information on the return, such as when the failure to file a timely return results in a penalty.

The Appellate Division in Meyers quoted Tax Law §2006(4) in holding that that section grants taxpayers a right to a prepayment hearing unless the right to a hearing is "specifically provided for, modified or denied by another provision of [the Tax Law]." Thus, the Appellate Division held that taxpayers are entitled to a prepayment hearing upon receipt of an amount asserted to be due by notice and demand as well as by a notice of deficiency or determination. The Memorandum in Support of this bill asserts that the increased workload and delay in the resolution of amounts due from taxpayers that would result from prepayment hearings being available to challenge notices and demands would increase the costs to the taxpayer and would result in a substantial revenue loss to the State.

The Tax Section agrees with the Department that there may be little utility -- and accordingly, substantial waste -- in granting a taxpayer a right to a prepayment hearing concerning a tax amount that the taxpayer has self-assessed by signing and filing a return showing the tax to be due. On the other hand, the Tax Section believes that penalties or additions to tax that may be calculated from such "self assessments" should be treated differently. Notwithstanding that the underlying tax may have been self assessed by the taxpayer, there may be valid reasons to abate or cancel any related penalty or addition to tax. This was the situation of the taxpayers in the Meyers case; the Meyers were seeking a hearing only with respect to challenging the penalty attributable to the tax shown to be due in the return filed by them.

In sum, the Tax Section believes (1) that it is acceptable to deny prepayment hearings in cases such as nonpayment of an amount of tax shown to be due on a tax return signed and filed by the taxpayer, or when a taxpayer has failed to file a timely protest to a notice of determination or deficiency, but (2) prepayment hearings should be made available in cases where the amount due has not been self assessed by the taxpayer, such as any case in which the Department is asserting a penalty. Consequently, the Tax Section recommends that the bill be withdrawn from the budget process and be considered only after revision.

6. S.1841/A.3141 - Amendments to Tax Law Article 9 relating to taxation of telecommunications.

S.1841/A.3141 would amend various provisions of Tax Law Article 9 so as to restructure dramatically the taxation of telecommunications in New York.

Background.

Under current law, telecommunications providers (i.e., corporations that are principally engaged in providing telecommunications) are subject to the two franchise taxes imposed by Tax Law Sections 183 and 184. Moreover, the additional tax of Section 186-a is imposed on any person (irrespective of whether it is subject to the franchise taxes imposed under Section 183 and 184, to the franchise tax imposed under Article 9-A on general business corporations, or to none of the franchise taxes) that (a) is regulated by the Public Service Commission or (b) provides telecommunications by wire.

Substantial controversy has developed over the past decade regarding the proper application of these Tax Law provisions to various aspects of the telecommunications industry. For example, the Court of Appeals recently held a provision of Section 186-a unconstitutional, because the statute required telecommunication carriers, when computing their gross receipts that were subject to New York tax, to deduct from their worldwide receipts only those access charges paid in New York; because this preapportionment figure was then allocated to New York by a property factor (New York property divided by worldwide property) obvious discrimination against interstate commerce resulted. AT&T v. Department of Taxation & Fin., 84 N.Y.2d 31, 614 N.Y.S.2d 366 (1994).

Summary of Provisions.

The proposed system of taxation would impose tax on local telephone businesses in a manner distinct from the tax imposed on interexchange telecommunications business. Only local telephone businesses (defined as those providing an intra-LATA "telecommunication service" (i.e., service within a Local Access and Transport Area, as determined pursuant to the Modification of Final Judgment issued in the AT&T divesture case) would remain subject to the Section 184 tax while all those providing telecommunications services (intra-LATA or inter-LATA) would be subject to a new excise tax that would be imposed under a new Section 186-e; the current Section 186-a gross receipts tax on telecommunication services would be eliminated. However, Section 186-a would continue to apply to receipts for non-telecommunication services of providers subject to the regulation of the Public Service Commission. "Telecommunication Services" is defined as:

> Telephony or telegraphy, or telephone or telegraph service, without limitation including any transmission of voice, image, data, information and paging, through the use of any medium or any combination of media and shall include services that are ancillary to the provision of telephone service (such as, but not limited to, dial tone, basic service, directory information, call forwarding, caller-identification, call-waiting and the like) and also include any equipment and services provided therewith, excluding from the definition of telecommunication services, however, video programming transmitted to subscribers by cable television service.
>
> Provided, the definition of telecommunication services shall not apply to separately stated charges for any service which alters the

substantive content of the message received by the recipient from that sent.

Proposed Section 186-e would impose an excise tax at the rate of 3 1/2% (the same rate that is applied currently under Section 186-a) to all gross receipts from intrastate telecommunications and to a portion of interstate and international telecommunications

The portion of interstate and international telecommunications gross receipts that would be subject to the new Section 186-e excise tax would be determined as follows:

-- Any gross receipts from interstate and international telecommunication services (except for private telecommunication services) that (a) originate or terminate in New York and (b) are charged to a service address in New York, regardless of where the amount charged for the service^ are billed or paid;

-- Gross receipts from private telecommunication that are attributable to channel termination points in New York and to segments between channel termination points in New York.

The Commissioner would be granted authority to utilize a different allocation method with respect to any specific private telecommunication services provider if the statutory provisions do not fairly and equitably reflect the services attributable to New York.

An exclusion would be available for sales of telecommunication services for resale as such to an interexchange carrier or to a local carrier. Refundable credits would be available (a) for purchases of telecommunication services for resale as such when purchased by one other than an interexchange carrier and (b) “in order to prevent actual multi jurisdictional taxation,” for tax paid to any other jurisdiction with respect to any interstate or international telecommunication services on which the New York tax has been paid.

The new tax that would be imposed by the bill would be effective as of January 1, 1995.

Comments.

According to the Memorandum in Support, the bill is the result of a negotiated settlement, between the State and “long distance carriers”, of the AT&T case. Moreover, the bill incorporates the basic structure approved by the U.S. Supreme Court in Goldberg v. Sweet, 488 U.S. 252 (1989), and is similar to statutes that have been recently enacted in several states. Because of these factors, and since such a “modern” statute would better reflect today's technological world (for example, by attempting to segregate receipts generated by transmission from receipts generated by providing “content”, and imposing the new tax only on the former) and therefore preclude much controversy, the Tax Section generally supports the bill.

A number of technical questions are however presented by the bill, and it may be these technical questions will not be resolved in this year's session of the Legislature. We therefore suggest that a working group be formed to review the legislation and to recommend such further technical legislative corrections or administrative guidance as may be needed.

Examples of technical questions raised by the bill include the following:

- -- How Section 184 is to be applied when a provider is providing both local telephone service and interexchange service.

- -- While Section 184 would be amended to impose tax only on the gross earnings of a corporation that is a “local telephone business”, the provision concerning the allocation of gross earnings of telephone corporations (Section 184.4(c)) was not amended. Thus, a corporation subject to tax under Section 184 as a local telephone business may be required to pay, in addition to a tax on 100% of its receipts from intrastate transmission services, tax on a portion of its receipts from interstate and international transmission services (computed under the regulations based on the corporation's property). Consideration should be given to the disparity created when a corporation that is a “local telephone business” is taxed on a portion of its receipts from interstate and international transmission services while a corporation that is not a “local telephone business” is not taxed on the provision of those same types of services.

- -- While amended Sections 184.1 and 184-a.l do define the term “local telephone business,” neither statute provides a definition of the term “telephone business.”

- -- Section 186-a continues to apply to receipts for nontelecommunication services of providers subject to the regulation of the Public Service Commission. Consideration should be given to the appropriateness of continuing the distinction between regulated and nonregulated corporations.

- -- The exclusion of video programming transmitted by cable television service from the definition of “Telecommunication services” in Section 186- e does not address the treatment of cable-provided audio services, such as FM services.

-- The definition of “Telecommunication services” in Section 186-e does not address the ramifications of interactive cable services.

-- The provision concerning the Commissioner's ability to utilize a different allocation method with respect to private telecommunication services in Section 186-e does not provide that such different allocation method must result in 100% or less of the gross receipts being allocated to all states.

-- There is no provision in Section 186-e allowing either the Commissioner or the taxpayer to use a different allocation method than that provided in the statute with respect to nonprivate telecommunications services.

-- The credit provided in Section 186-e applies to the amount of tax “actually paid with respect to the sale of telecommunication services” in the case of a purchaser that is not an interexchange carrier and that resells the service. It is unclear whether the term “actually paid” requires that the taxes be paid by the seller to the State. For example, it is unclear whether a credit would be permitted if the purchaser pays the tax to the seller as part of the seller's invoice but the seller does not pay over the taxes to the State.

-- The credit provided in Section 186-e is limited to a provider of telecommunication services that is not an interexchange carrier. An interexchange carrier is defined as any provider of telecommunication services between two or more exchanges and that qualifies as a common carrier. It is unclear whether resellers would qualify under this definition.