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January 8, 2002

Honorable Marc V. Shaw
Deputy Mayor for Operations
New York City Hall
New York, NY 10007

Honorable Daniel Doctoroff
Deputy Mayor for Economic Development
New York City Hall
New York, NY 10007

Dear Deputy Mayors Shaw and Doctoroff:

The enclosed NYSBA Tax Section Report No. 1002 proposes changes to cure a serious inequity in the New York City income tax treatment of certain shareholders of Federal Subchapter S corporations.

Under the Internal Revenue Code, noncorporate shareholders may elect under Subchapter S to have their corporations, in effect, treated in a manner similar to partnerships, with no tax at the corporate level or on corporate distributions as such at the individual level, but with corporate items of income or loss flowing through and reflected each year on the individual income tax returns of the shareholders.

New York State has made a policy decision to provide Federal Subchapter S corporation shareholders an election as to the treatment of the corporation for purposes of New York State corporation and individual income taxes. If all the shareholders so elect, the corporation may be treated as a New York S corporation. Where New York S corporation status has been elected, the corporation is subject only to a small "pick-up" tax, to the extent of the excess of the corporation franchise tax rate over the personal

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income tax rate, and the individual shareholders start with the same inclusions and deductions flowing through from the corporation as on their Federal income tax returns, before making the same adjustments applicable generally in arriving at their New York taxable income. If the New York S corporation election is not made, the corporation is a so-called New York C corporation, taxed at the corporate level like any non-Subchapter S corporation. In that case, the State has made a correlative policy decision to treat the shareholders for individual income tax purposes just like shareholders of other non-S corporations, with all the flow through items from the corporation eliminated from their returns, and corporate distributions taxed in the normal C corporation manner.

New York City has made a policy decision not to allow S corporation treatment for City corporation tax purposes. All Subchapter S corporations are taxed by the City as if they were C corporations. However, the City has failed to make the correlative policy decision to give consistent C corporation treatment to the shareholders for individual income tax purposes (in cases where at the State level the corporation is a New York S corporation) by allowing the same adjustments as are permitted by the State for New York C corporation shareholders. In that situation, the City shareholders remain with the same inclusions of corporate items in their City taxable income as in their State taxable income, even though the same items are fully taxed by the City at the corporate level. No such problems exist for City shareholders of Federal S-New York C corporations. As with their State taxable income, the corporate items remain eliminated in arriving at City individual taxable income, and the corporate level tax is not duplicated.

After outlining in some detail the treatment of S corporations and their shareholders under both State and City tax laws, the report discusses elections under Internal Revenue Code § 338 and recently proposed New York City corporation tax rules under Code §338 as offering a particularly stark example of the harsh and discriminatory effect of the City's income tax treatment of City shareholders of New York S corporations.

The report reiterates the Tax Section's traditional support for conformity by the City with the State's treatment of Subchapter S corporations. In addition to achieving simplification, this change would eliminate the existing discrimination against City shareholders of New York State S corporations. The report recognizes that this goal may, at present, be unattainable, particularly in light of the City's current inability to tax nonresidents on income flowing from City S corporations. Nevertheless, the report suggests that this topic is worth continued exploration.

Assuming that complete S corporation conformity is currently unattainable, the report makes two alternative recommendations for changes in the City personal income tax that would eliminate the existing

discrimination against City shareholders of State S corporations without disturbing the current City corporation tax treatment of S corporations.

The first alternative would simply extend to City shareholders of New York S corporations the same City personal income tax addition and subtraction modifications that are already available to shareholders of Federal S corporations that are New York C corporations. Although this change would achieve exact parity of City income tax treatment for all City shareholders of Federal S corporations whether the latter are New York State S or C corporations, it could result in a net reduction of revenue going beyond that needed to eliminate double taxation where a portion of the corporation's income is allocated outside the City.

The second alternative would avoid the latter problem by allowing a credit against personal income tax for City S corporation shareholders of a New York S corporation for their shares of the corporation's actual City corporation tax. This credit would be modeled on the existing UBT credit, but we support a full credit, not the phased down credit applicable to the UBT.

The final recommendation in the report is an unrelated proposal to cure an anomalous effect of the City's Code §338 rule amendments by allowing the purchasing corporation of a target S corporation as to which a Federal Code § 338(h)(10) election is in effect but inoperative for City purposes, to make a basic Code § 338(g) type election for City corporation tax purposes.

All our recommendations should be helpful to new business development in the City. We stand ready to work with you and your staff in the drafting and pursuit of the necessary legislation to carry out whichever of our recommendations you decide to support. We are prepared to meet with you and your staffs at your convenience to explore how these changes can promote economic development in New York City.

Respectfully submitted,

A handwritten signature in cursive script, appearing to read "Robert A. Jacobs". The signature is written in dark ink and is positioned to the right of the typed name.

RAJ:ch
Enclosure

NY2:#4444218

cc: Honorable Michael R. Bloomberg,
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New York City Commissioner of Finance
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