NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON THE GOVERNOR'S 2004 – 2005 BUDGET BILL (SENATE 6060/ASSEMBLY 9560)[1]

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Introduction

This report on the Governor's 2004-2005 Budget Proposals was prepared by the Tax Section of the New York State Bar Association. It focuses on those budget proposals in the Governor's 2004-2005 Budget Bill (S.6060/A.9560) (the "Bill") that the Section believes warrant comment because of technical, administrative or conceptual issues they raise.

I. Part G: Changes to Fixed Dollar Minimum Tax

A. Existing Law

Currently, the fixed dollar minimum tax is imposed on every corporation taxable under New York Tax Law ("Tax Law"), Chapter 60, Article 9-A ("Article 9-A") if it results in a greater amount of tax than that computed on entire net income or the other tax bases. The amount of minimum tax depends on the size of the corporation's gross payroll for the taxable year. The minimum tax is capped at $1,500 for corporations with a gross payroll of $6.25 million or more.

B. Proposed Changes

Part G of the Bill would modify the fixed dollar minimum tax by increasing the minimum tax base for corporations with larger payrolls and creating two new gross payroll levels. Under the Bill, if a corporation's gross payroll is $25 million or more, the minimum tax will be $10,000. If gross payroll is less than $25 million but more than $6.25 million, the minimum tax will be $5,000. The Bill would also reduce the minimum tax for corporations with smaller payrolls. The Bill does not change the existing definition of "gross payroll," which is defined as the total wages, salaries and other personal service compensation of all the taxpayer's employees both within and outside New York State.[2]

C. Comments

Although the language of the proposed changes is straight forward as a technical matter, the changes may heighten concerns regarding the Constitutionality of the entire fixed dollar minimum tax scheme. These concerns are present even under the existing statute, although we are not aware of any Constitutional challenges to the existing provisions.

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[2] N.Y. Tax Law § 210.1(d)(2)(A).

Specifically, the question is whether the minimum tax violates both the internal and external consistency tests under the Commerce Clause of the U.S. Constitution.[3]

A simple example illustrates the potential problem. Corporation A is a multistate corporation with a $25 million payroll. It conducts only minimal business in New York, and has only one employee located in the State. Corporation B has a gross payroll of $6.5 million, but it conducts business solely in New York and all its employees are located in the State. Under the Bill, Corporation A will be subject to a $10,000 minimum tax, while Corporation B will be subject to a $5,000 minimum tax.

This example raises two potential issues under the Commerce Clause. First, it may violate the "internal consistency" test because if every state imposed the same minimum tax as New York, it would impose a far greater cost on Corporation A, which engages in interstate commerce, than on Corporation B, which does not. Second, it may violate the "external consistency" test by imposing the minimum tax in amounts that bear no relationship to each corporation's in-state presence, based on activities — the corporation's gross payroll everywhere — that may have no connection with the New York. Although the existing minimum tax presents similar concerns, it seems logical that the larger the minimum tax, the greater the incentive for a Constitutional challenge.

The viability of a Constitutional challenge to the fixed dollar minimum tax is far from clear, however, and the case law is not dispositive. In *American Trucking Ass'ns. v. Scheiner*, 483 U.S. 266 (1987), the U.S. Supreme Court struck down on Commerce Clause grounds an unapportioned annual fixed axle tax imposed on trucks using Pennsylvania's highways. The Court held that the tax violated the internal consistency test because, if applied by every jurisdiction, it would impede the operation of trucks in interstate commerce. By analogy, if every state in which a corporation conducted business imposed the same fixed minimum tax as New York, a corporation would be subjected not only to multiple minimum taxes, but to multiple *higher* minimum taxes because of payroll levels in other states.

On the other hand, there is U.S. Supreme Court precedent upholding a Louisiana license tax on chain stores that was imposed at graduated rates based on the number of stores both within and outside the state.[4] In *Great Atl. & Pac. Tea Co. v. Grosjean*, the A&P supermarket chain, which operated approximately one hundred stores in Louisiana but approximately 15,000 stores everywhere, had to pay a greater Louisiana per store license fee ($550 per Louisiana store) than if it only operated the one hundred Louisiana stores ($30 per

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[3] U.S. Const., art I § 8, cl. 3.

[4] 301 U.S. 412 (1937).

Louisiana store). The Court rejected Equal Protection and Due Process challenges, finding that it was acceptable for a state to impose a higher privilege tax based on the "advantages and capacities" resulting from a corporation's entire business. Similarly, in a personal income tax case, the New York Court of Appeals in *Brady v. State*[5] rejected a Constitutional challenge to New York's application of the "Vermont method" for taxing nonresident individuals. Under that method, progressive tax rates are applied to an individual's in-State income based on the level of income earned both within and outside New York State. The Court rejected Due Process, Privileges and Immunities and Equal Protection challenges and upheld the use of the Vermont method. In neither case, however, did the court specifically address the Commerce Clause.

We recommend that the possibility of Constitutional infirmities with the existing fixed dollar minimum tax be considered before the minimum tax is increased. Perhaps consideration should be given to amending the current definition of "gross payroll" under Tax Law section 210.1(d)(2)(A) to be based on a corporation's gross payroll in New York State, rather than on its gross payroll everywhere.

II. Part H: Conformity with Federal Military Family Tax Relief Act of 2003

A. Proposed Changes

Part H of the Bill has two purposes, as set forth in the Bill Summary:

> This bill: (a) exempts from personal income tax, compensation received by members of the State organized militia for service provided pursuant to active duty orders in relation to efforts to combat terrorism in the state; and (b) conforms the Tax Law with the provisions of the Federal Military Family Tax Relief Act of 2003.

Item (a) above is adequately accomplished by section 4 of Part H, which adds a new paragraph 8-b to the list of modifications reducing Federal adjusted gross income in Tax Law section 612(c).

Item (b) above is addressed by sections 1 through 3, 5 and 6 of Part H of the Bill, dealing with various portions of the Internal Revenue Code amended by the Military Family Tax Relief Act of 2003 (P.L. 108-121) (hereinafter "the Act"). Much of the Act does not need specific action to be adopted by the State since it involves changes in items of gross income and deductions that are automatically incorporated in the Tax Law by section

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[5] 80 N.Y.2d 596 (1992), *cert. denied*, 509 U.S. 905 (1993).

612(a), defining "New York adjusted gross income" as "federal adjusted gross income", with modifications, and by section 615(a), defining "New York itemized deduction" as total "deductions from federal adjusted gross income", with modifications.

With one significant exception discussed below, those portions of the Act requiring specific State action are adequately addressed in Part H of the Bill. Sections 1 and 3 add astronauts dying in the line of duty after December 31, 2002, to the list of those entitled to exemption from income and estate tax. Section 2 provides that service members serving outside the United States in a "contingency operation", as defined in Federal law, will be afforded the same tolling of the limitations period and deadlines for filing returns and making payments under the Tax Law that is currently afforded to members of the armed forces serving in a combat zone. Section 5 adds ancestors or lineal descendants of members of the armed forces or of cadets to the list of individuals which an organization or post may include in determining whether it meets the 75% membership requirement for tax-exempt status for sales and use tax purposes under Tax Law section 1116. (No corresponding Tax Law amendment to incorporate this change, by the Act's amendment to Internal Revenue Code section 501(c)(19)(B), for State income and corporation tax purposes was presumably required because of the automatic adoption of Federal exemption rules in Tax Law section 601(h) for personal income tax and Regulation section 1-3.4(b)(6) for corporation tax.)

B. Comments

There is a drafting problem in section 6 of Part H, which purports to revoke, for State and local taxes, etc., the tax-exempt status of terrorist organizations. As drafted, the section may not accomplish its intended purpose. Section 6 would add a new section 27 to the Tax Law reading in part as follows:

> An organization that is removed from the tax-exempt organizations list by the Internal Revenue Service pursuant to Subsection (p) of section 501 of Title 26 of the United States code shall not be exempt from any tax, fee or other imposition administered by the commissioner, and it shall also not be an exempt organization with respect to any sale, transfer or assignment, beginning on the later of November eleventh, two thousand three, or the date that the

Internal Revenue Service publishes revocation of the organization's tax exempt status. (Underscoring added.)

All subsequent references are to revocation of exempt status. Unfortunately, the wording of Internal Revenue Code section 501 (p), as added by section 108(a) of the Act, is to provide for the suspension, not the revocation, of a terrorist organization's exemption from tax.[6] Furthermore, such suspension is effective, under section 501(p)(3), on the date of the first publication of a designation or identification as a terrorist organization under subsection (p)(2) (or the date of enactment of the Act if later), which, under section 501(p)(2)(A), is by the Secretary of State under section 212(a)(3)(B)(vi)(II) or 219 of the Immigration and Nationality Act (8 U.S.C.A. sections 1182(a)(3)(B)(vi)(II) and 1189), and, under, section 501(p)(2)(B) and (C), is by Executive order, i.e., by the President. The only function of the Internal Revenue Service, under section 501(p)(7), is to update its listings of tax-exempt organizations and publish appropriate notice to taxpayers of suspension of tax-exemption under the foregoing provisions so they will know when contributions are not deductible (not to give notice to the suspended organization).

Since there is never a revocation of tax-exempt status under Internal Revenue Code section 501(p), Tax Law section 27 may be a nullity if enacted as drafted. Furthermore, since the Federal action is a suspension of exempt status, the corresponding State action should likewise be suspension, not revocation. Accordingly, we recommend that section 6 of Part H be amended by replacing "revocation" and "revoked" with "suspension" and "suspended" wherever the words appear. Furthermore, the commencement or ending of suspension should not be keyed to publication, removal from a list, or "restoration" by the Internal Revenue Service, but to the period suspension begins or ends under Internal Revenue Code section 501(p)(3). This would make the period the suspension of State exemption commences coincide with the Federal period, which may well begin before the Internal Revenue Service gets around to updating its list of tax-exempt organizations.

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[6] Curiously, the catchline of proposed Tax Law §27, "Suspension of Tax-Exempt Status of Terrorist Organizations", is copied word for word from the catchline of IRC §501(p), although the word "suspension" is replaced by "revocation" throughout the text of §27.

Another discrepancy in proposed Tax Law section 27 is that restoration of State exemption would require a new application to and approval by the Commissioner. In contrast, the termination of suspension under Federal law is automatic once the designations and identifications in section 501(p)(2) are rescinded. See section 501(p)(3)(B). There is no apparent reason why the State suspension of exemption should continue longer than the Federal suspension. Accordingly, we recommend that the requirement for a new application for restoration of exemption be deleted from the Bill, and replaced by a provision making the State period of suspension coincide with the Federal period.

III. Part I: Single-Factor Apportionment for Manufacturers

A. Existing Law

1. *The Purpose of Using Formula Apportionment*

Formula apportionment is a device that apportions the income of a multistate business among the states where the income of the business was generated. Formula apportionment is used by most states to apportion the income of a corporation because separate accounting — which is an attempt to determine the amount of income actually earned in a jurisdiction by looking solely at activities in that jurisdiction — has been deemed inadequate for apportioning the income of a unitary business that is conducted in several states and/or by several corporations.[7] Formula apportionment is used when a unitary business is conducted in more than one state and/or by more than one corporation.[8]

There is no precise method of determining the portion of the income of a multistate business that is actually, as a matter of economics, earned in each of the states where the business operates. Instead, each state generally uses an apportionment formula to determine the amount of income that is attributable to it and thus subject to tax by it. The apportionment

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[7] John D. Schmidt, *State Taxation of Interstate Commerce and Apportionment of Income: The Iowa Formula Under Attack*, J. of Corp. Law. 125, 134 (Fall 1978)

[8] *See Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924) (the use of formulary apportionment was approved to attribute the income of a multistate business operated by one corporation); *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983) (the use of formulary apportionment was approved to attribute the income of a multistate business operated by many corporations).

formulas used by the states are specifically designed to reflect the economic activities that are related to or associated with the generation of income in the state.

> In a unitary multistate business, no method of assigning net income can precisely determine the exact amount of income attributable to any geographic area or to any given part of a series of multistate business operations culminating in the realization of net income. For all such income, the taxing States have devised statutory apportionment formulas designed to arrive at a portion of income properly and reasonably attributable to a given State.[9]

2. *The Business Allocation Formula Currently Used by New York State for Purposes of Article 9-A*

Currently, general business corporations that are subject to tax under Article 9-A almost all use the same allocation formula to determine the portion of their entire net income that is subject to tax.[10] (While certain industries, such as airlines, use a unique formula,[11] such deviations are rare).

3. *The Purpose For and Computation of Each Factor in New York's Current Business Allocation Formula*

New York State, like many other states, uses three factors in its allocation formula — property, payroll, and receipts. The payroll factor and the property factor each comprise 25 percent of the allocation formula and the receipts factor comprises 50 percent (*i.e.*, receipts are "double-weighted").[12] Use of these three factors has been viewed as fairly reflecting the location of the generation of income of a business. In *Container Corp. of America v. Franchise Tax Bd.*, the Supreme Court stated that "the three-factor formula . . . has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated."[13] The Court also noted that "not only has the three-

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[9] Paul J. Hartman, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION, ¶ 9:18 (1981). See *also* Schmidt, *supra,* at 134.

[10] N.Y. Tax Law § 210.3.

[11] *See* N.Y. Tax Law § 210.3.(a)(7).

[12] N.Y. Tax Law § 210.3(a)(4).

[13] 463 U.S. at 183.

factor formula met our approval [in a previous decision], but it has become . . . something of a benchmark against which other apportionment formulas are judged."[14]

Each factor utilized in the allocation formula is designed to reflect a different aspect of the generation of a corporation's income. The property factor reflects the location of the capital used to generate the income, the payroll factor reflects the location of labor used to generate the income, and the receipts factor reflects the location of the corporation's customers.

In conjunction, the factors in the three-factor apportionment formula are designed to identify how much of a company's income is earned in the state. In contrast, the use of a receipts factor alone, may not provide a fair representation since it only reflects the location of the corporation's customers, not the location of the corporation's own activities.

a. The property factor

The property factor is a fraction consisting of a corporation's in-state tangible personal and real property divided by the corporation's total tangible personal and real property.[15] The property factor is designed to represent the capital used by a corporation in generating its income. Property (i.e., capital) is included in the apportionment formula because it is one of the factors that generates a corporation's income.[16]

b. The payroll factor

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[14] 463 U.S. at 170 (citations omitted). *See also General Motors Corp. v. District of Columbia,* 380 U.S. 553, 561 (1965); Harold S. Peckron, *Apportionment Factors Employed by States in the Computation of Corporate Income Tax*, 3 Tax'n of Multistate Corp. 388, 392 (1977).

[15] *See* N.Y. Tax Law § 210.3(a)(1) ("the percentage which the average value of the taxpayer's real and tangible personal property, whether owned or rented to it, within the state during the period covered by its report bears to the average value of all the taxpayer's real and tangible personal property, whether owned or rented to it, wherever situated during such period.").

[16] *See* Schmidt, *supra*, at 134 ("economists agree that property, representing the cost of capital, is one element in the production of income"); Burgner, 1180-2nd T.M., *Income Taxes: Special Problems in Formulary Apportionment*, ¶ 1180.02 (the fractions in the apportionment formula "are intended to measure the contribution of capital (property), marketplace (sales), and labor (payroll) in the generation of income . . ."). See also Charles E. Ratliff, Jr., *Interstate Apportionment of Business Income,* XV Nat'l Tax J. 260 (1962); John Dane, Jr., *An Evaluation of the Income Tax Provisions of H. R. 11,798,* XIX Nat'l Tax J. 104 (1966).

The payroll factor is a fraction consisting of a corporation's in-state payroll divided by the corporation's total payroll.[17] The payroll factor is included in the apportionment formula to represent the contributions made by a corporation's labor in generating income.[18]

c. The receipts factor

The receipts factor is a fraction consisting of in-state sales divided by the corporation's total sales.[19] The receipts factor represents the marketplace for goods and services.[20]

B. Proposed Changes

If the Bill were to be enacted into law in its current form, the allocation formula used by manufacturers would change from the traditional three-factor formula to a single-factor

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[17] N.Y. Tax Law § 210.3(a)(3) ("the percentage of the total wages, salaries and other personal service compensation, similarly computed, during such period of employees within the state, except general executive officers, to the total wages, salaries and other personal service compensation, similarly computed during such period of all the taxpayer's employees within and without the state, except general executive officers . . .").

[18] Schmidt, *supra*, at 135 ("economists generally agree that [the payroll] factor, representing labor, is properly included"); Burgner, 1180-2nd T.M., *supra*, ¶ 1180.02 (the fractions in the apportionment formula "are intended to measure the contribution of capital (property), marketplace (sales), and labor (payroll) in the generation of income . . . ").

[19] N.Y. Tax Law §210.3(a)(2) ("the percentage which the receipts of the taxpayer, . . . arising during such period from (A) sales of its tangible personal property where shipments are made to points within this state, (B) services performed within this state, . . . (C) rentals from property situated, and royalties from the use of patents or copyrights, within the state, . . . and (D) all other business receipts earned within the state, bear to the total amount of the taxpayer's receipts, similarly computed, arising during such period from all sales of its tangible personal property, services, rentals, royalties, . . . and all other business transactions, whether within or without the state . . . .").

[20] Jerome R. Hellerstein & Walter Hellerstein, STATE TAXATION ¶ 8.06[2] (3d ed. 1998) (The receipts factor is "designed to give weight in the apportionment to the states in which the taxpayer markets its goods."); Burgner, 1180-2nd T.M., *supra*, ¶ 1180.02 (the fractions in the apportionment formula "are intended to measure the contribution of capital (property), marketplace (sales), and labor (payroll) in the generation of income . . . ").

allocation formula. The use of this single-factor formula would be gradually phased-in over a period of five years.[21] Once the single-factor formula was completely phased in, manufacturers would use a business allocation formula composed solely of a receipts factor, while general business corporations would continue to use a business allocation formula composed of a double-weighted receipts factor, a single-weighted payroll factor, and a single-weighted property factor.

The use by manufacturers of a single-factor allocation formula composed solely of a receipts factor is intended to reduce the tax burden on New York-based manufacturing companies by allocating a manufacturer's income based on the source of the manufacturing companies' receipts, which may be located nationwide, and eliminating the manufacturing companies' property and payroll factors, which are located in New York. Specifically, the Bill summary states that under the current tax scheme, "many traditional upstate based New York manufacturing industries compute higher payroll (i.e., employment) and property (i.e., facilities) factors as compared to their receipts factor. This is due to the fact that these New York manufacturers are predominantly 'exporters' that sell a high percentage of their products outside of New York."[22] The switch to a receipts-factor only business allocation formula for these manufacturers is intended to encourage the manufacturers to increase their employment and expand their facilities in New York because increases in such activities would no longer increase their New York tax liability from what it would be under the present three-factor system.[23]

C. Comments

1. *The Proposed Business Allocation Formula Raises Potential Constitutional Concerns*

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[21] For taxable years beginning on or after January 1, 2005, and before January 1, 2006, a manufacturer would use a 60 percent weighted receipts factor. For taxable years beginning on or after January 1, 2006, and before January 1, 2007, a manufacturer would use a 70 percent weighted receipts factor. For taxable years beginning on or after January 1, 2007, and before January 1, 2008, a manufacturer would use an 80 percent weighted receipts factor. For taxable years beginning on or after January 1, 2008, and before January 1, 2009, a manufacturer would use a 90 percent weighted receipts factor. For taxable years beginning on or after January 1, 2009, a manufacturer would use a 100 percent weighted receipts factor.

[22] Bill Summary, Part I.

[23] Bill Summary, Part I.

The use of an allocation formula composed of only a receipts factor may cause concerns under the Due Process and Commerce Clauses of the United States Constitution — namely, through an arguable failure to employ fair apportionment. According to the U.S. Supreme Court's decision in *Exxon Corp. v. Wisconsin Dep't of Rev.*,[24] the Due Process Clause requires that there be "'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" The Court has also specified that "it is necessary that "the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return."[25]

Similarly, the Commerce Clause demands that "income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'"[26] Thus, without fair apportionment, both the Due Process and the Commerce Clauses would be violated.

The fair apportionment requirement of the Commerce Clause is tested in two ways: an internal consistency test and an external consistency test.[27] As discussed previously, internal consistency is evaluated through the hypothetical application of one state's apportionment rules in all of the states across the country to determine whether a risk of multiple taxation would arise. In contrast, external consistency requires that "the State has taxed only that portion of the revenues from interstate commerce which reasonably reflects the *in-state component of the activity being taxed*."[28]

Some commentators believe that the receipts factor inherently lacks the economic justification that the property and payroll factors possess given that "'[i]ncome,' we were told long ago, 'may be defined as the gain derived from capital, from labor, or from both combined.'"[29] Under this view, a corporation's property and its payroll reflect "these essential

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[24] 447 U.S. 207, 219-220 (1980) (citation omitted).

[25] *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940).

[26] *Moorman Manufacturing Co. v. Bain*, 437 U.S. 267 (1978) (citing *Norfolk & Western Railway Co. v. State Tax Commission*, 390 U.S. 317, 325 (1968).

[27] *Container*, 463 U.S. at 169.

[28] *Goldberg v. Sweet*, 488 U.S. 252, 262 (1989) (citing *Container Corp.*, 463 U.S. at 169-170) (emphasis added).

[29] W. Hellerstein, *On the Proposed Single-Factor Formula in Michigan*, State Tax Notes, Oct. 2, 1995, at 1000 (quoting *Eisner v. Macomber*, 252 U.S. 189, 207 (1920), and further noting that

income-producing elements," while the receipts factor "is justified more by political than by economic considerations."[30] Thus, use of a single-factor allocation formula composed of solely a receipts factor might not satisfy the external consistency test since the use of such a formula might not reasonably reflect the in-state activities of the company on which the tax is being imposed.

In 1978, the United States Supreme Court in *Moorman Mfg. Co. v. Bair*[31] supported a single factor receipts-based apportionment formula. However, Moorman may not be very helpful, because the Court's decision to uphold such a formula largely turned on the taxpayer's failure to develop an adequate record to support the constitutional arguments as the taxpayer had framed them. Moorman was a manufacturing corporation that had over 500 salesmen and six warehouses in Iowa; it could not deny that it had a significant level of business activity within Iowa's borders. Indeed, although Moorman attacked Iowa's single-factor receipts-based formula on the grounds that it caused duplicative taxation when viewed together with Illinois' taxation of Moorman, the Supreme Court expressly couched its rejection of this argument to Moorman's failure to make its record: "[s]ince the record does not reveal the sources of appellant's profits, its Commerce Clause claim cannot rest on the premise that profits earned in Illinois were included in its Iowa taxable income and therefore the Iowa formula was at fault for whatever overlap may have existed."[32] Moreover, in the time since *Moorman* was decided, the standards for fair apportionment and discrimination have been developed by subsequent decisions (such as the internal and external consistency tests of *Container Corp.*). Thus, the Supreme Court's *Moorman* decision did not address either the internal or external consistency test.

A single-factor allocation formula comprised of only a receipts factor nevertheless may withstand constitutional challenge given the wide latitude states have been allowed in designing apportionment formulas.[33] Furthermore, the chance of the single-factor allocation

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the "overwhelming majority of states impose a three-factor formula of property, payroll, and sales").

[30] *Id.*

[31] 437 U.S. 267 (1978).

[32] 437 U.S. at 277.

[33] *See Butler Bros. v. McColgan*, 315 U.S. 501, 507 (1942) ("one who attacks a formula of apportionment carries a distinct burden of showing by 'clear and cogent evidence' that it results in extraterritorial values being taxed").

formula being successfully challenged may not be large, especially given that other somewhat questionable aspects of the allocation formula have not been challenged, such as the constitutionality of the three-factor allocation formula with a double-weighted receipts factor and the constitutionality of excluding executive compensation from New York's payroll factor. Finally, as a practical matter, a court considering this issue might be influenced by the fact that several other states have enacted similar single-factor apportionment formulas.[34]

We do not express a view as to the constitutionality of a single-factor receipts apportionment, whether applied generally or applied solely to manufacturers. We do, however, believe that there are legitimate questions as to the constitutionality of the proposal. Manufacturers whose plant and payroll are primarily outside New York, and whose New York taxes would therefore increase under the proposal, might have a basis for challenging the Bill.

2. *The Problems Inherent in Determining Which Entities Would Be Eligible to Use the Single-Factor Allocation Formula*

The Bill defines a manufacturer as "a taxpayer which during the taxable year is principally engaged in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture, commercial fishing and research and development." In determining whether the members of a combined group of corporations should be considered manufacturers, "the entire combined group shall be considered a 'manufacturer' if the combined group during the taxable year is principally engaged in" the manufacturing activities described above. A corporation (or a group of corporations) will be considered to be principally engaged in manufacturing if more than 50 percent of the corporation's (or the group's) income is derived from manufacturing activities.

While at first glance it may seem simple to apply the rules set forth above, experience indicates that in many situations it will be difficult to determine whether a corporation will be considered a "manufacturer" to which the single-factor allocation formula applies. Examples of this difficulty can be found in an the application of the allocation provisions of the New York City General Corporation Tax (the "GCT").[35] For purposes of the

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[34] In addition to the potential Commerce Clause and Due Process Clause challenges, some commentators have suggested that use of a single-factor apportionment formula composed of only a receipts factor may violate international trade rules that prohibit export subsidies. Charles E. McLure, Jr. & Walter Hellerstein, *Does Sales-Only Apportionment Violate International Trade Rules?*, 96 Tax Notes 1513 (2002).

[35] Administrative Code of the City of New York ("Administrative Code"), Title 11, Chapter 6, Subchapter 2.

GCT, manufacturing corporations can elect to use either the evenly-weighted three-factor allocation formula that is used by most general business corporations or a three-factor allocation formula where the receipts factor is double-weighted.[36] The New York City Department of Finance (the "City Department") has recently issued new rules providing guidance as to whether a corporation will be considered a manufacturer for purposes of this election.

Under the rules originally proposed by the City Department, magazine publishers would qualify as manufacturers only if they printed their magazines themselves. Those publishers that performed all of the other steps in manufacturing a magazine — determining the content of each issue, creating the content through the manufacture of photographic images and text, and determining the final layout — but did not perform the actual printing function, the last step in the process of manufacturing magazines, would not have been considered engaged in the business of manufacturing magazines. This questionable distinction was protested by the publishing industry, and the final rules issued by the City Department specify that a magazine publisher will be considered a manufacturer, even if it does not actually print its magazines, as long as it conducts all of the pre-printing activities.[37]

Another problem in determining whether an entity is a manufacturer arises from the requirement that more than 50 percent of the corporation's income must come from manufacturing activities for the company to be considered a manufacturer. Again, the City Department's rules interpreting the allocation provisions of the GCT are illuminating. For purposes of the GCT, receipts that a publisher receives from advertising are not considered receipts attributable to the manufacture of magazines. Thus, two companies that are engaged solely in the same activity — the publishing of magazines — may be treated differently for purposes of allocating their income under the GCT. If more than 50 percent of the income of one of the publishers is from subscriptions for its magazine, while more than 50 percent of the income of the other publisher is attributable to revenue from advertisements published in its magazines, the first company would be considered a manufacturer while the second company would not. This distinction is questionable since both companies perform the same activities.

While the Bill contains a definition of manufacturer that differs from the definition set forth in the Administrative Code for purposes of the GCT, many of the same issues could arise in attempting to determine whether an entity is a manufacturer for purposes of using the single-factor allocation formula.[38] Application of a different allocation formula for

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[36] Admin. Code §11-604.3(a)(4), (8).

[37] New York City rule §(c)(4)(ii)(C)(2)(v) Example 13.

[38] For purposes of determining whether a corporation is a manufacturer that is eligible to elect the alternate business allocation formula for purposes of the GCT, a "manufacturer" is defined as

manufacturers will certainly add complexity to the Tax Law. Thus, it may be better policy in crafting tax incentives and tax statutes to focus on the various types of income streams, rather than the identity or nature of the taxpayer. With more industries diversifying every day, and the "principally" test serving to operate as an all-or -nothing standard, this policy decision becomes even more significant.

3. *The Proposed Business Allocation Formula and Nexus Issues*

To date New York State has not taken the position that a corporation with no physical presence in New York can have sufficient nexus with New York State to become subject to tax under Article 9-A. However, the Department arguably does have the authority to extend the reach of its nexus provisions since the statute provides that the Article 9-A tax is imposed upon corporations for the privilege of "doing business" in New York.[39] Some states have taken the position that a corporate income tax can be imposed on a corporation that does not have any physical presence in the state; those states have determined that direction of the corporation's activities towards the state's residents is sufficient.[40] However, this issue has not been reviewed by the U.S. Supreme Court.

By passing the Bill, we understand that the Legislature would merely be changing the method used to allocate the income of manufacturing corporations. We suggest that the legislative history clarify that the Legislature does not intend through this proposal to change the current authority concerning nexus in New York State.[41]

> a corporation primarily engaged in the manufacturing and sale thereof of tangible personal property; and the term "manufacturing" includes the process (including the assembly process) (i) of working raw materials into wares suitable for use or (ii) which gives new shapes, new qualities or new combinations to matter which already has gone through some artificial process, by the use of machinery, tools, appliances and other similar equipment. A corporation shall be deemed to be primarily engaged in the activities described in the preceding sentence if more than fifty percent of its gross receipts for the taxable year are attributable to such activities.

Admin. Code. § 11-604.3(a)(8)(c).

[39] N.Y. Tax Law § 209.1. The statute itself does not provide a physical presence requirement.

[40] *See, e.g., Geoffrey. Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993); *Kmart Properties, Inc. v. Tax'n & Revenue Dep't*, No. 21,140 (N.M. Ct. App. Nov. 27, 2001), *cert. granted*, 40 P.3d 1008 (N.M. Jan. 9, 2002).

[41] It would be strange if expanded nexus provisions were applied to manufacturing corporations, in light of their changed apportionment formula, but not to general business corporations. The

4. *Conformity Issues*

If the provision concerning single-factor apportionment for manufacturers under Article 9-A remains in the Bill, consideration should be given to adding a similar provision to the Bill providing for the use of a single-factor apportionment formula by manufacturers for purposes of the GCT. Passage of the Bill without the addition of such language with respect to the GCT would result in increased variation between Article 9-A and the GCT, which would result in more complexity for taxpayers.

If harmonizing the State and City apportionment formulas to be used by manufacturers is not effected, then — at a minimum — the definition of a "manufacturer" should be harmonized for purposes of Article 9-A and the GCT; such harmonization would again result in reduced complexity for taxpayers. The goal of simplifying tax compliance for taxpayers (and tax administration by the government) could also be furthered by harmonizing the definition of "manufacturer" used for all New York State and City taxes, including the New York State Sales and Use Taxes imposed under Article 28 of the Tax Law.

Enactment of the single-factor apportionment formula for only those manufacturers subject to Article 9-A will exacerbate the disparate treatment afforded to different types of taxpayers conducting the same types of businesses; more specifically, the disparate treatment of incorporated versus unincorporated manufacturers will increase. As noted before, for purposes of Article 9-A, corporations currently use an apportionment formula that has a double-weighted receipts factor. Individuals, however, apportion their income through means of a single-factor apportionment formula (if the individual's books and records are not adequate to apportion the income).[42] If the single-factor apportionment formula is enacted for manufacturers, the mismatch will be even greater as manufacturers operating their business activities through sole proprietorships or partnerships will still use an evenly weighted three-factor apportionment formula.

IV. Part J: Sales Tax Surcharge on Detective and Protective Services

A. Existing Law

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existence of different nexus standards for different types of corporations would be inappropriate and might be difficult to justify from legal and policy perspectives.

[42] New York Code Rules and Regulations ("N.Y.C.R.R.") § 132.15.

Currently, services provided by or through alarm or protective systems[43] are subject to sales tax, as are detective agencies, armored car services, guard, patrol and watchman services ("protective services").[44] New York also imposes its sales tax on any admission charge over ten cents to or for the use of any place of amusement in the state ("admission charges").[45] These services are not currently subject to a surtax.

B. Proposed Changes

The Bill seeks to increase revenue available for public security and safety activities by imposing: (1) a three percent sales and use tax surcharge on Protective Services currently taxed under Tax Law § 1105(c)(8); and (2) a four percent sales and use tax surcharge on "admission charges" currently taxed under Tax Law § 1105(f)(1).

C. Comment

1. *Additional Complexity.*

While imposing new taxes on specified services to raise needed revenue is not without precedent, we believe that alternative revenue raising mechanisms should be explored. The new surtax would add an additional layer of complexity to the tax law for both taxpayers and the Department. Taxpayers would have to determine if and how the tax applies, and the Department would be forced to incur additional administrative burdens. (This provision, for example, requires the Commissioner of the Department to certify the amount of taxes collected and to deposit them in a special account).

Imposing non-uniform rates on similar services also creates an incentive for taxpayers and the Department to recharacterize the nature of the services performed. For example, these tax surcharges will invite taxpayers to categorize what should be viewed as protective services as some other lower-taxed services—e.g., maintenance to real property, which is taxable under Tax Law § 1105(c)(5). Conversely, auditors may have an incentive to treat real property maintenance services as protective services. This will impose additional audit burdens on the taxpayer and the Department, and will increase the Department's costs in ensuring compliance with the tax laws.

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[43] Included is protection against burglary, theft, fire, water damage or any malfunction of industrial processes or any other malfunction of or damage to property or injury to persons.

[44] N.Y. Tax Law § 1105(c)(8).

[45] *Id.* at § 1105(f)(1).

2. *The New Sales Tax Surcharges May Conflict with New York's Participation in the Streamlined Sales Tax Project.*

In the 2003-2004 legislative session, New York agreed to participate in the Streamlined Sales Tax Project (the "SSTP"). One key feature of the sales tax system that the STTP seeks to implement is rate simplification. Generally, this would require all participating states to have only one state rate; states could not, for example, tax telecommunication services at one rate and all other items at another rate. Accordingly, the sales tax surcharges on protective services and admissions charges may conflict with any taxing system that New York agrees to as a participant of the SSTP.

V. Part L: Rights Regarding Availability of Tax Hearings

A. Proposed Changes

Part L of the Bill, proposes that a new section 173-a be added to the Tax Law limiting the availability of prepayment hearing rights under certain circumstances.

In New York State, prior to the Appellate Division's decision in Meyers v. Tax Appeals Tribunal, 201 A.D.2d 185 (3rd Dept. 1994), a taxpayer was not afforded a prepayment hearing regarding amounts of tax reported as due on a return by the taxpayer but not paid. In Matter of Meyers, (June 3, 1993), the Tax Appeals Tribunal held that additions to tax for failure to pay amounts reported on a return were "assessed" by the taxpayer and thus were not subject to the notice of deficiency procedures, including prepayment hearing rights. The Appellate Division held, however, that there was no provision in the Tax Law that expressly denied or modified the right to a hearing under such circumstances and, therefore, a taxpayer was entitled to a prepayment hearing regarding taxes self-assessed on a return but not paid.

In Matter of Jaffe, (September 14, 1995), the Tax Appeals Tribunal extended the reasoning of the Appellate Division in Meyers to include mathematical errors assessed by notice and demand and additional tax due resulting from Federal changes assessed by a notice of additional tax due.

Part L eliminates the availability of prepayment hearings with respect to corporate and personal income taxes for (1) taxes self-assessed on a return but not paid, (2) taxes resulting from mathematical or clerical errors, and (3) additional tax due resulting from Federal changes when the taxpayer has not properly reported those changes to New York State and a notice of additional tax due is issued. It also eliminates the availability of such hearings for situations (1) and (2) with respect to sales and compensating use tax and miscellaneous taxes.

The amounts of additional tax resulting from the circumstances referenced above include penalties because Part L defines "tax" or "taxes" to include "special assessments, fees, interest,

additions to tax, penalties or other impositions which are administered by the Commissioner." Therefore, any penalties that may result or be asserted under the circumstances stated above would not be subject to a prepayment hearing.

The statutory language is consistent with the legislative intent expressed in the bill summary.

B. Comments

Consideration should be given to permitting prepayment hearings for penalties. A taxpayer may have had reasonable cause for not timely filing a return. Further, mathematical errors (such as incorrectly adding line amounts to a sub-total) or clerical errors (such as using an incorrect table or following instructions that may not be clear) could conceivably result in the assertion of negligence penalties. Under the Bill, the only way a taxpayer in the described circumstances can obtain a hearing to challenge the penalty is to pay the amount due including the penalty and apply for a refund. If the refund claim is denied, the taxpayer may appeal the denial to the Division of Tax Appeals and obtain a hearing. This may be unduly burdensome.

VI. Part M: Corporation Tax Benefit Transfer Program

A. Existing Law

Under Article 9-A, corporations are permitted a net operating loss deduction in computing their entire net income for franchise tax liability purposes. The deduction is based on the net operating loss deduction allowable under section 172 of the Internal Revenue Code, with certain modifications.[46] Under current federal law, net operating losses may be carried forward up to 20 years before expiring.[47] To the extent that a corporation does not have taxable income during the carryforward period, its accumulated net operating loss carry forwards ("NOLCs") will remain unused and ultimately expire.

B. Proposed Changes

Part M of the Bill adds a new section 30 to the Tax Law, entitled "Corporation Tax Benefit Transfer Program" (the "Program"). Pursuant to this Program, biotechnology corporations headquartered or having a principal base of operations in New York, and having NOLCs, would be able to "sell" all or an identified part of their NOLCs to other corporate

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[46] N.Y. Tax Law § 208.9(f)

[47] IRC § 172(b)(1)(A)(ii).

franchise taxpayers subject to tax in New York State. The sale would be contingent upon approval by the New York State Department of Economic Development (the "DED"), in consultation with the Department. The Bill correspondingly amends Articles 9-A, 32 and 33 to allow the purchasing corporations a deduction from entire net income allocated to the State in respect of the "Tax Benefits" acquired through the Program.

1. *Operative Rules*

The Bill requires the DED to establish the corporation tax benefit transfer program through which the DED would receive and review applications from "Eligible Biotechnology Companies" who wish to transfer Tax Benefits. Under the Bill, an "Eligible Biotechnology Company" is a "Biotechnology Company" that is subject to tax under Article 9-A in the year that it seeks approval to transfer Tax Benefits and --

(i) has its headquarters or principal base of operations located in New York State;

(ii) has less than 225 employees, 75 percent of whom are employed in New York State; and

(iii) "has not been a party to a liquidation of a corporation to which section 332 of the Internal Revenue Code applies or to a reorganization under subparagraph A, C, D, F or G of Paragraph (1) of subsection (A) of section 368 of the Internal Revenue Code."[48]

A "Biotechnology Company" is defined as:

> "a company which is primarily engaged in the business of applying technologies, such as recombinant DNA techniques, biochemistry, molecular and cellular biology, genetics and genetic engineering, biological cell fusion techniques, and new bioprocesses, using living organisms, or parts of organisms, to produce or modify products, to improve plants or animals, to develop microorganisms for specific uses, to identify targets for small pharmaceutical development, or to transform biological systems into useful processes and products or to develop microorganisms for specific

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[48] Proposed N.Y. Tax Law § 30(a)(1).

uses."[49]

The amount of Tax Benefits that may be transferred upon approval by the DED is equal to the product of:

(i) the amount of the Eligible Biotechnology Company's NOLCs (either all or some specifically identified part thereof) allowed pursuant to Tax Law section 208.9(f) which the Eligible Biotechnology Company seeks to surrender and transfer pursuant to the Program;

(ii) the Eligible Biotechnology Company's business allocation percentage ("BAP") for the taxable year immediately preceding the taxable year in which the Tax Benefit is transferred; and

(iii) the corporate tax rate set out in Tax Law section 210.1(a) in effect for the taxable year in which the Tax Benefit is transferred.[50]

If approved, Tax Benefits may be transferred by the "Approved Biotechnology Company" to general business corporations, banks, or life insurance companies subject to taxation in New York State under Article 9-A, 32 or 33, respectively.[51] The Bill requires that the acquiring corporation pay a sum of money equal to at least 90 percent of the amount of Tax

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[49] Proposed N.Y. Tax Law § 30(a)(2). We do not have sufficient expertise to comment on the adequacy of this definition.

[50] Proposed N.Y. Tax Law § 30(a)(4). The reference in the Bill to the tax rate applicable under N.Y. Tax Law § 210 indicates that the MTA surcharge is not factored in to the benefits of the Program. Consequently, biotechnology companies doing business within the MTA surcharge area will not enjoy the full benefit of their NOLCs under the Program.

[51] Proposed N.Y. Tax Law § 30(f)(1). Transfers are not permitted to any corporation which owns or controls, directly or indirectly, 5 percent or more by vote or value of stock or other ownership interests of the Eligible Biotechnology Company, or to any corporation 5 percent or more of whose stock or other ownership interests is owned or controlled, directly or indirectly, by vote or value by the same entity that owns or controls, directly or indirectly, 5 percent or more by vote or value of the stock or other ownership interests of the Eligible Biotechnology Company (i.e., 5% parent or sibling corporations). Proposed N.Y. Tax Law § 30(b).

Benefits acquired under the Program.[52] The cash received must be used toward funding expenses of the Eligible Biotechnology Company's New York State operations.[53] The Approved Biotechnology Corporation is deemed to have surrendered the NOLCs used to compute the amount of Tax Benefits it transfers, and will not be permitted to seek a refund of tax paid in any taxable year which contributed to or was included in the amount of net operating losses forming the basis of the amount of Tax Benefits transferred.

In the year that it acquires the Tax Benefits, the acquiring corporation is allowed to deduct from its entire net income allocated to New York an amount equal to the product of:

(i) the amount of the NOLCs surrendered by the Approved Biotechnology Company; and

(ii) the Approved Biotechnology Company's BAP for the taxable year immediately preceding the taxable year in which the Tax Benefit is transferred.[54]

Under the Bill, the acquiring corporation does not acquire NOLCs, *per se*, and does not treat the deduction as a net operating loss deduction.[55]

2. *Application Process and Review*

An Eligible Biotechnology Company may transfer Tax Benefits only upon

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[52] Proposed NY Tax Law § 30(c)(1).

[53] The Bill stipulates that the money received in exchange for the Tax Benefits.

> "shall be used to fund expenses incurred in connection with the operation of such Company in the state, including but not limited to the expenses of fixed assets, such as the construction and acquisition and development of real estate, materials, working capital, salaries, research and development expenditures and any other expenses determined by the department of economic development to be necessary to carry out the purposes of the corporation tax benefit transfer program."

Proposed N.Y. Tax Law § 30(f)(2). The Bill, however, does not include a mechanism for monitoring use of the funds.

[54] N.Y. Proposed Tax Law §§ 30(q), 210.3(f), 1453(a), 1503(d).

[55] Id.

approval by the DED. Under the Bill, applications for approval must be submitted to the DED by May 1st of each year.[56] The DED will reject any applications from Eligible Biotechnology Companies which have demonstrated positive net income or a ratio of operating revenues to expenses in excess of 110% in any of the two previous full years of ongoing operations as determined on its financial statements.[57] All other applications will be approved or disapproved based on factors including the company's competitiveness, need for capital, and the company's employment in the State. The DED Commissioner may add to the list of criteria included in the Bill.[58]

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[56] N.Y. Proposed Tax Law § 30(c)(2).

[57] Applications will also be denied from Eligible Biotechnology Corporations that are 50% owned or controlled, directly or indirectly, by another corporation that has demonstrated positive net income in any of the two previous full years of ongoing operations as determined on its financial statements, or that are part of a consolidated group of affiliated corporations, as filed for Federal tax purposes, that in the aggregate have demonstrated positive net income in any of the two previous full years of ongoing operations as determined on the financial statements of such corporations. Proposed N.Y. Tax Law § 30(c)(4).

[58] Evaluation shall be based on criteria adopted by the Commissioner of Economic Development, and weighted in the Commissioner's discretion, including, but not limited to:

> (1) the Commissioner's judgment of the Eligible Biotechnology Company's actual or potential scientific and technological viability,
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> (2) whether the Eligible Biotechnology Company's principal products or services are sufficiently innovative to provide a competitive advantage,
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> (3) whether the proceeds from the transfer of Tax Benefits will result in significant growth in permanent, full-time employment in the State,
>
> (4) whether the Eligible Biotechnology Company does not have sufficient resources to operate in the short term or cannot secure financial assistance from venture capital, stock issuance, product sales revenue, a parent corporation or other affiliated corporation, bank or any other method of obtaining capital, and
>
> (5) whether the financial assistance provided by transfer of Tax Benefits demonstrates the prospect of a significant positive change in the Eligible Biotechnology Company's net income. Proposed N.Y. Tax Law § 30(c)(3).

If approved, the Eligible Biotechnology Company will be deemed to be an "Approved Biotechnology Company," and will receive two certified copies of the "Corporation Tax Benefit Approval Certificate" showing the amount of Tax Benefit available for transfer and the computation of such amount. All Tax Benefits must be transferred by December 31st of the year in which approval is received, or approval will be rescinded.[59]

Review of the applications requires a coordinated effort by the DED and the Department. The Bill requires that the DED review all applications "in consultation with" the Department. The Department shall review each applicant's tax reports to determine the applicant's proper amount of Tax Benefits, and is required to notify the DED of such proper amount before the DED shall approve or disapprove any application.[60] By March 1st of each year, the DED shall provide the Department with information identifying all Approved Biotechnology Companies and the corporations that purchased the Tax Benefits, the amount of Tax Benefits allocated to each Approved Biotechnology Company, and information regarding approvals that were rescinded.[61]

3. *$10 Million Annual Aggregate Limit*

The cost to the State is limited under the Bill to $10 million per year for ten years. Specifically, the DED is authorized to approve the transfer of no more than $10 million of Tax Benefits per year for ten years, beginning in 2005. A $10 million amount of Tax Benefits, based on a business allocation percentage of 100% and at current corporate tax rates, represents the equivalent of approximately $133 million of NOLCs that could be sold annually.[62] To the extent the DED receives requests to transfer Tax Benefits in excess of $10 million, applicants' Tax

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[59] Proposed N.Y. Tax Law § 30(f)(1). The Approved Biotechnology Company must notify and supply the DED within 30 days of a transfer of Tax Benefits, with the name of the acquiring taxpayer and the sum of money received for the Tax Benefits. The Bill does not appear to allow Approved Biotechnology Companies to divide their Tax Benefits among several transfers.

[60] Proposed N.Y. Tax Law § 30(c)(1), (c)(6).

[61] Proposed N.Y. Tax Law § 30(e)(2). Furthermore, the DED is also required to provide a report describing the effectiveness of the Program, by April 1 of each year beginning in 2006, to the Governor, the Director of the Division of the Budget, the Temporary President of the Senate and the Speaker of the Assembly. Proposed N.Y. Tax Law § 30(i).

[62] Proposed N.Y. Tax Law § 30(d). Assuming a corporate tax rate of 7.5% and a 100% BAP, $10 million of transferable Tax Benefits would result from $133,333,333 NOLCs. Assuming a lower BAP, say, 88.89%, $10 million of Tax Benefits would result from $150,000,000 NOLCs.

Benefits permitted to be sold may be reduced. The mechanism by which Tax Benefits are allocated among Approved Biotechnology Companies where the requested Tax Benefits exceed $10 million is discussed below.

C. Comments

1. *Generally*

The Program is intended to enable the targeted biotechnology companies to raise cash by selling "tax assets" they cannot currently use. This is a somewhat novel concept, and may indeed provide infusions of current cash into companies that otherwise would not enjoy the benefit of NOLCs until future years.

We note, however, that providing governmental support to specific businesses through a tax-based program such as this burdens the tax system with significant additional complexities, some of which are discussed below. The Program requires joint DED/Departmental administration of a complex yet relatively small, relatively narrow, and time-limited program of specifically-targeted governmental support; and further requires a certain amount of investigation and involvement by private sector corporations purchasing these Tax Benefits. Incorporating the Program into the tax laws of New York also potentially creates constitutional constraints on the ability of the Program to reach its intended beneficiaries, as discussed below.

We are concerned that the proliferation of these kinds of programs will cause undue complexity in the Tax Law, and will create undue burdens for tax administrators. Each such program requires its own interpretations, administration, and audit mechanisms, which necessarily will draw the Department's resources from more generally relevant issues under the Tax Law. For example, the Program requires that the funds derived from sales of Tax Benefits be applied to certain specified purposes.[63] The mechanism for auditing the application of such funds would appear to require ongoing audit by some agency, perhaps the Department; and the consequences of a failure to satisfy this requirement may further mean that acquiring corporations' tax liabilities depend upon the future activities of the selling biotechnology companies. These are clear burdens on the tax system.

We suggest that consideration be given to whether there are other, more efficient means to provide $10 million of annual governmental support to biotechnology companies, rather than through this system of permitting certain taxpayers to sell certain tax attributes within the defined limitations of this particular Program. For instance, direct grants can be targeted to

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[63] Proposed N.Y. Tax Law § 30(f)(2). *See* fn. 7, *supra*.

maximize the benefit to the intended beneficiaries, without the need to implicate the tax system, or third party purchasers, to any degree. Moreover, since private sector acquiring corporations are expected to pay only 90% of the value of the Tax Benefits, a direct grant program would seem better able to provide to qualified biotechnology companies 100% of their Tax Benefits, at the same net cost to New York State's coffers.

Alternatively, the State could offer biotechnology companies the ability to obtain current tax refunds by relinquishing their NOLCs. A similar approach was included in New York's recent brownfields tax credit legislation, under which qualified taxpayers who cannot currently use the brownfields tax credits can treat them as overpayments of tax, and will receive a refund in the amount of the unused credits.[64] An analogous approach to the NOLCs of biotechnology companies would permit them to treat an amount equal to the Tax Benefits associated with relinquished NOLCs as an overpayment of tax, which overpayment (subject, with admitted complications, due to the $10 million annual cap) would be refunded to the biotechnology company.

Either alternative would lessen the strain of the Program on the Department's resources, reduce or eliminate the added complexity in the Tax Law, free the State and biotechnology sector from reliance on the participation of outside corporations, and possibly provide more net benefit to biotechnology companies, at the same net cost to the State. Again, the Program operates by having acquiring corporations pay cash to biotechnology companies for the right to deduct their NOLCs; and then permitting those corporations to deduct such NOLCs and thereby pay less New York State corporate tax. The acquiring corporations are not adding funding to the picture; instead they are in fact enjoying some benefit by paying only 90% of the value of the deductions they can take.

2. *"Tax Benefits"*

The term Tax Benefits, while not inappropriate, may raise some confusion. The term as defined refers to the *value* of the NOLCs to the Approved Biotechnology Company had it been able to use the NOLCs currently. However, while the Bill provides for the annual transfer of $10 million of Tax Benefits, the *dollar amount* of the NOLCs that can be transferred is much higher. As noted above, under the Program, a minimum of $133 million of NOLCs would need to be transferred every year to produce a savings in State franchise taxes of $10 million. With lower BAPs, or higher tax rates, the dollar amount of NOLCs available for "sale" will increase.

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[64] N.Y. Tax Law § 210.33. The excess of a corporation's brownfields redevelopment tax credit over its minimum tax liability is treated as an overpayment of tax refundable under N.Y. Tax Law § 1086.

Thus, guidance promulgated to explain the Program will need to clarify the distinctions between the dollar amounts of NOLCs that are transferred and the "Tax Benefits" such transfers effect.

3. *Tax Treatment of the Sale Transaction; New York City Treatment*

An Approved Biotechnology Company with $1 million of NOLCs and a 100% New York State BAP would, under the Program, be authorized to sell such benefits to a corporate purchaser for an amount not less than 90% of the Tax Benefits. The Tax Benefits, assuming a 7.5% rate, would be $75,000, and would be sold for at least $67,500. This raises the question of the proper income tax treatment, under federal, New York State, and potentially New York City tax laws, of the $67,500 paid for the Tax Benefits. By analogy to federal income tax principles, that receipt would likely be treated as income to the selling biotechnology company; and the amount paid by the acquiring corporation would likely be treated as deductible — perhaps even as a payment of tax — by the acquiring corporation. However, since New York State taxes are not deducted in computing New York entire net income, the better treatment for New York tax purposes might be that the seller has no income; and that the buyer has no deduction in respect of the amount paid to acquire the Tax Benefits.

This issue requires clarification in the Bill. We note that, if the sale of Tax Benefits does produce New York income to the selling biotechnology companies, the calculation of the amounts of NOLCs such companies choose to sell may become complicated, inasmuch as they may prefer to retain some NOLCs to shelter the income generated from the sale.

Apart from the taxation of the sale itself, in the absence of the adoption of a similar "Program" at the New York City level, it would appear that the State's Program permitting the sale of Tax Benefits by an Eligible Biotechnology Company to an acquiring corporation would have no effect on the City taxation of either of those parties. Thus, the biotechnology company would deduct its NOLCs for City purposes at the same time as it claims federal deductions; and the acquiring corporation would not claim any City deduction in respect of Tax Benefits.

4. *Acquirers' Deductions*

Under Proposed Tax Law section 30(g), and corresponding amendments to Articles 9-A, 32 and 33, corporations purchasing Tax Benefits from Approved Biotechnology Companies are allowed to deduct, from their entire net income allocated to New York State, an amount equal to the product of (i) the NOLCs surrendered by the Approved Biotechnology Company under the Program, and (ii) such biotechnology company's BAP for the year prior to

sale.[65] The Bill further provides that "such deduction shall not be treated as a net operating loss deduction."[66]

If an acquiring corporation sustains a net operating loss in the year in which Tax Benefits are purchased, such purchaser should be entitled to include the deduction for the acquired Tax Benefits in calculating its own NOLCs. Obviously, a corporation would not ordinarily purchase Tax Benefits under the program if it had no current tax liability, but if, as it appears, the sale of the NOLCs must be completed in the tax year in which the deduction in respect of Tax Benefits is claimed, it is possible that circumstances unforeseen at the time the Tax Benefits were purchased could produce a net loss for the acquiring corporation in that year. Uncertainty as to the ability to utilize the acquired NOLCs in calculating the purchaser's NOLC will impair to some degree the attractiveness of the Program.

5. *Ineligibility Following Certain Corporate Transactions*

The Bill does not permit biotechnology corporations to participate in the Program if they acquired assets in a distribution to which Internal Revenue Code section 332 applied, or if they were a party to a reorganization under Internal Revenue Code sections 368(a)(1)(A), (C), (D), (F) or (G). These designated provisions of the Internal Revenue Code track the reorganizations listed in Internal Revenue Code section 381(a), pursuant to which an acquiring corporation would succeed to a transferor corporation's NOLCs. It would therefore appear that this limitation was designed to preclude "trafficking" in Tax Benefits.

The proposed limitations will however have some potentially onerous effects on entities that have engaged in transactions that would not ordinarily be considered "transfers" of NOLCs to new parties. For example, a corporation that reincorporated, changing its state of incorporation from New York to Delaware, would have undergone an "F" reorganization, and would as a result be disqualified from participation in the Program.[67] The proposed limitations also would eliminate from the Program two biotechnology corporations that happen to have merged with one another in an earlier year, or a parent which had previously liquidated *any* subsidiary.

As an initial matter, since the object of the Program is to permit outright cash sales of NOLCs, it is not clear why this limitation is proposed. It narrows the class of potentially

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[65] *See also* Proposed N.Y. Tax Law §§ 210.3(f), 1453(u) and 1503(d).

[66] Id.

[67] *See, e.g.,* TSB-A-03(12)C.

eligible sellers, but the policy reason for doing so is not clear. In any event, rather than the proposed limitations, it may be more appropriate to limit the availability of the Program by excluding corporations that "acquire" NOLCs through reorganizations with corporations with which they were *not* under common control prior to the reorganization. *See e.g.,* Internal Revenue Code section 384, which operates generally to restrict trafficking in NOLCs, yet provides reasonable exceptions for transactions that do not represent significant changes in beneficial ownership.[68]

6. *Limitation on Refunds*

The Bill provides that any Approved Biotechnology Company that has transferred Tax Benefits "shall be precluded from seeking a refund of tax paid in any taxable year which contributed to or was included in the calculation of the net operating loss carryforward which was the basis of the amount of Tax Benefit transferred."[69] This provision raises several questions.

Clearly it makes sense to preclude the Approved Biotechnology Company from deducting the transferred NOLCs, in any year, which the Bill does. However, a tax year which "contributed to or was included in" the calculation of a NOLC would not appear to be a year in which tax was paid based on net income. Instead, the biotechnology company would have been subject to one of New York's alternative minimum taxes. It seems odd that, should it later be determined that the transferring biotechnology corporation overpaid its alternative minimum tax, there would be no entitlement to a refund.

7. *Departmental Certification of NOLC Amounts*

The Bill contemplates that the Department will review and certify the amount of NOLCs available for transfer before an Approved Biotechnology Company may transfer Tax Benefits.[70] It is not clear whether this is an audit, which finally determines the amounts of NOLCs generated by such taxpayer in the relevant years. Nor is it clear what the effects of a subsequent federal audit reducing NOLCs would be.

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[68] *See also*, IRC § 382, which provides a different approach to this problem.

[69] Proposed N.Y. Tax Law §30(h).

[70] Proposed N.Y. Tax Law § 30(c)(6).

8. *Attribution Rules*

The Bill proscribes transfers of Tax Benefits to acquiring corporations owning five percent or more of the transferring biotechnology company. It is not clear how the ownership of one company is attributed to another, or to a common owner.[71] A similar issue arises in the limitation that is based on the "positive net income" of a related corporation.

9. *New York Headquarters/Principal Base of Operations Requirement*

Biotechnology companies will not be eligible to participate in the Program if they are not "headquartered," or do not have a "principal base of operations" in New York State, or if they do not maintain a minimum workforce in the State. These requirements raise significant questions as to the constitutionality of the Program.

The Commerce Clause confers upon Congress the exclusive power to "regulate commerce . . . among the several States,"[72] and thus restrains states from policies of economic protectionism. "Though phrased as a grant of regulatory power to Congress, the Clause has long been understood to have a 'negative' aspect that denies the states the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce."[73] The Commerce Clause is violated when a state taxes an incident or transaction "more heavily when it crosses state lines than when it occurs entirely within the state."[74]

There are many cases striking down state taxes that discriminate against interstate commerce. These cases, stretching over decades, demonstrate a consistent unwillingness to tolerate any kind of burden on interstate commerce that has the effect of favoring local interests over out-of-staters. For instance, New York's attempt to favor local brokerage houses through reduced stock transfer taxes was struck down;[75] as was its attempt to impose the New York City

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[71] *Cf.* IRC § 318, for example.

[72] U.S. CONST., art. I, §8, cl. 3.

[73] *Oregon Waste Systems, Inc. v. Dep't of Environ. Quality of the State of Oregon*, 511 U.S. 93, 97 (1994) (Oregon statute imposing an additional fee on waste generated out-of-State and brought into the State for disposal was facially discriminatory and unconstitutional).

[74] *Fulton Corp v. Faulkner*, 516 U.S. 325, 331 (1996) (citing *Chem. Waste Management, Inc. v. Hunt*, 504 U.S. 334, 342 (1992)).

[75] *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318 (1977.

Commuter Tax only on nonresidents of New York State;[76] and its attempt to favor local investment through accelerated depreciation.[77] In the *R.J. Reynolds* decision the Court specifically stated that, while the total dollar amount of New York City tax due over the life of the asset was not increased by reason of applying slower depreciation schedules to non-New York assets, impermissible discrimination nonetheless existed due to the fact that the taxpayer lost "today's use of increased funds" that would otherwise be released under the accelerated depreciation rules available for New York assets. It is therefore unconstitutional not only to impose higher taxes on interstate commerce, but also to deprive participants in interstate commerce of the use of funds, the "time value of money," by requiring them to pay taxes sooner than the locals do.

Because the Program is designed to operate as part of New York's tax laws, these authorities raise concerns about the constitutionality of the Program, which expressly favors "New York" biotechnology companies in the annual allotments of sales of Tax Benefits. Moreover, since the amount of Tax Benefits available to any selling company is already measured by its economic presence in New York, through its business allocation percentage, the outright exclusion of companies based outside New York appears even more clearly to direct the benefits of this tax program to New York businesses. We therefore question whether the exclusion of non-New York companies from participation in the Program will survive Commerce Clause scrutiny. We also note that a declaration of the invalidity of the Program some years after companies have begun to sell Tax Benefits, and others have claimed deductions for purchased benefits, could prove quite burdensome for the State.

10. *Allocation of Tax Benefits Where Requests Exceed $10 Million*

The Bill provides an allocation method to address years in which the DED receives requests for transfers of Tax Benefits that in the aggregate exceed the Program's annual $10 million limit.

If the DED receives requests to transfer Tax Benefits which in aggregate total less than $10 million, then each Approved Biotechnology Company may transfer all of its requested Tax Benefits. If however the DED receives requests in excess of $10 million, then the DED is required first to divide the Approved Biotechnology Companies into three groups, as follows:

(i) Approved companies with $250,000 of Tax Benefits or less;

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[76] *City of N.Y. v. State of N.Y.*, also known as *Igoe v. Pataki*, 94 N.Y.2d 577 (2000).

[77] *R.J. Reynolds Tobacco Company v. City of New York Department of Finance*, 237 App. Div. 2d 6, 14 (First Dept. 1997).

(ii) Approved companies with more than $250,000 of Tax Benefits, which have not previously been approved to transfer Tax Benefits; and

(iii) Approved companies with more than $250,000 of Tax Benefits, which have been approved to transfer Tax Benefits in a prior year.

Companies in each Group will then be allocated, subject to further addition or reduction, an amount of Tax Benefits as follows:

(i) Group (i) companies will be authorized to transfer the entire amount of their Tax Benefits.

(ii) Group (ii) companies will be authorized to transfer a *minimum* of $250,000 of Tax Benefits.

(iii) Group (iii) companies will be authorized to transfer a *minimum* amount of Tax Benefits equal to the greater of $250,000 or 50 percent of the Tax Benefits transferred in prior years (but not in excess of the current year's allowed Tax Benefits).

The Bill then provides for pro rata adjustments (up or down) to bring the total authorized transfers to $10 million.

Under this formula, corporations in Group (iii) receive a more favorable allocation than those in Group (ii); it is not clear why companies that have previously sold Tax Benefits would be favored over those that have not. We also note that the authorized transfers for companies in Groups (ii) and (iii) are expressed in terms of a *minimum* allowance. This is confusing. Where the concern is that the companies' requested Tax Benefits exceeds the $10 million limit, this authorization does not clearly resolve the problem of limiting the total allocations to $10 million. Also, if it is intended that such adjustments be based on the *minimum* amounts specified in (ii) and (iii), that should be clarified.

VII. Part S: Sales of Cooperative Apartment Stock By Nonresidents

A. Existing Law

Currently, nonresidents are not subject to New York State income tax on gains from sales of stock in a cooperative housing corporation unless the apartment was devoted to business purposes.[78]

B. Proposed Changes

Part S of the Bill treats the sales of shares of stock in a cooperative housing corporation coupled with a proprietary leasehold as the sale of an interest in real property, by (a) imposing the mortgage recording tax upon the filing of a financing statement under the Uniform Commercial Code to perfect a security interest in shares of a cooperative housing corporation to conform with how mortgages on other forms of home ownership (deeds or condominiums) are treated; and (b) by imposing the personal income tax on the gains from the sale or other disposition of shares in a cooperative housing corporation by nonresidents to conform with the taxation of gains from the sales of other types of interests in real property.

C. Comments

1. *Possible Technical Corrections*

In Section 2 of the Bill, the additional mortgage recording tax under Section 253(2) is not specifically described in subsection 5 on p. 56 of the Bill, as are the other components of the tax. It is not clear whether this is picked up generally in Subsection 8 on page 58, lines 20-22.

In proposed Tax Law section 631(b)(1)(E),we wonder whether the words "gains from" on page 59, line 55 should be eliminated. Section 631(b) sets forth "[i]ncome and deductions from New York sources," and Section 631(b)(1) provides that "[i]tems of income, gain, loss and deduction derived from or connected with New York sources shall be attributable to...:" Therefore, it would seem unnecessary to begin new Section 631(b)(1)(E) with the words "gain from." It would seem that losses from the sale, conveyance or other disposition of shares of stock in a cooperative housing corporation would also be taken into account in computing total New York source income.

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[78] TSB-A-88(6)I.

In Section 4 of the Bill, we suggest that the word "and" on page 60, line 1 be replaced with the words "that is" (or the words "that are" if the change set forth immediately above is not taken).

In Section 4 of the Bill, while helpful, the words "whether such shares are held by a partnership, trust or otherwise" on page 60, lines 2-3 are not consistent with, for example, Section 631(b)(1)(A).

In Section 6, Page 60, line 29, the word "and" should be replaced with the words "that is."

2. *Principal Residence Exception*

In Section 7 of the Bill, page 60, lines 41-45, under Section 663(c)(4), if the cooperative shares sold together with the proprietary leasehold represented the "principal residence of the seller or transferor within the meaning of Section 121 of the Internal Revenue Code," the provisions of Section 663 are not applicable. However, as drafted, there is no time frame for which "principal residence" status may be established. Section 121 of the Internal Revenue Code (i) allows a seller of a principal residence to exclude a certain amount of the gain realized from the sale from gross income under certain circumstances and (ii) operates if during the 5-year period ending on the date of sale or exchange the taxpayer owned and used the property as the taxpayer's principal residence for periods aggregating 2 years or more. See Treas. Reg. §§ 1.121-1(a), 1.121-1(b)(2) . While it may be implied from the reference to Internal Revenue Code Section 121, it is not clear that the period specifically set forth in Code Section 121 is applicable in Section 663(c)(4) since no time period is taken into account in the definition of "principal residence," which is the reference in the new statute. It is hard to imagine that a nonresident could be selling his/her principal residence unless the type of a time frame described in (ii) above applies. For example, if a taxpayer used a property in New York as a principal residence within the meaning of Internal Revenue Code Section 121 in years 1 and 2, resided principally outside of New York in years 3, 4 and 5, and returns to the property at the end of year 5, the taxpayer would be a New York nonresident at the date of the sale and would qualify for the exclusion under Internal Revenue Code Section 121. The same problem currently exists in Section 663(c)(1).

We suggest that the words "within the meaning of" on p.60, line 44, be replaced with the words "and qualifies for the exclusion under." This would more clearly tie the time frame set forth in Internal Revenue Code Section 121 to Section 663(c)(4). The same fix could be applied to Section 663(c)(1).

3. *Retroactivity*

The provisions imposing an income tax on the sale are retroactive. In general, the Tax Section opposes retroactive effectiveness on fairness grounds, and here we recommend that the new statute instead have an effective date on or after enactment of such statute. Taxpayers closing on the sale of cooperative shares prior to the enactment of the new statute would be unaware that a tax is due on any gain from such sale, and could suffer economic harm as a result of the new statute.

VIII. **Part T: Changes to Empire Zone Program**

The Bill makes a number of policy changes to the General Municipal Law and the Tax Law that affect the economic and tax incentives offered by Empire Zones. We assume that most of these changes are based on judgments as to the best way to achieve the state's economic development goals and are beyond the scope of Tax Section commentary.

Under the Bill, Tax Law Section 14(d)(4) would be amended to permit the Commissioner of Economic Development to award a 100% employment increase factor to any QEZE that makes a "Qualified Empire Zone Investment" (QEZI). Section 959(l) of the General Municipal Law would be amended to define a QEZI as a significant investment in a part of the zone satisfying certain census tract and other criteria. There is no guidance, however, on what other criteria would be applied, and there is no guidance on what would constitute a "significant investment." The absence of guidance gives the Commissioner a great deal of discretion, adds undue complexity to the program, and may in some cases circumvent the statutory intent that there be job creation to get the full tax reduction and real property credits under the program.

The proposal would also amend Tax Law Section 15(e) to permit lessees under "triple net" leases to obtain the real property credit. This would depart from the federal income tax treatment of lessee-paid real property taxes, which is to characterize such payments as additional rent, deductible as rent by the lessee and included in income by the lessor, who then takes an equivalent deduction for the real property taxes paid. Under the proposed statutory language, unsophisticated taxpayers may be confused as to which taxpayer is entitled to the credit since the deduction for real property taxes would go to the landlord while the credit for taxes paid could go to the tenant.

By allowing the credit to the lessee instead of the lessor, the proposal, if adopted, could substantially change the economics of many existing landlord/tenant relationships; for that reason, if this new provision is enacted it will be important to make the applicable rules very clear.

Generally, the proposed statutory amendments would reduce the benefits available to a business certified as a "qualified empire zone enterprise" ("QEZE") on or after April 1, 2004. Businesses certified prior to April 1, 2004 would be able to retain the benefits available under the prior statutory language.

The proposed amendments to Sections 14 and 15 of the Tax Law, provide for an exception to this grandfather rule, however, when applying the Employment Test and Employment Increase Factor to a business certified before April 1, 2004 if the business has a "base period of zero" or if the business is an electric generating facility. A business has a base period of zero if its first taxable year is the qualification test year. This exception to the grandfather rule stems from a concern that certain businesses with a base period of zero were not in fact new businesses that created jobs in New York, but were mere changes in the form of already existing businesses. An amendment to Section 14(g) of the Tax Law corrects the problem prospectively by expanding the definition of "related person" to include predecessor entities that have ceased to exist or operate.

The Part T proposals would, however, retroactively reduce the benefits available to all businesses not eligible under the grandfather rule. Section 26 of Part T provides that a business ineligible for the grandfather rule will be entitled to apply to the Commissioner of Economic Development for permission to be treated under the prior statutory provisions. The Commissioner is directed to prepare standards and procedures used to determine whether such permission should be granted. The statute gives no guidance as to the criteria the Commissioner is to consider in promulgating the regulations that will govern the determination of which QEZEs will merit this special treatment. The lack of guidance to the Commissioner creates the possibility of results that are inconsistent among taxpayers and not in accord with the intent of the legislation.

Generally, the Tax Section opposes retroactivity in the administration of the tax laws because of the uncertainty it creates. In this instance, particularly, it is our understanding that in a number of instances, existing businesses were openly encouraged on at least a quasi-official basis merely to change their form of organization so as to qualify for the maximum tax benefits under the law. In those circumstances, enacting a retroactive change in the Law while granting broad administrative discretion to waive retroactivity seems inappropriate.

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