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June 11, 2003

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Comments on Estimated Tax Provisions
S. 1406-B, A. 2106-B

Gentlemen:

We wish to comment on certain aspects of the estimated tax provisions of the 2003 New York State tax legislation that require immediate corrective action by the Legislature.[1] In particular, these provisions, as written, will require that in some cases estimated tax must be paid twice on the same income. In addition, the provisions will require, in other cases, that estimated tax must be paid that is far in excess of the actual tax liability of the taxpayer. We believe these provisions are inequitable, will cause confusion and hardship for many taxpayers, and will discourage nonresidents from investing in partnerships carrying on activities in New York State.

[1] The bill (S. 1406-B, A. 2106-B) became law on May 15, 2003.

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The problems arise from new Section 658(c)(4) of the Tax Law, contained in Part L3 of the budget bill, which imposes estimated tax responsibilities on partnerships, limited liability companies treated as partnerships for federal income tax purposes and S corporations (collectively, "entities") having New York source income. For tax years ending after December 31, 2002, these entities are required to make quarterly estimated tax payments on behalf of their partners, members or shareholders (collectively, "owners") who are either (i) individual nonresidents of New York State or (ii) C corporations.

This letter was prepared on an expedited basis, bypassing the Tax Section's normal procedures for governmental submissions because of the importance and urgency of the comment.[2]

Summary of Recommendations

The mechanics of the transitional rules for the new estimated tax responsibilities, and the manner in which the estimated taxes are to be paid without regard to the owners' taxable income, will likely result in overstated estimated tax payments. We believe this result is in urgent need of correction and we recommend that the various technical changes described in this letter be enacted promptly.

Under the new estimated tax provisions, an entity's required estimated tax payments are calculated by taking each owner's distributive share or

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[2] This letter was not submitted to the Tax Section Executive Committee for approval. The principal draftsperson of this letter was Irwin M. Slomka. Helpful comments were received from Andrew N. Berg, Kimberly S. Blanchard, Peter Faber, Robert A. Jacobs, David E. Kahen, Carolyn J. Lee, Robert J. Levinsohn, Richard O. Loengard, Jr., Arthur R. Rosen, Seth L. Rosen, Michael L. Schler and Lewis R. Steinberg.

prorata share of the entity income derived from New York sources and multiplying it by either (i) the highest rate of tax under Tax Law § 601 (for owners who are nonresident individuals) or (ii) the rate of tax on entire net income under Tax Law § 210(1)(A) (for owners that are C corporations). Estimated tax must be paid with respect to C corporation owners, "whether or not such C corporation is subject to tax" under Articles 9, 9-A, 32 or 33.

In order to insure compliance, the new law subjects the entity to penalties and additions to tax, including the additions to tax for underestimated tax under Tax Law § 685(c), for failing to pay the required estimated tax. Given the uncertainties resulting from the retroactive effect of these new requirements, the law provides that no penalties or additions to tax will be imposed with respect to any estimated tax payments required to be made before September 15, 2003, provided the entity makes the required first, second and third quarterly estimated tax payments (generally, for calendar year entities, due on April 15, June 15 and September 15) by September 15, 2003.

We have summarized below our more urgent recommendations.

1. Possibility of Duplicate 2003 Estimated Tax Payments on the Same Income

The new law requires an entity to make estimated tax payments without regard for whether the owner made its own required estimated tax payments for the same period and on the same income. Even if the owner makes its own estimated tax payments, the entity is required to pay estimated tax on the same income allocable to the owner. This will result in double estimated tax payments on the same income.

The reason for this result is that while the new law properly treats estimated tax payments made by the entity as if they were made by the owner, there is no corresponding provision treating estimated tax payments made by the owner as if they were made by the entity. This necessarily requires the

making of duplicative estimated tax payments in order to avoid the imposition of entity-level penalties. For example, a calendar year partnership will owe estimated taxes for the 2003 tax year on April 15, June 15, and September 15, 2003, and on January 15, 2004. In many cases, individual nonresident partners will have already made their April 15, and possibly their June 15, estimated tax payments for 2003, prior to the enactment of the new entity-level estimated tax provisions. Some will no doubt make their June 15 payment completely unaware of the new provisions. As it now reads, the law requires that the entity make the estimated tax payments, *even if each owner has already made its own estimated tax payments.* As a result, for the 2003 tax year, a portion of the estimated tax for many nonresidents and C corporations will likely have been paid twice by both the owner and the entity.[3] This is likely an unintended result, and a harsh one, compelled by the language of the new law requiring that the entity pay estimated tax regardless of whether the owner has already paid it.

To avoid this confiscatory result (*i.e.*, a forced "loan" to New York State without interest), we propose that the law should be amended to provide that the entity's obligation to make estimated tax payments should commence with payments that are due on or after September 15, 2003, at least in cases where the nonresident individual or C corporation certifies to the entity, in a form satisfactory to the New York State Department of Taxation and Finance ("Department"), that the owner has made estimated tax payments prior to September 15, 2003. Alternatively, the law should be amended so that any estimated tax payments made by the owner on April 15 and June 15, 2003 *can* be applied toward the entity's estimated tax obligations for 2003 tax year.

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[3] Although owners eventually will be given credit for the resulting overpayments, they will not be able to claim a refund of the overpayment until they file their annual New York tax returns. Their refunds will be made without interest, notwithstanding the loss of use of the money for a year or more.

2. Estimated Tax Payments for Many C Corporations Will Likely Be Overstated

The technical problems with respect to C corporation owners are particularly troublesome. The first problem stems from the reference in the new law to "C corporations." Under Internal Revenue Code § 1361(a)(2), a "C corporation" is broadly defined as any corporation that is not an S corporation. Thus, the reference in the new law to "C corporations" appears to include a variety of corporations which are either not taxable, or minimally taxable, in New York. Among these are religious, charitable or educational organizations (which should be fully exempt from corporate tax) and regulated investment companies ("RICs"), real estate investment trusts ("REITs") (which are not exempt, but pay only minimal New York corporate tax because of the way they calculate their taxable income) and insurance companies (which are taxed under a formula based on a combination of premium income and entire net income, which could not be captured by the flow-through only without reference to investment income).

To require entities to pay estimated tax on behalf of exempt C corporations makes little sense. It is similarly illogical to have tax paid on behalf of RICs and REITs, for example, far beyond what these owners they will ever owe in New York corporate tax. We therefore urge that the legislation be amended to permit the Department to implement procedures under which the entity's estimated tax obligations would be eliminated where the owner demonstrates to the entity that it is not itself required to pay New York tax or is subject to a special method of taxation as are RICs, REITs and insurance companies.

Other inequities stem from the requirement that estimated tax be paid on behalf of all C corporations. The law as currently written will significantly affect the vast majority of C corporations that regularly file New York corporate returns and pay estimated tax measured by their actual estimated taxable income. The calculation of those estimated tax payments reflect a variety of factors, including the corporation's profitability, its method of

apportionment, and whether it files New York corporate returns on a combined basis with other entities. The new requirement that an entity pay estimated tax on behalf of a C corporation without taking into account the corporation's actual tax liability represents a radical change from existing practice and will likely lead to significant overpayments of estimated tax on behalf corporate owners. It also puts the C corporation itself at risk for underestimated tax penalties if the entity does not properly pay the C corporation's estimated tax. We therefore urge that the new legislation be amended to provide that the estimated tax requirement will not apply with respect to a C corporation owner that certifies to the entity, in a form acceptable to the Department, that it pays tax based on the existing estimated tax requirements under Articles 9, 9-A, 32 or 33.[4]

We also make the following secondary recommendation:

3. Estimated Tax Payments for Many Individuals May Be Greatly Overstated

The new estimated tax provisions may require individuals to pay estimated taxes that are far in excess of their actual tax liability. This is a

[4] The meaning of the statutory reference requiring the making of estimated tax payments on behalf of C corporations "whether or not" subject to tax under Articles 9, 9-A, 32 or 33 is somewhat unclear. One can read the reference as requiring that estimated tax payments be made on behalf of all C corporations, whether or not subject to New York tax. It is also possible to interpret that provision as merely confirming that estimated tax should be paid with respect to C corporations using the Article 9-A tax rates, irrespective of which article of the Tax Law would actually apply. If the latter is what is meant, the ambiguity could be cured simply by deleting from the statute, on line 21 of page 596, the words "whether or not such C corporation is."

radical departure from the existing practice with respect to estimated tax payments. Estimated tax payments are usually based either on a taxpayer's taxable income for the prior year or on its actual taxable income (reflective of the taxpayer's actual income, gain, deduction or loss) for the current year. As such, estimated taxes are supposed to reasonably approximate the taxpayer's tax on the actual taxable income for the year.

In contrast, the new estimated tax provisions require the entity to pay estimated tax at the top rate based solely on the entity's New York source income. This creates an inequitable system of requiring the payment of estimated tax without considering the owner's actual taxable income and will likely cause unnecessary estimated tax payments to be made with respect to those individual owners. For example, the owner's actual New York taxable income may be reduced by personal deductions or allowable losses.[5] It also could result in systematically greater estimated tax payments for nonresident partners than are required of similarly situated resident partners, raising possible constitutional implications.[6]

To avoid the inequity of forced overpayments of estimated tax, we recommend that the bill be amended to direct the Department to implement

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[5] To take a simple example, an individual partner of a law firm or accounting firm may make substantial alimony payments each year out of his or her share of the partnership's earned income. While the alimony payments are deductible in computing the individual's New York taxable income, they would not be taken into account in computing the partnership's estimated tax obligations.

[6] While the owner eventually will have an opportunity to get a refund of any overpayment, this could take many months after the payments are made, and the refund will be made without interest, notwithstanding the loss of use of the money.

procedures under which the fundamental objective of the new legislation -- that being to insure that taxes due to New York from nonresidents and C corporations are properly paid -- can be achieved while still permitting the payments made in respect of nonresident individual and C corporation owners to resemble the payments required under § 685(c) for resident partners paying estimated tax directly.[7]

There is another flaw in the provision of new § 658(c)(4)(C)(ii) that the penalty for any underpayment of estimated tax by the entity is determined pursuant to § 685(c). Left unclear is how to apply the provisions of § 685(c)(3)(B)(ii) and (C), which provide for an alternative method of calculating the installments of estimated tax required to avoid penalties, based on "the tax shown on the return of the individual for the preceding taxable

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[7] Certain states, including New York and California, already permit group returns to be filed on a voluntary basis so that partnerships and other pass-through entities can pay estimated income tax on behalf of their nonresident partners or other owners. We note that in New York, for example, the entity filing a group return must make estimated tax payments on behalf of nonresident partners and owners without taking into account the standard or itemized deductions, personal exemptions, carryovers or credits of the partners themselves. 20 NYCRR § 151.17. In the case of such group returns, this result seems entirely justified since the filing of a group return is voluntary, with each nonresident partner making an election to be included in the return. Each partner decides whether the convenience of paying tax through the filing a group return (and paying tax at the highest tax rate without considering the partner's actual taxable income) outweighs the additional tax that the partner may have to pay under that election. The newly-enacted estimated tax provisions, however, are mandatory, not elective. Accordingly, there is no justification for *requiring* nonresidents to pay artificially high estimated taxes without consideration of their actual taxable income.

year." The statute should be amended to specify whether this calculation may be made based solely on the individual's share of the entity's income from New York sources in the preceding taxable year.

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We recognize that the responsibilities imposed on pass-through entities and their owners under the new estimated tax provisions may well be entirely justified by New York State's legitimate need to collect taxes properly payable to the State. There is, however, no justification for requiring duplicative tax payments during the transitional period or for requiring the payment of tax that is out of all proportion to their actual liability. The mechanics of the transitional rules, and the manner in which estimated taxes are paid without regard to the owners' taxable incomes, will result in overstated estimated tax payments, amounting to the making of "interest-free loans" to New York State. We do not believe the Legislature intended this result and, if it did, we believe such intent is ill-advised and in urgent need of correction. For these reasons, we urge that the changes described above be enacted promptly.

We would be pleased to assist the Legislature in any way we can to address these and any other issues.

Respectfully submitted,

Andrew N. Berg
Chair

cc: Hon. Arthur J. Roth
Steven A. Taylor
Brien R. Downes
Governor Pataki