NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON TAX PROVISIONS OF

THE NEW YORK STATE 2007 – 2008 BUDGET LEGISLATION

(CHAPTER 60 OF THE LAWS OF 2007)

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THE NEW YORK STATE 2007 – 2008 BUDGET LEGISLATION

(CHAPTER 60 OF THE LAWS OF 2007)[1]

Introduction

This report on the tax provisions of the 2007–2008 New York State budget legislation, Chapter 60 of the Laws of 2007 ("Chapter 60"), was prepared by the Tax Section of the New York State Bar Association. It focuses on certain technical, administrative and conceptual issues raised by the legislation and identifies aspects we think should be clarified by subsequent legislation or regulations.

Before making our specific comments, we have two general observations:

1. Uncertainty. First, Chapter 60 introduces considerable uncertainty into a number of areas of the New York State Tax Law (the "Tax Law").[2] Uncertainty can be a natural byproduct of tax laws that must cover a wide variety of taxpayers and fact patterns, often in broad strokes and relatively few words. However, uncertainty can also create a number of very real and often serious problems, both for taxpayers and for tax administrators.

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[1] The principal drafters of this Report were: Robert E. Brown, Paul R. Comeau, Christopher Doyle, Peter Faber, Maria T. Jones, Elizabeth Kessenides, Carolyn Joy Lee, Arthur R. Rosen, Irwin Slomka. Helpful comments were received from Patrick C. Gallagher, Robert J. Levinsohn, Carlyn S. McCaffrey, Erika W. Nijenhuis, Michael L. Schler, R. John Smith, and Diana L. Wollman.

[2] Unless otherwise indicated, all "section" references herein are to the Tax Law.

The types of problems that concern us include the following:

- Taxpayers (both individuals and businesses) need to be able to plan and budget for the tax consequences and costs of their activities on a real time basis. When the application of the Tax Law is uncertain, it is simply more difficult to do business in New York.

- Businesses required to prepare US GAAP financial statements are subject to new rules for reporting income tax uncertainties.[3] These new rules have increased the complexity of accounting for income tax exposures, and uncertainties in the law will exacerbate this complexity. Businesses that are subject to the Sarbanes-Oxley rules face potentially significant consequences if they resolve such uncertainties incorrectly in their financial statements. In this environment, not knowing how to interpret the Tax Law is a very real burden for New York businesses.

- Uncertainty results in disparities in compliance. Uncertainty causes some taxpayers to take aggressive positions because they question whether similarly situated taxpayers are interpreting ambiguous provisions of the law in the same way.

- Uncertainty can in fact result in disparate treatment of similarly situated taxpayers. If each taxpayer interprets the law differently, similarly situated taxpayers may end up paying different amounts. It is unlikely they will all be audited. Even if they are, it is unlikely that all the audits will be resolved in the same manner, since the law may be no more certain to the tax administrator. As a result, similar taxpayers will likely end up paying different amounts of tax.

- Uncertainty creates a need for more extensive and coordinated audit and enforcement. It becomes incumbent upon New York State tax administrators to (1) identify

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[3] Financial Accounting Standards Board Interpretation 48, "Accounting for Uncertainty in Income Taxes," issued June, 2006 ("FIN 48").

taxpayers and situations for which adjustment may be appropriate, (2) develop a formal position on the uncertain law, communicate it to the field, and in some cases direct and manage the audits centrally to insure consistency, (3) quantify the needed adjustments based upon the formal position as to meaning of the law, and (4) defend the asserted adjustments, frequently in litigation. If these matters are not managed centrally, then inconsistent administrative positions and uneven enforcement will result, which will undermine the Tax Law. This can be a significant burden on the government's resources.

- Uncertainty increases compliance costs and workload for taxpayers and tax administrators. For taxpayers, there are increases in the time and expense of tax planning, tax compliance, financial statement preparation, financial statement audits, non-tax regulatory compliance, tax audits and tax controversies. For tax administrators, requests for rulings increase, the need for regulatory guidance increases and audits and controversies become more complicated, time consuming and expensive. Experience has shown that the resolution of uncertainty through litigation can lead to even greater uncertainty and confusion.[4]

In various comments below, this report points out aspects of Chapter 60 that introduce uncertainty as to the meaning or application of the Tax Law. In a number of instances, this uncertainty goes to very basic and fundamental questions, such as: Who is the taxpayer? Which Article of the Tax Law applies to the taxpayer? This degree of confusion can be extremely burdensome for all concerned. We therefore suggest that consideration be given, in every case, to whether uncertainty can be eliminated, or significantly ameliorated, through clarifying guidance that provides straightforward rules. Alternatively, perhaps a different approach could accomplish the same policy goal with less structural uncertainty.

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[4] See, for example, the compliance difficulties that arose from the decision in Matter of Grieg (New York State Tax Appeal Tribunal, DTA No. 815529, September 16, 1999).

2. New York State/City differences. Our second general observation is that Chapter 60 increases the disparities between the New York State and New York City corporate tax laws. With the exception of the extension of the taxes on banks and the related "Gramm-Leach-Bliley" transitional rules, the corporate tax amendments enacted at the State level have not been made applicable to the equivalent City taxes. We understand there may be good policy reasons for divergence between the State and City tax rules. Nevertheless, thorough consideration should always be given to whether the potential costs of having different rules might outweigh the hoped-for benefits. Most importantly, we believe it is optimal for the State and City to work together to develop tax legislation, even if, in the end, the legislative proposals or the enacted laws are not the same.

I. Part F: REIT/RIC Provisions.

Real estate investment trusts ("REITs") and regulated investment companies ("RICs") are creations of U.S. federal tax law and are intended to be vehicles through which the public may invest in a diversified portfolio of real estate assets (in the case of REITs) or securities (in the case of RICs), with only one layer of tax (which, under U.S. federal law, is imposed at the shareholder level). If the REIT or RIC distributes all or substantially all of its income annually, the entity is entitled to a U.S. federal dividends-paid deduction, which reduces its federal taxable income. Usually, a REIT or RIC will distribute all of its income and pay no U.S. federal income tax. The owners of equity interests in a REIT or RIC are taxed on the distributions received, with the character of the income determined on a modified flow-through basis. The federal dividends received deduction for a corporate shareholder does not apply to

distributions received from a REIT, and applies only on a limited flow-through basis to distributions received from a RIC.[5]

Prior to 2007, because New York State generally follows the federal definition of taxable income, REITs and RICs were entitled to the dividends-paid deduction for New York State tax purposes and therefore generally paid little or no direct State tax. In addition, general business corporations taxed under Article 9-A of the Tax Law and insurance companies taxed under Article 33 of the Tax Law were permitted to exclude all of the dividends received from their subsidiaries,[6] including dividends received from any subsidiary that was a REIT or RIC. Banking corporations taxed under Article 32 of the Tax Law were permitted to deduct 60% of dividend income received from subsidiaries, including dividends from any subsidiary that was a REIT or RIC. Gains from the sale by corporate owners of shares of REIT and RIC subsidiaries were treated the same as dividends (a full exclusion from income if under Article 9-A or Article 33, and a 60% exclusion if under Article 32).

A. Summary of Changes

Part F of Chapter 60 made the following changes to the treatment of REITs and RICs:

1. Combination under Article 9-A. If substantially all of the capital stock of a REIT or RIC is owned or controlled directly or indirectly by an Article 9-A taxpayer, or by a corporation included in a New York Article 9-A combined reporting group, then: (i) the REIT or RIC is required to file a combined report with such corporation(s); (ii) in computing its taxable income for New York State tax purposes, the REIT or RIC will be denied the U.S. federal

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[5] See sections 243(d) and 854 of the Internal Revenue Code of 1986, as amended (the "Code").

[6] For purposes of Articles 9-A, 32 and 33, a "subsidiary" is defined as a corporation of which over 50% of the voting stock is owned by the taxpayer.

dividends-paid deduction; and (iii) the REIT's or RIC's capital will be included in computing the Article 9-A group's taxable capital.

2. Dividend and gain exclusion phase-outs under Articles 32 and 33. For banking corporation taxpayers taxed under Article 32, the 60% exclusion for dividends received from subsidiaries that are REITs and RICs (and for gains recognized upon the sale of REIT or RIC shares) will be phased out over a four year period as follows: (i) there will be a 30% exclusion for tax years beginning on or after January 1, 2007 and before January 1, 2009; (ii) a 15% exclusion for tax years beginning on or after January 1, 2009 and before January 1, 2011; and no deduction for tax years beginning on or after January 1, 2011.

For insurance company taxpayers taxed under Article 33, the existing 100% deduction for dividends received from subsidiaries that are REITs or RICs (and for gains recognized upon the sale of shares of REITs and RICs) is also phased out over the same four year period.

The phase-out of the dividend and gain deductions applies not only with respect to income from REITs and RICs owned directly by banking corporation or insurance company taxpayers, but also with respect to dividends and gains from any "REIT/RIC holding company" through which the bank or insurance company indirectly owns or controls over 50% of the capital stock of the REIT or RIC, to the extent such dividends or gains are "attributable to" the REIT or RIC.

These new disallowance provisions do not apply to banking corporations, or combined groups of banking corporations, with taxable assets of $8 billion or less.

B. Comments

Chapter 60 changes provisions in the Tax Law that resulted in the income of REITs and RICs owned predominantly by New York corporate taxpayers to be subject no New

York State tax or to reduced New York State tax. Chapter 60 uses two different techniques to accomplish this. Generally, if the REIT/RIC is a subsidiary of an Article 9-A taxpayer, the dividends-paid deduction is denied, so that REIT/RIC income is taxed at the REIT/RIC level. If instead the REIT/RIC is a subsidiary of an Article 32 or 33 taxpayer, the partial or full exclusion of the dividend income in the shareholder's hands is modified so that the income is taxed at the shareholder level.

The use of different methodologies is based in part on the differing fact patterns and differing uses of REITs and RICs prevailing among the different classes of taxpayers, and in part on the differences that already exist in the tax regimes applicable to general business corporations, insurance companies and banking corporations. However, applying different solutions does exacerbate the difference in New York's treatment of general business corporations, banks and insurance companies engaging in the same activities.

Guidance is needed under Articles 32 and 33 to clarify how new sections 1453(u)(3)(C) and (u)(4)(C) apply to dividends and gains from REIT/RIC holding companies. These sections essentially apply the REIT/RIC taint to dividends and gains derived from a "holding company to the extent the dividends [or gains] are attributable to such holding company's ownership interest in a REIT and RIC". To take a very simple example:

> Parent is a bank or insurance company that owns Subsidiary. Subsidiary is engaged in investment activities. Among its investments is a controlling interest in a REIT. The value of the REIT shares held by Subsidiary is 10% of Subsidiary's total asset value, and the income Subsidiary receives from the REIT is 10% of its total income.

In this case, the Parent should treat 10% of the dividend income received from Subsidiary (i.e., the REIT holding company) as income that is "attributable to" the underlying REIT. It would be

helpful if this was confirmed in regulations, which of necessity must deal with more complicated fact patterns.

In addition, because the definitions of "REIT holding company" and "RIC holding company" include corporations that satisfy the fifty percent threshold by virtue of affiliates' holdings, regulations that illustrate that dividends and gain "attributable" to REITs and RICs is determined on an economic basis, by tracing through the sources of the distributions and gains from holding companies, would be helpful.

Certain aspects of the amendments have unduly harsh, and we believe unintended, results. For example, assume a publicly-traded REIT has a subsidiary that is itself a REIT. The new rules require the subsidiary and parent to file on a combined basis, and disallow the dividends-paid deduction to the subsidiary REIT. If third parties hold, say, a 10% interest in the lower-tier REIT, either directly or indirectly through an "UPREIT" structure (in which the 10% interest is held through a partnership interposed between the upper-tier and lower-tier REITS), the effect of disallowing the dividends-paid deduction to the lower-tier REIT is to impose corporate tax on income that is earned by the subsidiary REIT and distributed to the 10% shareholders. That seems inconsistent with the intention of "closing loopholes" under which we understand REITs were used by corporate parents to shelter operating income from New York tax.

Another problem exists where a REIT subsidiary is held by an Article 9-A parent, which in turn is held by an Article 32 grandparent. In that case, the layered application of the new Article 9-A REIT rules disallowing the dividends-paid deduction, followed by the new Article 32 rule treating income from REIT holding companies as fully taxable, could technically result in the imposition of New York corporate tax on 200% of the REIT's income. This

problem arises because the reference in section 1452(u)(5)(A) to dividends included in the 9-A group's income is not technically correct. This problem can be solved by substituting the words "the entire net income of the REIT or RIC" for the words "such dividends."

A change is also required to provide for the same treatment for gains derived from a REIT or RIC holding company where the underlying REIT or RIC has been subject to combined reporting under Article 9-A. Currently, there is no provision excluding such gains from the definition of "disallowed investment proceeds."

Even with these changes, there will end up being taxation of 140% of the income of the REIT/RIC by virtue of the combination of the new Article 9-A rule for REIT subsidiaries and the existing Article 32 rule that taxes 40% of dividends and gains from "subsidiary capital." Query whether this is consistent with legislative intent as it goes beyond ensuring that income earned in a REIT or RIC does not escape New York State taxation completely (i.e., that it is subject to tax at either the REIT/RIC *or* at the shareholder-level).

At the other end of the spectrum are circumstances in which REITs and RICs continue to offer tax advantages to New York corporate taxpayers. For example, under the new provisions a significant deferral benefit remains available to banking corporations that interpose a non-nexus affiliate between the bank and its closely held REIT or RIC. Unless the REIT/RIC earnings are distributed through the non-nexus affiliate to a New York taxpayer, or the non-nexus affiliate is sold, the REIT/RIC earnings remain free from New York tax. And under Article 9-A, corporations that own more than 50% but less than 80% of a REIT or RIC are still eligible to treat dividends and gain as nontaxable income from subsidiary capital, while the REIT or RIC claims a dividends paid deduction.

II. Part G: Changed Treatment of Certain Article 9-A Corporations Owned by Banking Corporations

A. Summary of Changes

Part G of Chapter 60 makes changes in the treatment of what are referred to generally as "grandfathered Article 9-A corporations." There are three different types of grandfathered 9-A corporations.

First, there are 65% (or greater) owned subsidiaries of banking corporations that made a one-time election under section 1452(d) to continue to be taxed under Article 9-A. Section 1452(d) was enacted in 1985 as part of the substantial revisions to Article 32.[7] It permitted certain corporations that had been taxed under Article 9-A prior to 1985, but would otherwise be taxed under Article 32 as revised, to make a one-time election to continue to be taxed under Article 9-A. The election was made by filing an Article 9-A return for the taxable year ending in 1985.

Two additional types of grandfathered 9-A corporations were introduced following the 1999 enactment of the Gramm-Leach-Bliley Act ("GLB"), federal legislation which significantly altered the banking laws. Under GLB, it became possible for an entity subject to federal regulation as a "bank" to control, be controlled by, or be under common control with, various non-banks, including insurance companies and "general" business corporations. New York's separate tax regimes for banks, insurance companies and general business corporations were premised on the assumption that all the members of an affiliated group of corporations would be engaged in the same type of business and, therefore, would be subject to only one of the three regimes. After GLB, that was no longer the case.

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[7] Chapter 298, Laws of 1985.

New York responded to the GLB rules by enacting "transitional" relief, which at the time was planned to be followed by a more comprehensive revision of the tax regime for banks. Under the "GLB transitional rules," any corporation whose tax status under Article 9-A had been established prior to 2000 would continue that status, notwithstanding a subsequent affiliation with an Article 32 group (provided that it was not a banking corporation defined in any of sections 1452(a)(1) through (8)). In addition, under the GLB transitional rules, any corporation newly formed after 2000 that satisfied certain requirements was entitled to choose which status (Article 9-A or Article 32) applied. The GLB transitional rules have been extended numerous times since 2000, most recently as part of Chapter 60, which extends the rules to tax years beginning before January 1, 2010.

The changes contained in Part G prevent all three types of grandfathered 9-A corporations from continuing to be taxed under Article 9-A if any of the following "triggering events" applies to that corporation at any time starting with the first day of its first taxable year beginning on or after January 1, 2007:

1. The corporation ceases to be a taxpayer under Article 9-A.

2. The corporation becomes subject to the fixed dollar minimum tax under section 210(1)(D)(1)(f).

3. The corporation "has no wages or receipts allocable to New York State pursuant to section 210(3), or is otherwise inactive," unless (i) the corporation "is engaged in the active conduct of a trade or business," or (ii) "substantially all of the assets of [the corporation] are stock and securities of corporations which are directly or indirectly controlled by it and are engaged in the active conduct of a trade or business."

4. A "purchase," as defined, of 65% or more of the voting stock of the corporation (subject to certain exceptions) .

5. A transaction or series of related transactions in which the corporation acquires assets having an average value (or, if greater, a total tax basis) in excess of 40% of the average value (or if greater, the tax basis) of all the assets of the corporation immediately prior to such acquisition, if as a result of such acquisition the corporation is principally engaged in a business that is "different from the business immediately prior to such acquisition."

B. Comments

1. Definition of "active trade or business." The term "active conduct of a trade or business" is not defined. Guidance should be provided on the meaning of this term since this is a critical element in determining whether an entity is eligible to retain its 9-A filing status. For example, is a corporation engaged in an active trade or business only if it perform active and substantial management and operational functions through its own employees? Many affiliated groups will have one "employer-company" whose employees provide services to the other members of the group.

We note that the current text mirrors the "active conduct of a trade or business" phrase appearing in numerous places in the Code, such as Code sections 355(b) (tax-free spinoff requirement), 367(a)(3) (transfers of property outside the United States), and 954(c)(2)(A) (Subpart F exception for active rent and royalty income). The Tax Law generally provides that undefined terms have the meaning specified in the Code and Treasury Regulations thereunder.[8] If it is intended that the definition of "active conduct of a trade or business" under section 1452(n)(3)(C) conform to a particular Code standard, we recommend clarifying this. We

[8] See, e.g., 20 NYCRR § 1-2.1 and § 16-2.1.

caution, however, that Code section 355 in particular has historically been rather volatile, subject to frequent statutory and regulatory amendments (as recently as 2006), as well as evolving interpretation in administrative rulings. Linking New York's standard to Code section 355 or another Code provision therefore may add complexity and confusion to the Tax Law, and it may instead be preferable for New York to adopt its own clear rules.

Chapter 60 does not apply if the grandfathered 9-A corporation or "corporations which are directly or indirectly controlled by" it are engaged in the "active conduct of a trade or business." "Indirect" control is a concept requiring clarification. Is it intended to correspond to the affiliation tests used in the combination rules, or is a different standard intended?

The statute applies when the entity has "no" wages or receipts or if the entity is "otherwise inactive," *unless* it is engaged in the "active conduct of a business." It is not clear whether "otherwise inactive" is a different test from having no wages or receipts. If it is a different test, as the language implies, guidance is needed as to what it means to be "otherwise inactive."

One additional question on the "otherwise inactive" and the "active trade or business" standards is whether the test is measured over the course of a taxable year (assuming the grandfathered 9-A corporation is engaged in activities at some point during the year), or whether any period of inactivity during the course of the year would trigger the "otherwise inactive" condition. Similarly, it is unclear how long an active trade or business must be conducted during a year for the exception to apply. Guidance should be provided as to how long a period of inactivity or activity is required.

2. Acquisition of a 65% or greater interest. As drafted, a mid-year sale of stock can cause an entity to lose its classification as a grandfathered Article 9-A corporation

retroactive to the beginning of the taxable year in which the sale occurred. It is not clear whether that was intended, or makes sense in all cases. It should be clarified whether the rules are intended to operate in this manner. For example, if a grandfathered 9-A corporation is purchased from an Article 9-A group by an Article 32 group, under the statute as drafted, it appears that either (i) the former grandfathered Article 9-A corporation would be required to file a stand-alone return under Article 32 for the full year, or (ii) the entity's tax year would terminate on the date of sale, and it would be required to file a stand-alone Article 32 return for the short-year that ends on the sale date. Both results seem odd.

We suggest that a better rule would be for the grandfathered 9-A corporation to remain a 9-A until the end of the day on which the sale occurs, and to begin a new taxable year as an Article 32 taxpayer on the day after the sale.

3. Acquisition of assets. This provision should be revised to make it clear that the test is applied either by comparing before-and-after tax basis or by comparing before-and-after fair market values. As it currently reads, the language would appear to permit comparison of either tax basis or value before the contribution to either tax basis or value after the contribution. It is more logical to compare "apples to apples," so that the same standard (either fair market value or tax basis) is applied for purposes of both the numerator and the denominator.

This provision also raises certain questions regarding when a business would be considered "different" from the business that existed immediately prior to the contribution or acquisition of assets. Clarification or guidance on this issue would be helpful.

It should also be clarified, inasmuch as Chapter 60 has continued the GLB transitional rules through 2009, that a corporation newly-formed and capitalized under the

transitional rules will not then automatically be reclassified under these provisions of Chapter 60 if the fair market value or basis of its assets after it is capitalized is more than 40% higher than the fair market value or basis of its assets before it is capitalized. Particularly as corporations often are formed with nominal capital that may be temporarily invested until the corporation embarks upon its intended purpose, clarification that the corporation's start-up period activities will not be considered a separate and different business from its intended first real business for purposes of the 40% test, if that is in fact what is intended, would be helpful.

4. "No wages or receipts allocable to New York." This rule currently does not contain a "de minimis" threshold. Query whether it was intended that even a single dollar of "New York source" income or wages satisfies this condition. The statute seems clear on this point, using the word "no." Therefore, if a different standard is intended, that should be clarified.

5. Net operating loss carryforwards. Under the current law, an entity that changes from Article 9-A status to Article 32 status is not permitted to use any of its Article 9-A net operating losses once it becomes taxable under Article 32. This result does much more than close loopholes; it deprives a New York business of deductions for actual losses incurred as an Article 9-A taxpayer. We recommend that this harsh result be corrected legislatively, particularly inasmuch as the new law may change the status of corporations that have been operating under the Article 9-A rules for decades, including pre-1985 Article 9-A taxpayers under section 1452(d).

6. Section 1452(a)(9) changes. Section 1452(a)(9) has been amended by adding a new clause (iii) that defines "banking corporation" as including any corporation 65% or more of whose voting stock is owned by a bank, bank holding company, or savings and loan

company if the corporation is "principally engaged in a business ... which ... holds and manages investment assets". The definition of investment assets for this purpose includes "partnership interests" and "other interests," as well as certain other categories of securities. Query whether all partnership interests should be treated as investment assets for this purpose. Consideration should be given to cases in which it might be more appropriate to look through the partnership interest to the underlying assets and activities of the partnership, to determine whether the true activity is investing. We note in this regard the recent regulations under Article 9-A, which generally prefer an "aggregate" concept in applying Article 9-A to corporate partners.

Similarly, it should be clearly stated that, in the case of wholly-owned non-corporate entities classified as disregarded entities, grandfathered 9-A corporations will be treated as owning directly any assets owned by the disregarded entity.

We also recommend clarifying that the entity must hold the investment assets *as investment assets*, and not for example as inventory, such as assets of this type in the hands of a broker-dealer.

III. Part J: Combined Reporting

A. Summary of Changes

New combined reporting rules are set forth in section 211.4(a) for general business corporations taxed under Article 9-A, and in section 1515(f) for insurance companies taxed under Article 33. Under prior law, the Commissioner of Taxation and Finance was given the discretion to require or permit combined reports when corporations were under common control and the Commissioner deemed combined reports necessary because of intercorporate transactions or to reflect the companies' tax liabilities properly. State regulations provided that combined reports would be permitted or required if the corporations were engaged in a unitary

business and separate filing would distort the income of those corporations that were themselves subject to New York State taxation.[9] These regulations provided that distortion would be presumed if there were substantial intercorporate transactions among the related corporations.

The distortion requirement gave rise to a considerable amount of controversy, both in situations where one of the parties (the Department of Taxation and Finance or the taxpayer) was trying to rebut the presumption, and in situations where the presumption did not apply because the intercorporate transactions were not "substantial." The arms' length standards set forth in U.S. Treasury Regulations under section 482 of the Code have been applied since the early 1990's to determine whether distortion existed; nevertheless that exercise frequently involved extensive factual analysis, and frequently led to controversy and litigation.

The genesis of the new statutory provisions was a belief that the then-existing regime was expensive and inefficient. Taxpayers and the Department were required to retain expert witnesses to analyze and then opine on whether dealings among related corporations met arm's-length standards. In an attempt to curtail these "transfer-pricing" controversies, the new law requires combination when there are substantial intercorporate transactions.

Specifically, sections 211.4(a) and 1515(f) provide that corporations that are owned or controlled by the same interests *must* file combined reports "if there are substantial intercorporate transactions among the related corporations, regardless of the transfer price for such intercorporate transactions." The statute goes on to provide that "[i]t is not necessary that there be substantial intercorporate transactions between any one corporation and every other related corporation. It is necessary, however, that there be substantial intercorporate transactions

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[9] 20 NYCRR §§ 6-2.1, 6-2.3.

between the taxpayer and a related corporation or collectively a group of such related corporations."

The statute specifically provides that in determining whether substantial intercorporate transactions exist "the commissioner shall consider and evaluate all activities and transactions of the taxpayer and its related corporations."

In describing intercorporate transactions, section 211.4 states that these include, but are not limited to: "(I) manufacturing, acquiring goods or property, or performing services, for related corporations; (II) selling goods acquired from related corporations; (III) financing sales of related corporations; (IV) performing related customer services using common facilities and employees for related corporations; (V) incurring expenses that benefit, directly or indirectly, one or more related corporations; and (VI) transferring assets, including assets as accounts receivable, patents or trademarks from one or more related corporations." In the case of insurance companies taxed under Article 33 of the Tax Law, the statute adds several types of transactions that are unique to insurance companies: "selling policies or contracts of insurance for related corporations; ... reinsuring risks for related corporations; ... [and] collecting premiums or other consideration for any policy or contract of insurance for related corporations...".

In the absence of substantial intercorporate transactions, the Department continues to have discretion require the filing of combined reports if necessary to reflect properly the taxpayer corporations' tax liabilities.[10]

Section 211.4(a)(5) of the Tax Law also has been amended to make clear that corporations organized under the laws of countries other than the United States may not be

[10] Section 211.4(a)(4).

permitted or required to file a combined report. This reflects a requirement that was included in the Department's regulations but that was not part of the statute under prior law.

The Governor's Memorandum in Support of the Governor's Budget Bill (which, with some amendments, became Chapter 60) (the "Governor's Memorandum") indicates that the purpose of the changes to the combined reporting rules was to make the old presumption of distortion resulting from substantial intercorporate transactions mandatory. The changes were not intended to require combined reports whenever related corporations were engaged in a unitary business. The Memorandum in Support distinguishes the new combination rules from the unitary combination rules of other states by noting that New York would remain a separate reporting state that requires combination only in the presence of substantial intercorporate transactions. In the absence of substantial intercorporate transactions, distortion must still be shown to support (or permit) combined reporting.

B. Comments

The statute is ambiguous in certain respects and the Department should address these points in regulations, or in a few instances by legislative correction.

Although the new statute contains a list of categories of intercorporate transactions, the list is explicitly not exhaustive and appears to give the Commissioner some latitude in determining what other types of intercorporate transactions may be taken into account in the analysis of whether combined reporting is to be required. This grant of discretion, without any statutory guidance, is troubling. Accordingly, we recommend that regulations be promulgated promptly to give taxpayers clear notice as to what is and what is not an intercorporate transaction.

For example, one of the new categories of intercorporate transactions that should be clarified is (V), expenses that "directly or *indirectly*" benefit one or more related corporations.

"Indirect" benefit is a very vague concept and, without clarification, is likely to lead to more controversy. We also assume that capital transactions (such as long-term debt financing, contributions to equity capital, and dividend distributions) and the provision of administrative staff services are not considered intercorporate transactions. Again firm guidance would be very helpful.

More specifically, under the existing regulations, the status of holding companies providing headquarters services to operating affiliates is unclear. The new statute indicates that all transactions among related corporations should be considered in determining whether substantial intercompany transactions exist, but holding company headquarters services are not clearly addressed in the statute. They may be covered by the reference to expenses that benefit other companies, but this is unclear. Obviously, given New York's history as a "headquarters" location, clarity on this point is important.

The statute does not define or quantify "substantial." Under the Department's existing regulations, "substantial" means 50% or more (determined by reference to the corporation's receipts or expenses). Regulations should make clear that the old 50% standard continues to apply under the new statute, as implied by the Governor's Memorandum.

There are some ambiguities in situations when substantial intercorporate transactions are not present. The new statute provides the Department with discretion to require combined reporting in such situations when necessary to reflect income properly. We assume that the existing case law involving "distortion" (e.g., the applicability of Code section 482) will continue to apply and also that, as provided by current case law, taxpayers will have the same opportunity as the Department to prove distortion and be permitted to file on a combined basis. This should be made clear either by statutory amendment or in regulations.

With the new primacy of the substantial intercompany transactions rule, it is very important to provide guidance on which corporations are tested, and included, under this standard. The regulations should indicate that substantial intercorporate transactions must exist between a taxpayer and other related corporations that are included in the combined report, whether (i) directly between the taxpayer and an affiliated corporation, or (ii) indirectly, through "back-to-back" arrangements where a taxpayer engages in such transactions with one affiliated corporation, and that affiliated corporation then engages in such transactions with a second affiliated corporation.

On the other hand, assume, as is very often the case, that a U.S. parent corporation has a U.S. subsidiary and that the intercompany transactions between the U.S. parent and the U.S. subsidiary are not substantial. However, the U.S. subsidiary has substantial transactions with subsidiaries of the parent that are organized in foreign countries. The foreign subsidiaries cannot be included in a New York State combined report. Under these circumstances, the regulations should provide that the existence of substantial intercorporate transactions between the U.S. subsidiary and the foreign subsidiaries should not require that combined reports be filed by the U.S. parent and the U.S. subsidiary. Although the statute is not entirely clear in this regard, this seems to be the better reading of the statutory language and reflects our understanding of the Department's audit practice. Moreover, requiring combination in such cases does not cure any improper reflection of income, which is the reason for employing combined reporting. Combined reports are required "covering any related corporations" only if there are substantial intercorporate transactions "among the related corporations." This strongly suggests that there must be substantial intercorporate transactions among the corporations included in the combined report.

It also should be clarified whether non-New York taxpayers must be included in the group based on transactions with New York taxpayers, where the intercorporate transactions are "substantial" as to the New York taxpayers, but not as to the non-New York companies. For example, many corporate groups base their finance subsidiaries in New York, due to its preeminence as a financial center. The finance company will likely have substantial intercorporate loans with all of its affiliates, but as to any given affiliate the borrowing and lending activities (if those are considered intercorporate transactions) or the accruals of interest income and expense (if those are considered intercorporate transactions) may not be substantial. If the presence of a financing affiliate in New York means that all of the non-New York affiliates are now included in a combined state report, that should be clearly stated.

Chapter 60 codifies the exclusion of alien (i.e., non-U.S.) corporations from a combined report. The statute defines this as any corporation that is "organized under the laws of a country other than the United States." Given the increasing sophistication of federal and foreign tax laws and international transactions,[11] this generally is an area where guidance would be useful.

The clearly announced policy of the Department has been not to permit or require a combined report covering corporations taxed under different Articles of the Tax Law (e.g., a banking corporation may not be combined with a general business corporation). Further, this principle extends to nontaxpayer corporations so that, for example, an insurance company that is not subject to tax in New York may not be combined with a general business corporation taxed in New York because the insurance company would, if it were taxable in New York, be subject to Article 33 while the general business corporation is taxed under Article 9-A. Now that

[11] For example, Code section 7874(b), enacted in 2004, treats certain foreign corporations as domestic corporations for federal income tax purposes.

combined reporting will be required much more often than in the past, the statute should be amended to clearly reflect this policy.

IV. Part K: Personal Service Corporations

A. Summary of Changes

Part K addresses circumstances in which individuals who earn money for the provision of personal services interpose a personal service corporation ("PSC") or S corporation between the service provider and the service recipient/ultimate payor, for the purposes of reducing New York tax. For example, a nonresident individual working outside New York allocates income to non-New York sources based[12] on the employee's physical location while working, whereas a partner performing services for his or her partnership determines New York source income based on the apportionment factors of the partnership. If the partnership's apportionment ratio produces more New York source income than the individual would have as an employee, then interposing a PSC or S corporation as the partner, which corporation then pays a salary to the individual as an employee, can significantly lower the individual's New York taxes.

Chapter 60 addresses this kind of planning by adding to the Personal Income Tax a provision authorizing the Commissioner to reallocate "income, deductions, credits, exclusions and other allowances" between the PSC or S corporation and its employee/owners, "where necessary to prevent avoidance or evasion of New York State income tax or to clearly reflect the source and the amount of the income of the PSC or S corporation or any of its employee owners."[13]

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[12] Subject to the convenience of the employer rule. See 20 NYCRR §132.18.

[13] Section 632-a(a)(1).

The provision applies where "substantially all of the services of a [PSC] or S corporation are performed for or on behalf of another corporation, partnership or other entity."[14]

B. Comments

Regulations should define "substantially all," making it clear how the quantity of services is measured (receipts, hours), and over what time period. In addition, it should be clarified whether "another corporation, partnership or other entity" refers to a single such entity (or related group of entities), or instead could encompass a case in which multiple entities are the recipients of services. It would appear the latter situation does not implicate the same level of potential manipulation, as the alternate construct would likely be to perform services as an independent contractor, and not as a partner or owner. Moreover, the provision in section 632-a(4) treating all related persons as "one entity" indicates the latter situation was not intended to trigger the provision. It would be helpful to clarify this, however.

Presumably the reduction of New York income or New York source income includes deferral of income. Regulations containing examples illustrating that the provision can be invoked when the structure is utilized to defer New York tax, rather than eliminate it entirely, would be useful.

Clause 2 of section 632-a(a) resembles Code section 269A, although it tests for "the effect," rather than "the principal purpose," of forming or availing of the corporation. It also appears to define the concept of "avoidance or evasion of New York income tax" as occurring in any circumstance in which (i) the New York income of an employee-owner is reduced, (ii) the New York source income of a nonresident employee owner is reduced, or

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[14] Id.

(iii) the employee owner secures the benefit of any expense, deduction, credit, exclusion or other allowance, in each case where the advantage would not be otherwise allowable (presumably to the employee-owner). Where these conditions are met the Commissioner is authorized to reallocate all income, deductions, credits, exclusions and other allowances, provided that allocation is necessary (i) to prevent avoidance or evasion or (ii) to clearly reflect income.

The construction of this provision raises a few questions. The remedy appears to be a reallocation of "all" five items listed in this provision. By comparison, Code section 269(c) permits reallocations "in part." Given that section 632-a apparently can be triggered by any reduction in taxes, fine tuning the Commissioner's remedies to permit something besides all or nothing seems useful.

It is not clear whether the second reference in the clause to "avoidance or evasion" is to be interpreted in accordance with the first reference. Particularly since any tax-reducing effect triggers the possibility of reallocation, it seems reasonable to interpret the second reference as contemplating a higher threshold of tax reduction, and not simply repeating that any reduction triggers a full reallocation.

The Commissioner's authority to reallocate obtains "even if such [PSC] is taxed under Article 9-A of this chapter or is not subject to tax in this state." Where the parties to the reallocation are all New York taxpayers, a potential for whipsaw exists if the statute of limitations is open for one taxpayer, but not for the counterparty. Taxpayer secrecy rules may further complicate coordinated application of the reallocations, in particular because an employee-owner subject to reallocation can have as little as a 10% interest in the corporation, or even none if it is the Code section 318 attribution rules that makes the taxpayer an employee-owner.

The intent of this provision is to achieve a proper accounting to New York, so that the proper tax is paid. The scenarios in which the provision is invoked likely will usually entail persons who are aware of the potential reallocation on all sides, and are able to protect their rights and exchange information. However, that will not always be true. We therefore suggest that the Department consider appropriate procedures to ensure that, where adjustments are made, they produce the correct results for all affected taxpayers.[15] Experience with the sales tax "overlapping audits" policy and the better coordination currently seen in responsible officer controversies indicate ways in which similar issues have been addressed in other areas.

A somewhat related question involves New York City taxation. Administration of the City resident income tax is linked to the State personal income tax, so presumably any reallocation at the State level affecting a City individual taxpayer will also apply for City purposes. However, if the PSC or S corporation on the other side of the reallocation is a City taxpayer, there is no direct linkage of the reallocation. The corporation would report its New York State audit change to the City. However, the City would not be required to conform to the State change, because no provision in Subchapter 2 of Chapter 6 (or elsewhere in Chapter 6) of the New York City Administrative Code appears to require the City to adjust income of a PSC or S corporation that has been subjected to the City General Corporation tax, where that income has been reallocated by the State for personal income tax purposes to an individual. Consideration might be given to an amendment to the Administrative Code to address this problem.

Guidance also is needed as to the collateral effects of the reallocation of income. For example, if the Commissioner determines that income from a partnership nominally

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[15] We note that the reallocation provision is contained in Article 22, the personal income tax. For the avoidance of doubt, similar authority should be included in Articles 9, 9-A, 32 and 33, to ensure that the Commissioner's reallocation under the personal income tax is matched by the appropriate change under the relevant corporate tax.

allocated to a corporate partner is in fact allocable to an individual employee-owner, query what effect that has, on an ongoing basis, on the partnership's obligations to pay estimated taxes in respect of its C corporation and nonresident employees. These and other considerations devolving from the reassignment of income, etc. may require modifications to existing law to achieve the correct results.

More significantly, while the statute gives Commissioner authority to reallocate income, that statutory authority remains subject to constitutional constraints on the ability of New York to impose tax on persons who do not, in fact, have nexus with the state. An individual who never works in New York, for example, may not be taxable here, notwithstanding the statute.

The definitions of PSC and S corporation refer to corporations whose "principal" activity is the performance of personal services, where such services are "substantially" performed by employee-owners. It would be helpful if the two quoted terms were defined. As with other places in which similar terms are used, a simple, bright-line definition would eliminate uncertainty and controversy.

Regulations should clarify how 10% is measured in testing for an "employee/owner." It could be by vote or by value, or both. In this connection, we note that the provision utilizes Code section 318 to attribute constructive ownership, and Code section 318(a)(2)(C) bases attribution from corporations on value. In addition, it should be clarified how preferred stock will be treated.

V. Part L: Mandated New York S Corporation Election

A. Summary of Changes

In 1984, when New York first recognized federal S corporations, it enacted a statutory regime under which corporations doing business in New York[16] could choose to elect New York S corporation status, or not to elect that status. Certain elements of New York's taxation of C corporations made it advantageous, in certain circumstances, to elect S corporation status federally, but not make a New York S election. (Such corporations are referred to herein as "hybrid S corporations.") This scenario would, for example, enable the corporation to earn income from investment capital and enjoy New York's favorable Article 9-A treatment of investment income, with the shareholders deferring tax by receiving no dividends, or postponing dividends until they were no longer New York residents.

In other cases, New York's separate S election procedure may have been advantageous to nonresidents. Classifying the corporation as a C corporation localized New York tax in the corporation, and relieved nonresident shareholders of the need to file in New York.

There also were circumstances in which the separate election rule served as a trap for shareholders. For example, shareholders may have considered their corporations to be absent from New York, and thus "automatic" S corporations for state tax purposes that did not require a separate state S election. If it turned out the corporation was doing business in New York, special permission was required to make a late election. And in some cases, especially as S corporations often are small businesses, advisors simply were unaware of New York's separate S election, and failed to make a timely election where S corporation treatment was intended.

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[16] In the case of corporations not doing business in New York, the State's position is that they are treated with respect to their New York resident shareholders, as if a New York S election had been made. Publication 35.

Responding to the affirmative use of New York's separate election requirement to reduce New York taxes, Chapter 60 includes a new provision that mandates a New York S corporation election where certain conditions are met. If an S corporation was eligible for a New York S election but that election was not made, and if the hybrid S corporation is filing in New York State under Article 9-A (rather than Article 32) the new provision deems the shareholders to have made an S election for the current tax year in which the statutory conditions are satisfied.

B. Comments

It is not clear from the statute whether this is to be a year-by-year inquiry, with S or C corporation status changing each year based on the composition of gross receipts. The estimated tax provisions discussed below suggest that is the case. Alternatively, this may be a test that, once met, renders the hybrid S corporation a New York S corporation for as long as it remains eligible for S corporation status. Or it is possible that the New York S election could be revoked in later years[17] if the conditions mandating a deemed election no longer exist. This should be clarified.

The shareholders of a hybrid S corporation will be deemed to have made the New York S election "if the eligible S corporation's investment income for the current taxable year is more than fifty percent of its federal gross income for such year . . . ."[18] "Investment income" is defined as gross income from "interest, dividends, royalties, annuities, rents, and gains derived from dealings in property," and includes as well the distributive share of such items derived

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[17] See Section 660(c).

[18] Section 660(i)(1).

through partnerships, estates and trusts,[19] to the extent includible in federal gross income for the taxable year. This definition of investment income is broader than the definition of "income from investment capital," which is afforded favorable apportionment under Article 9-A.[20] It includes, for example, interest and dividend income from affiliates; rental income from real and tangible personal property; royalty income from licenses of intangible personal property or mineral interests; and gains from dealings in property, a term broad enough to encompass retail sales. While described as a provision targeted at closing loopholes, the new provision therefore literally appears to require a New York S election in myriad circumstances where the hybrid S status would not appear to have reflected a scheme to avoid New York taxation.[21]

Because the bulk of the tax engineering behind hybrid S corporations appeared to relate to Article 9-A's favored treatment of investment income, a deemed S election might be tied to a lower percentage threshold of "income from investment capital," as already defined in New York's tax law.[22] As currently drafted, however, section 660(i) appears rather randomly to mandate New York S elections, including in circumstances where a single-year's unusual event causes the 50% threshold to be met. Given this operation of the new provision, it would seem simpler, and more certain of application, simply to deem all federal S corporations to have made a New York S election as well.[23]

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19 Section 660(i)(3).

20 Section 210(3)(b).

21 Note that, under Publication 35 New York S corporations are to compute their income based on the Article 9-A rules, so features like apportionment formulae are identical for hybrid S corporations and New York S corporations.

22 See 20 NYCRR § 3-3.2.

23 By comparison, Code section 1362(d)(3) applies an S corporation termination rule that is based upon a corporation's having undistributed earnings and profits and, for three consecutive years, "passive investment income" that exceeds 25% of gross receipts. Though this provision has the opposite effect of the New York rule (i.e., it terminates S status rather than deeming an S election to occur), it is noteworthy for (i) looking over

Clarification should also be provided as to the treatment of S corporations with "qualified subchapter S subsidiaries" ("Q Subs") under the new rule. For federal income tax purposes all of the income, etc. of a Q Sub flows up to the S corporation parent, so the determination of gross income, and its relative components, will include all Q Sub income, as well as the income of the S corporation. For New York State purposes, however, the hybrid S corporation and its subsidiaries are separate corporations, some of which may not be doing business or taxable in New York. Under Article 9-A, "entire net income" is defined, in the case of a hybrid S, as the income the corporation would have been required to report to the U.S. Treasury Department "if it had not made an election under subchapter S."[24] Depending upon the facts, the inclusion of Q Sub income, whether or not it is that of a New York-taxable separate corporation, may cause the hybrid S to meet the new 50% test, or cause it not to meet that test. It is therefore important to clarify whether the "gross income" referred to in the new Article 22 rule refers to the "federal gross income" actually reported, or the federal gross income as described in Article 9-A.

New section 660(i)(4) addresses the need to coordinate estimated tax payments. A hybrid S corporation may not know its status until the close of its tax year, either because the 50% test is uncertain as a matter of fact, or because the change in status cannot be given effect until the end of the year that establishes it has, in fact, met that test. The hybrid S corporation and its shareholders may rely on the corporation's status in the prior year. Thus, if in year 1 the hybrid S was a New York C corporation, then (i) the corporation would make estimated tax

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a three-year period, thus avoiding a change in status based solely on one year's results, and (ii) its definition of investment income, which more closely identifies true investments as distinguished from receipts derived from an ongoing business.

[24] Section 208(9)(ii).

payments in year 2 as required under Article 9-A, (ii) it would not be responsible for making New York estimated tax payments in respect of its nonresident shareholders, and (iii) all of the shareholders would determine their year 2 New York estimated taxes as if the corporation were not a New York S corporation.

If it turns out that the shareholders of the hybrid S corporation are deemed to have made a New York S election for year 2 because the corporation met the 50% threshold in year 2, section 660(i)(4) prescribes that "the corporation or the shareholders, as the case may be, which made the payments shall be entitled to a refund of such estimated tax payments." While it will likely be obvious which estimated taxes the corporation paid based on the prior year's status, it may be less clear, in the case of individual shareholders, what "such" payments are. In addition, while not specified in this provision, it would seem more logical to credit the estimated taxes paid against the estimated taxes due given the change in status. For example, taxes paid under Article 9-A could be credited against the estimated taxes the same corporation is obligated to pay as an S corporation in respect of its nonresident shareholders. Similarly, if a shareholder paid estimated taxes in respect of a distribution by the hybrid C, thinking that distribution constituted New York taxable income under section 612(b)(20), it would seem logical to credit that payment against the estimated taxes due in respect of the shareholders' distributive share of the S corporation's income, and refund only any excess.

In the case of underpaid estimated tax, the new provision states that "no additions to tax with respect to any required declarations or payments" will be imposed on the corporation or the shareholder, "whichever is the taxpayer for the current taxable year."[25] As noted above, the last-quoted phrase suggests that the S corporation status of a hybrid S corporation is

[25] Section 660(i)(4).

determined by applying the 50% test each year, meaning that corporations will move in and out of taxable status depending upon each year's gross income—a rather complex situation.

The forgiveness of penalties also applies only where "the corporation or the shareholders file such declarations and make such estimated tax payments by January 15th of the following calendar year, regardless of whether the taxpayer's tax year is a calendar or a fiscal year."[26] This means most hybrid S corporations effectively have 15 days following the end of their tax year to apply the 50% test, communicate the results to their shareholders, and fund any new taxes required by reason of a change in status. For many small businesses this will be a daunting task. Moreover, since the State is unlikely to refund the payments made by the "wrong" taxpayers over the course of the year of change on a comparatively accelerated basis, the January 15 payment date as a practical matter means the State will hold two inconsistent sets of tax payments for some months, without paying any interest.[27]

The provision states that it applies to taxable years beginning on or after January 1, 2007. Prompt guidance is therefore crucial so that taxpayers can plan for their 2007 New York tax status, and where possible satisfy the January 15, 2008, deadline for any required catch-up estimates.

VI. Part N: Tax Rate Reduction for Manufacturers

A. Summary of Changes

Part N of Chapter 60 amends the Tax Law by reducing certain tax rates imposed under Articles 9-A, 32 and 33, effective for tax years beginning after 2006. The tax rate on

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[26] Id.

[27] Interest on overpaid estimated tax does not begin to run for individuals until 45 days after April 15th of the following year, or for corporations until three months after the due date for the return for the year. See sections 687(h), 687(i), 688(b), 688(c), 1087(h), 1087(i), 1088(b), 1088(c).

entire net income under these taxes has been reduced from 7.5% to 7.1%. Moreover, there are further rate reductions under Article 9-A for corporations with entire net income ("ENI") below $390,000, as well as to the tax rate on minimum taxable income.

The new law also reduces the tax rate under Article 9-A from 7.5% to 6.5%, regardless of the level of ENI, for "qualified New York manufacturers." This provision applies to tax years beginning on or after January 31, 2007.[28] A "qualified New York manufacturer" is defined as a corporation for which all of the following are true:

- the corporation is principally engaged in the production of goods by, among other things, manufacturing, processing, assembling, or refining;
- the corporation has property located in New York (of the type described under Section 210.12(b)(i)(A) for investment tax credit purposes); and
- either (i) the corporation's New York property has an adjusted basis for federal income tax purposes of at least $1 million, or (ii) all of the corporation's real and personal property is located in New York.

B. Comments

Under the law as enacted, the ability of a manufacturer to qualify for the lower tax rate depends on whether it has certain property located in New York State, or on whether all of its real and tangible personal property is located in the State. We believe that conditioning the lower rate of tax on whether a corporation maintains a sufficient level of its property in New York will be susceptible to constitutional challenge as discriminating against interstate commerce. Particularly as to smaller manufacturers, who can qualify for a lower rate of tax only

[28] Section 210.1(a)(vi).

if "all" of their property is in New York, the new statute plainly imposes a higher rate of tax on persons engaged in interstate commerce. This is highly suspect.

The New York courts have struck down a former New York City tax provision which allowed generally favorable accelerated depreciation only for corporations with property located in New York State. The court held that this impermissibly discriminated against interstate commerce because it favored taxpayers having property in the City over those that did not.[29] Indeed, a tax rate differential based on where a corporation's property is located is an even more direct form of prohibited discrimination than was prohibited in R.J. Reynolds. Because the new law creates a tax advantage to similarly situated manufacturers based on the location of their facilities, it may well violate the Commerce Clause of the United States Constitution.[30]

Although we do not question the Legislature's right to grant reduced tax rates to manufacturers, we urge that prompt consideration be given to this serious constitutional issue, as the likelihood of litigation, and the potential that this statute will be struck down as unconstitutional, create the risk of significant disruption and confusion.[31]

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[29] *R.J. Reynolds Tobacco Co. v. City of New York Department of Finance*, 237 A.D. 2d (1st Dep't 1997), *appeal dismissed mem.*, 91 A.D. 2d 956 (1998). In contrast, while New York City currently provides a tax benefit to manufacturing corporations by permitting them to double-weight the receipts factor of their business allocation percentage, the law does not condition double-weighting on where the manufacturer's property is located. Therefore, the current New York City law does not discriminate against interstate commerce.

[30] See, e.g., *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 333 (1977) (the U.S. Supreme Court found unconstitutional a provision under the New York stock transfer tax that resulted in a greater tax liability for out-of state stock sales than for in-state stock sales); *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 401 (1984) (the Supreme Court invalidated an Article 9-A tax credit based on the portion of exports shipped from New York because "it penalize[d] increases in the [export] shipping activities in other States").

[31] See the discussion of "Uncertainty" on pages 1-3 above. The extensive litigation, administrative burdens and taxpayer confusion as a result of the "commuter tax" legislation in 1999, which rescinded New York City tax on nonresidents of New York City working in the City but retained the tax for out-of-State residents working in the City, is an example of such disruptive confusion. In *City of N.Y. v. State of N.Y.*, 94 N.Y.2d 577 (2000), the New York Court of Appeals found that the legislation violated the Commerce Clause of the U.S. Constitution. Thereafter, the State was obligated to pay refunds to thousands of taxpayers, and to account to the courts on the refund process and results.

VII. Retroactivity and Effective Dates

Except for Part N, the Parts of Chapter 60 on which we have commented in this report have effective date provisions that read as follows: *"This act shall take effect immediately and apply to taxable years beginning on or after January 1, 2007."* In contrast, Part N states that the rate reduction under Article 9-A for qualified New York manufacturers contained therein is effective for tax years beginning after January 31, 2007. The legislative bill summary does not note this difference, but sets out the effective date for the whole Part as January 1, 2007. Query whether the unusual January 31, 2007 effective date set forth in the statute is an error in need of technical correction, or is intentional and simply was not reflected in the bill summary.

Because the legislation was not enacted until April 9, 2007 (when it was signed by the Governor), the January 1 effective date is retroactive. In addition, although the legislation was introduced in proposed form on January 31, 2007, material modifications to the bill were made prior to its April 1, 2007 passage by the legislature.

Taxpayers have made estimated payments and will be making additional estimated payments shortly that are affected by the new provisions. Because of the retroactive effect of the new provisions, and without the answers to the many questions they raise, including those identified in this report, it has been and will be difficult for taxpayers to make accurate estimated payments. Therefore, we recommend that consideration be given to adopting a policy of forgiving penalties with respect to underpayments of estimates for 2007.

Further, entities that are required to prepare US GAAP financial statements quarterly throughout the year (which includes all corporations subject to the Sarbanes-Oxley rules) must know for purposes of their quarter ending in April, May or June how the new provisions impact their 2007 tax obligations. Under the new FIN 48 rules, these entities must determine for financial statement reporting purposes their tax liabilities based upon the law as

written, which will be difficult when it comes to Chapter 60. To enable these taxpayers to comply with their financial reporting obligations, it is important that the necessary guidance be issued, and appropriate technical corrections be made, promptly.

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