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One Elk Street, Albany, New York 12207 • PH 518.463.3200 • www.nysba.org

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMENTS ON THE 2023-2024 NEW YORK STATE EXECUTIVE BUDGET

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Report No. 1472

New York State Bar Association ("NYSBA") Tax Section

Comments on 2023-2024 New York State Executive Budget[1]

1. Introduction

This report on selected tax provisions of the 2023-2024 New York State Executive Budget (the "Budget Bill")[2] was prepared by the Tax Section of the NYSBA (the "Tax Section"). It focuses on certain technical, administrative, and conceptual issues raised by selected provisions of the Budget Bill with reference to the New York Tax Law (the "Tax Law") and identifies aspects we think should be clarified or reconsidered prior to adoption by the Legislature.

This report offers comments and, in some cases, recommendations on the following parts of the Budget Bill:

Part A: Provide Authority to Abate Interest for Taxpayers Impacted by Declared Disasters

Part B: Clarification of the Treatment of Limited Partners for the Metropolitan Commuter Transportation Mobility Tax

Part E: Abatement of Penalties for Underpayment of Estimated Tax by a Corporation

Part J: Make Technical Changes to Tax Law

Part V: Allow the Department of Taxation and Finance (the "Department") the Right to Appeal Tax Appeals Tribunal Decisions

Part CC: Require State S Corporation Conformity with Federal Return

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[1] The principal drafters of this report were: Jack Trachtenberg, Mary Jo Brady, Michelle Chionchio, Gaby Kraushaar, Alysse McLoughlin, Elizabeth Pascal, and Jennifer White. Helpful comments were received from Andrew Braiterman, Kimberly Blanchard, Robert Cassanos, Paul R. Comeau, Peter Connors, Peter Faber, Stephen B. Land, Jiyeon Lee-Lim, Elliot Pisem, Dennis Rimkunas, Yaron Reich, Leah S. Robinson, Arthur Rosen, Michael Schler, Marc A. Simonetti, Irwin M. Slomka, Philip Wagman, Andrew Walker, Gordon Warnke and Libin Zhang. This report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of NYSBA's Executive Committee or its House of Delegates.

[2] FY 2024 New York State Executive Budget, Revenue Article VII Legislation, available at https://www.budget.ny.gov/pubs/archive/fy24/ex/artvii/revenue-bill.pdf (hereafter, the "Budget Bill").

2. **Discussion**

I. Part A: Provide Authority to Abate Interest for Taxpayers Impacted by Declared Disasters

A. Summary of Changes

The proposed legislation would authorize the Department to abate interest charges on the underpayment of tax for taxpayers who are affected by a presidentially or gubernatorially declared disaster, regardless of a tax deadline extension. Specifically, the proposal seeks to add a new subsection (d) to Tax Law § 171(28), which states "where a taxpayer who . . . is determined for federal tax purposes to be affected by a presidentially declared disaster, or who is determined to be affected by a disaster emergency declared by the governor, but the commissioner has not postponed a tax deadline pursuant to the authority in paragraph a of this subdivision due to such disaster, the commissioner may abate any amount of interest from the underpayment of any tax administered by the commissioner under this chapter that accrued for the period during which the taxpayer was unable to meet such deadline due to direct impacts of the disaster." A "taxpayer" has been defined to include any person or entity required to file a return or remit tax, and therefore applies to all taxes enumerated under Chapter 60 of the Tax Law.[3] The change would take effect immediately.

B. Comments

Under current law, the Department is authorized to extend filing deadlines when either the federal or state government has declared a disaster.[4] When a deadline has been extended, no interest and penalties accrue during the period of extension for any taxpayer in the disaster area or otherwise affected by the disaster.[5] However, when a deadline has not been extended, the Department currently only has the authority to abate penalties, and not interest (the Department may be authorized to abate penalties for reasonable cause, which may include the impacts of a disaster on a taxpayer).

The Tax Section supports the proposed change, thereby providing the requisite statutory authority

[3] Proposed Tax Law § 171(28)(c)(2).
[4] *See* Tax Law § 171(28).
[5] *Id.*

to abate interest charges on underpayments of tax for taxpayers affected by a declared disaster, which constitutes a circumstance beyond the taxpayer's control, regardless of tax deadline extensions. We note, however, that the proposal would apply only for "the period during which the taxpayer was unable to meet [the filing] deadline due to direct impacts of the disaster." Such period will have to be defined for each declared disaster, leaving open the question of who should define the impact period. Each taxpayer could be permitted to establish the time period during which the disaster made it impossible to comply; or, alternatively, the Department could declare a time period during which all affected taxpayers would be presumed to be unable to comply. The latter of these two approaches may be easier to administer. It should also be considered whether one, or the other, of these two approaches might cost more revenue.

Further, and in an effort to meet the fairness goals sought by the Legislature, we recommend that proposed Tax Law § 171(28)(d) should be revised to explicitly include both "interest and penalties." This change would ensure that the same standard is applied–across all tax types–when considering the abatement of penalties and interest due to the direct impacts of a disaster. Moreover, this change would extinguish the need for the proposed change included in Part E (discussed below), and its personal income tax counterpart already found in Tax Law § 685(d)(4).

II. Part B: Clarification of the Treatment of Limited Partners for the Metropolitan Commuter Transportation Mobility Tax

A. Summary of Changes

The proposed legislation would amend the definition of "net earnings from self-employment" in the Tax Law solely for purposes of the Metropolitan Commuter Transportation Mobility Tax ("MCTMT") to include income received by limited partners who actively participate in the management of the partnership.

The MCTMT is a tax imposed on both employers and self-employed individuals engaged in business activities in the Metropolitan Commuter Transportation District ("MCTD"). The tax base is compensation earned in the MCTD. For employers, compensation includes salaries, wages, and bonuses paid to employees. For self-employed taxpayers, compensation includes net earnings from self-

employment. The tax rate on self-employment income is currently 0.34%, but proposed legislation seeks to increase that rate to 0.42% as of January 1, 2023; and to 0.50% as of January 1, 202.[6]

The current definition of net earnings from self-employment in the Tax Law references Internal Revenue Code ("IRC") § 1402; IRC § 1402 contains a provision – § 1402(a)(13) – which excludes certain limited partner payments from the definition of net earnings from self-employment, thus exempting limited partners from paying self-employment tax on their distributive share of partnership income in most circumstances. The proposed change to the Tax Law would reference IRC § 1402(a)(13) specifically and provide that "an individual shall not be considered a limited partner if the individual directly or indirectly takes part in the control, or participates in the management or operations of the partnership such that the individual is not a passive investor, regardless of the individual's title or characterization in a partnership or operating agreement."

The FY 2024 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support (hereafter, "Memorandum in Support")[7] notes that the term "limited partner" is not defined within the IRC or the Tax Law. As such, according to the Memorandum in Support, partners who do in fact actively participate in the partnership "can simply label themselves as 'limited partners' on paper to avoid paying the MCTMT."[8] The Department thus views the amendment as a "clarification" to prevent tax avoidance that would take effective immediately. Assumedly, that would make the new definition applicable to all open tax years.

B. Comments

IRC §1402 does not explicitly define "limited partner" for purposes of the exclusion from the definition of "net earnings from self-employment." In such circumstances where a term is not defined, the plain meaning of the term controls. If the term is ambiguous, it is necessary to look to the legislative history

[6] S. 4008/A. 3008, Part Q. This proposed legislation also seeks to increase the tax rate on the MCTMT's payroll-based tax to 0.50% effective for tax quarters beginning on or after July 1, 2023. *Id*.
[7] FY 2024 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support, available at https://www.budget.ny.gov/pubs/archive/fy24/ex/artvii/revenue-memo.pdf.
[8] *Id.*

to determine Congressional intent. IRC § 1402(a) provides that an individual's "net earnings from self-employment" means the gross income derived from any trade or business.[9] IRC § 1402(a)(13) narrows that definition to explicitly exclude a limited partner's distributive share of any item of income from the partnership other than guaranteed payments to that partner for services rendered to or on behalf of the partnership to the extent that these payments are compensation for services.[10]

For decades now, [11] Congress has considered narrowing the limited partner exception to address limited partners who are active in the partnership's business, but it has failed to act.[12] In the meantime, Tax Court decisions have held that the limited partner exclusion did not apply to individuals who owned interests in, and were active participants in a business (particularly a services business) conducted by, an entity organized under state law as a limited liability partnership[13] or a limited liability company.[14] The IRS

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[9] IRC § 1402(a).

[10] IRC § 1402(a)(13).

[11] Beginning in 1997, the IRS released a Proposed Regulation that attempted to narrow the definition of "limited partners" for purposes of the limited partner exclusion. Proposed Regulation § 1.1402(a)-2. Congress issued a moratorium in response to the IRS's Proposed Regulation, prohibiting the IRS from finalizing it. Though the moratorium has expired, the IRS has not since attempted to narrow the definition of "limited partners" for purposes of the limited partner exclusion.

[12] In Joint Committee Reports issued in 2005, 2006, and 2012, the Congressional Joint Committee on Taxation noted that, for the purposes of the limited partner exclusion, "limited partner status is determined under state law." Staff of the Joint Comm. on Tax'n, 109th Cong., Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-2-05, at n.219 (2005); Staff of the Joint Comm. on Tax'n, 110th Cong., Additional Options to Improve Tax Compliance, at n.72 (2006). Staff of the Joint Comm. on Tax'n, 112nd Cong., Selected Issues Relating to the Choice of Business Entity, JCX-66-12, at n.113 (2012). The 2005 and 2006 Committees also proposed legislation that would subject any partner (or member of a pass-through entity) who materially participates in the entity's business to self-employment tax on such partner's share of the entity's income. Staff of the Joint Comm. on Tax'n, 109th Cong., Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-2-05, at n.219 (2005); Staff of the Joint Comm. on Tax'n, 110th Cong., Additional Options to Improve Tax Compliance, at n.72 (2006). Congress declined to implement such legislation. Since then, there have been numerous attempts to introduce federal legislation to subject an active limited partner's distributive share of a limited partnership's income to self-employment tax. Most recently, the Department of the Treasury, in its Green Book issued in May of 2021, proposed amending the law to ensure that limited partners who provide services and materially participate in their partnerships are subject to the self-employment tax on their distributive shares of partnership income. Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals, "*Rationalize Net Investment Income and Self-Employment Contributions Act Taxes*" (2021).

[13] *Renkemeyer, Campbell & Weaver LLP v. Comm'r*, 136 T.C. 137 (2011). There, the Tax Court noted that all partners of an L.L.P. "enjoy limited liability protection and have management powers" citing 1 Bromberg & Ribstein, supra sec. 1.01(b)(5) (2005–1 Supp.), and that "[i]n essence, an L.L.P. is a general partnership that affords a form of limited liability protection for all its partners by filing a statement of qualification with the appropriate state authorities (citations omitted)" *Id.*

[14] *Castigliola v. Comm'r*, T.C. Memo 2017-62 (Apr. 12, 2017). *See also Riether v. U.S.*, 919 F. Supp. 2d 1140 (D.N.M. 2012); *Hardy v. Comm'r*, T.C. Memo 2017-16 (Jan. 17, 2017).

has also asserted that the exemption does not apply to some limited partners of state-law limited partnerships. This position is currently being challenged in Tax Court in *Soroban Capital Partners LP v. Commissioner*.[15]

In view of this lengthy unsettled history of IRC § 1402(a)(13), we believe that instead of creating an exception to the "limited partner" exception under federal tax law, the proposed legislation should take a more direct approach. Specifically, we believe it is preferable to define income subject to tax for purposes of the MCTMT to include an individual's distributive share of income from a business conducted by an entity treated as a partnership for federal income tax purposes in which the individual owns an interest, where the individual is actively involved in the management or operation of that business. In our view, having its own definition of the income that is subject to the MCTMT will provide clarity for taxpayers and will not be tied to case law or regulatory developments under or statutory amendments to IRC § 1402(a)(13). This approach also avoids the problem of trying to define who is a limited partner (suggested by the proposal to be the equivalent of a passive investor, which may or may not be the same thing) which may be defined differently depending on the circumstances.[16]

Regarding the effective date, we note that the Memorandum in Support calls this provision a "clarification" and the proposed legislation states that it would "take effect immediately." Given our understanding that the Department currently is asserting that active limited partners are subject to the MCTMT on audit, we believe that the intention may be to assert this provision applies for all open years. If this is the case, we believe the proposal should have a specific statement to that effect; alternatively, if the proposal is meant to apply only prospectively, the proposal should set forth the prospective date or periods for which it is effective and, if desired, could provide explicitly that the adoption of the proposal does not have any implication as to the proper interpretation of current law.

In addition, if the intention is to apply the proposal to all open periods, we question whether the

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[15] *Soroban Capital Partners LP v. Commissioner*, Docket Nos. 16217-22 and 16218-22.

[16] In addition to the proposal's reference to a "passive investor," its reference to "direct or indirect" participation by an individual in the management or operations of a partnership also is unclear, as is the reference to "tak[ing] part in the control" of the partnership.

provision is truly a clarification of existing law. As discussed above, IRC § 1402(a)(13) has a long and somewhat troubled history of potential legislative changes, proposed regulations, and court cases. In addition, the Memorandum in Support acknowledges that there is no definition of "limited partner" in New York or federal tax law. Thus, the amendment seems to create a new definition of "limited partner" for purposes of the MCTMT rather than clarifying existing law.

While we recognize that the Department may apply tax statutes retroactively in some cases where it is truly a "clarification"—the Court of Appeals in *Caprio v. New York State Department of Taxation and Finance*[17] concluded that the Department could apply a statute retroactively where it was only a clarification of Department interpretation of the statute existing at the time of the transaction at issue—it is another question as to whether retroactive application is good policy. If, in fact, the Department is seeking to impose its own definition of a "limited partner" in an area that has been of debate and dispute both federally and in New York, and where there may still be significant disagreement over the application of the new definition, making this provision retroactive may not be appropriate.

If our recommendation above to decouple from IRC § 1402(a)(13) is adopted, it must again be determined whether it is appropriate to make it retroactive to all open periods. In this regard, we believe there is nothing about adopting our proposal prospectively that would prohibit the Department from taking the position that under current law limited partner taxpayers who are active in the partnership's business are subject to MCTMT, which, based on our understanding, is the Department's current approach.

III. Part E: Abatement of Penalties for Underpayment of Estimated Tax by a Corporation

A. Summary of Changes

The proposed legislation seeks to add a new subsection (e-1) to Tax Law § 1085, to read as follows: "Waiver of addition for underpayment of estimated tax. No addition to tax shall be imposed under subsection (c) of this section with respect to any underpayment to the extent the commissioner determines that by reason of casualty, disaster or other unusual circumstances the imposition of such addition to tax

would be against equity and good conscience." This change will take effect immediately.

B. Comments

Under the current Tax Law, corporations with expected tax liability in excess of $1,000 must file declarations of estimated tax and make quarterly installment payments.[18] Corporations who fail to pay the installment payments required by law may be subject to an underpayment penalty. There is currently no statutory authority to abate such penalty due to casualty, disaster or other unusual circumstances. Comparatively, such authority is available for underpayment penalties associated with personal income tax estimated payments.[19]

Similar to the discussion above regarding Part A of the Budget Proposal, the Tax Section supports this change. As stated in the Memorandum in Support, the proposal would provide taxpayers relief from the imposition of penalties for circumstances outside of their control.

IV. Part J: Make Technical Changes to Tax Law

A. Summary of Changes:

The proposals in Subpart C of this section would make several technical changes to the New York Pass-Through Entity Tax ("PTET") and the New York City Pass-Through Entity Tax ("NYC PTET"). The Budget Bill would amend the definitions of "passthrough entity taxable income" and "city pass-through entity taxable income" in Tax Law §§ 860(h) and 867(b) to require entities to include any PTET taxes, NYC PTET taxes and substantially similar taxes paid to other jurisdictions that are paid and deducted in the taxable year, and are included in the taxable income of the partners/shareholders subject to tax under Article 22 for the taxable year in the computation of their PTET taxable income and NYC PTET taxable income. This change would take effect beginning in 2021 for the PTET (i.e., the year the PTET went into effect) and beginning in 2022 for the NYC PTET (i.e., the year the NYC PTET went into effect). There was contrary guidance from the Department initially regarding this calculation (pre-September 15),

[18] *See, e.g.*, Tax Law §§ 213-a (declaration of estimated tax for Article 9-A Franchise Tax on Business Corporations) and 213-b (payments on account of estimated tax).
[19] Tax Law § 685(d)(4).

however, the most recent Department guidance clarified that PTET taxes would be included in the computation of PTET taxable income. This proposal is consistent with the most recent Department guidance.

In addition, effective for tax years beginning on or after January 1, 2023, the Budget Bill would amend the definition of "city taxpayer" to include city resident trusts and estates; currently, "city taxpayer" generally is defined as a city resident individual. This change would allow partnerships and S Corporations with city resident trust or estate owners to participate in NYC PTET filings (assuming other applicable requirements are met). Tax Law § 867 (e) would be amended to read "[a] city taxpayer means . . . (1) a city resident individual, as defined in subsection (a) of section thirteen hundred five of this chapter; and (2) a city resident trust or estate, as defined in subsection (c) of section thirteen hundred five of this chapter."

Lastly, the Budget Bill clarifies that entities must annually elect into each of the PTET and NYC PTET "on or before" the due date of the first estimated payment and that an election is irrevocable after the due date. Regarding the PTET, Tax Law § 861(c) would be amended to read "the annual election must be made on or before the due date of the first estimated payment under section eight hundred sixty-four of this article and will take effect for the current taxable year" and "[a]n election is irrevocable after the due date." Tax Law § 868(c), addressing the NYC PTET, would contain corresponding changes. As above, this would be effective as of 2021 for the PTET and as of 2022 for the NYC PTET.

B. Comments

We appreciate the clarification that the PTET tax, the NYC PTET tax and taxes paid to other jurisdictions that are substantially similar are added back in the computation of PTET taxable income and NYC PTET taxable income. This change "resolves an unintentional mathematical error" according to the Memorandum in Support when calculating PTET and NYC PTET taxable income and is in line with the most recently published guidance issued by the Department.

However, we have a comment relating to certain language used in this proposed amendment as it relates to the accounting treatment of the tax year that certain expenses are treated as incurred. As stated above, the Budget Bill would amend the definitions of "pass-through entity taxable income" and "city pass-

through entity taxable income" to require entities to include any PTET taxes, NYC PTET taxes and substantially similar taxes paid to other jurisdictions *that were paid and deducted in the taxable year for federal income tax purposes*, in the computation of their PTET taxable income and NYC PTET taxable income. Under the recurring items exception described in IRC § 461(h)(3) and Treasury Regulation § 1.461-5, in certain circumstances, the payment of an expense may be treated as incurred in the tax year even if such payment takes place after the close of such tax year. Since we assume that the language of the proposed amendment would seek to be conform with tax accounting rules established under the IRC, we suggest that the words "paid and" be removed so the focus is on whether the taxes at issue were deducted in the taxable year for federal income tax purposes. If this change is not made, it would be unclear under this provision how to treat a PTET, NYC PTET or substantially similar tax expense treated as incurred under the recurring items exception (i.e., deductible in the tax year and paid in the following year).

We also applaud the inclusion of city residents and trusts and estates in the definition of city taxpayer, which addresses an "unintentional omission" in the statute according to the Memorandum in Support. This change allows S-Corporations with city residents and/or city resident trusts and estates to be eligible to elect into the NYC PTET (assuming other applicable requirements are met).

In terms of the election deadline, unlike other states, the deadline to elect into the PTET and NYC PTET is March 15 of the tax year, for both calendar year and fiscal year taxpayers; if an entity is formed after March 15, it is generally unable to elect into the PTET and NYC PTET in its first year. We recognize and appreciate the clarification of the election deadline. However, the vast majority of states with a pass-through entity tax provide taxpayers with more time to evaluate and make the election after the tax year closes (e.g., New Jersey, California). We note that New York's early election date (i.e., in the tax year) avoids the issue of taxpayers needing to make a tax payment during the tax year if the election is in the following year in order to qualify for the federal tax deduction; a later deadline could also create an issue with the PTET being properly reflected in a partner/shareholder's estimated tax payments. Nevertheless, taxpayers (particularly those formed after March 15) generally would benefit from additional time to make the election, either by the due date for the return or after the tax year closes.

V. Part V: Allow the Department the Right to Appeal Tax Appeals Tribunal Decisions

The Budget Bill's proposed amendments mirror those found in the 2021-2022 New York State Executive Budget.[20] Our full comments are available in Report No. 1449.[21] Per those comments, a majority of the Executive Committee of the Tax Section supports the proposal for two main reasons:

1. Unlike the former State Tax Commission, which exercised adjudicative as well as administrative and regulatory functions, the Tribunal is an independent, adjudicative body. Thus, whereas there was no need for a right of appeal when the State Tax Commission (i.e., the Department) made its own final determinations of tax cases (because it had ultimate control of such determinations), each litigant before the independent Tribunal should have the right to appeal. Such a procedure would be consistent with the procedure at the United States Tax Court, which permits the Internal Revenue Service to appeal adverse United States Tax Court decisions;[22] and

2. The Tax Section's historic support for granting the Department a right to appeal an adverse Tribunal decision was based on the belief that in cases where (a) the degree of the persuasiveness of the adverse parties' positions are approximately equal and (b) only one party can appeal further, a decision-making body will tend to rule against the party that has the opportunity to pursue such an appeal. This seems to be especially true when broad questions, such as Constitutional issues, are being decided. The Tax Section's concern has been that this will create the perception, whether valid or not, that the system lacks fairness because the Tribunal will decide close cases involving important tax principles against taxpayers. The Tax Section sees no reason why these considerations do not remain valid.

However, some members of the Tax Section (the "Status Quo Members") oppose the proposed amendments because they believe that granting the Department an appeal right would create undue burdens on taxpayers that are not justified by the reasons being asserted for granting the appeal right:

1. If the proposed amendment is adopted, the Department would have the power to extend the litigation process beyond these proceedings, not just to the New York State Supreme Court, Appellate Division, Third Department, but potentially to the New York State Court of Appeals. The Status Quo Members are concerned that a large segment of the taxpayer community will be unable to endure an extended litigation process due to financial, time or other resource constraints, or even because the taxpayer does not have the psychological stamina to proceed.

2. The Status Quo Members argue that the potential imbalance in "staying power" between the government and taxpayers should be considered, as should the legislative history behind the 1986

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[20] FY 2022 New York State Executive Budget, Revenue Article VII Legislation, available at https://www.budget.ny.gov/pubs/archive/fy22/ex/artvii/revenue-bill.pdf.

[21] NYSBA Tax Section Report No. 1449, available at https://nysba.org/app/uploads/2021/03/Report-1449.pdf ("Report 1449").

[22] *See* NYSBA Tax Section Report No. 382; *see also* Letter from Erika W. Nijenhuis, Chair, Tax Section, NYSBA to Hon. David A. Paterson, Governor, New York State (Apr. 24, 2009); NYSBA Tax Section Report No. 1391, available at https://nysba.org/NYSBA/Sections/Tax/Tax%20Section%20Reports/Tax%20Reports%202018/1391%20Report.pdf.

legislation creating the Tribunal. They say that legislative history makes it clear that the Tribunal was created primarily to benefit taxpayers by, among other things, establishing an independent adjudicative body and providing for a "rapid" system for resolving tax dispute.[23] As such, they believe permitting the Department to extend litigation beyond the Tribunal arguably goes against the purpose of the 1986 legislation.

Overall, the Executive Committee of the Tax Section recommends that the following non-exclusive list of safeguards be considered[24] if the proposal is adopted:[25]

1. Provide the Division of Taxation the right to seek leave to appeal from the Appellate Division, Third Department, based on specified criteria (i.e., the Division would need permission from the Third Department before being permitted to proceed with the appeal.

2. Require the Division of Taxation to reimburse the taxpayer's reasonable litigation costs if the Department is unsuccessful in its appeal.

3. Provide that the Attorney General must approve of the Division of Taxation's request to appeal and provide written justification as to why: (1) an appeal is in the best interest of the State; and (2) imposing the litigation burden on the particular taxpayer is warranted.

4. Provide a mechanism by which the Division of Taxation may move the Tribunal to render its decision non-precedential (similar to "unpublished decisions" in many states), rather than appeal.

5. Provide that the Division of Taxation may appeal an adverse Tribunal decision only where either the dollar amount at issue exceeds a certain threshold and/or the taxpayer's net worth exceeds a certain threshold.

6. Provide the Division of Taxation with the right to appeal an adverse Tribunal decision only where the decision is based on the federal Constitution, a federal statute, or the provisions of a treaty between the United States and a foreign government, with the result that the decision cannot be corrected by the Legislature. The scope of this alternative would require some further consideration but should apply to decisions barring taxation under the United States Constitution or under Public Law 86-272 (as Public Law 86-272 is federal law). Presumably any such determination that the law could not be overturned legislatively would have to ultimately be determined by the Supreme Court, Appellate Division (Third Department).

3. Part CC: Require State S Corporation Conformity with Federal Return

A. Summary of Changes

Under the Article 9-A regime currently in place, corporations doing business in New York, and which have elected to be taxed under Subchapter S of the IRC, could choose whether to elect S corporation

[23] *See* Memorandum of State Executive Department, L.1986, c.282 at 2898-2899 (July 19, 1986).
[24] We do not recommend that any specific safeguard be adopted; instead, we are merely providing a non-exclusive list of options for consideration if the proposal is adopted.
[25] We note that all of the following possible safeguards were also listed in Report 1449.

status in New York. Corporations treated as S corporations for federal but not New York purposes (so-called "hybrid S corporations") are offered advantages in certain situations. For example, shareholders could take advantage of New York's favorable treatment of investment income under the pre-2015 corporate tax regime and exempt income under the current corporate tax regime. It also provided a planning opportunity for nonresident shareholders, whereby the corporation paid tax to New York, with shareholders relieved of New York tax on distributions treated as dividends for New York tax purposes and potentially relieved of any obligation to file in New York.

On the other hand, the requirement of separate S elections for federal and New York purposes proved problematic for some corporations and their shareholders. Many out-of-state corporations and their tax preparers were caught unaware of the requirement to separately elect S corporation status in New York, often requiring them to get shareholders' and New York's permission to make the election retroactively. In addition, resident shareholders were sometimes unaware that a hybrid S corporation could prevent them from claiming resident credits for taxes paid to other state jurisdictions where S corporation status meant that the shareholders were subject to tax on income sourced to that state.[26]

The 2007-2008 enacted budget legislation[27] added new subsection (i) to Tax Law § 660, mandating that a New York S corporation election will be deemed to have been made in that year "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." The new mandatory S election created a new and broader definition of "investment income" for this purpose, including a wider array of items of income than the existing Article 9-A definition of "income from investment capital." While the provision was designed to close perceived loopholes, it also resulted in disputes over the interpretation of the new "investment income" definition, as well as unintended consequences, such as an unusual gain from an asset sale pushing a hybrid corporation into the

[26] Tax Law § 620(d).
[27] S2110-C, A4310-C.

mandatory S election category.[28]

The Governor's Executive Budget for FY 2023 proposed S corporation election conformity, but this provision was ultimately left out of the final enacted budget. Part CC of the Budget Bill once again proposes to require federal and New York conformity regarding S corporation elections.

B. **Comments**

The Budget Bill's proposed amendments to Tax Law Articles 9-A, 13, and 22 are similar to last year's[29] in that they provide that all federal S corporations would be treated as S corporations for New York tax purposes. However, unlike last year's proposal, the Budget Bill would carve out corporations that satisfy the requirements of a qualified New York manufacturer ("QNYM") under Tax Law § 210(1)(a)(vi) and choose New York C corporation status on their tax returns from the requirement to conform to federal S corporation status.

We agree with the Memorandum in Support that S corporation election conformity does, indeed, simplify certain aspects of the Tax Law and reduces the risks of uninformed shareholders or tax preparers either neglecting to make the separate New York S election or assuming that credits for taxes paid to other jurisdictions at the shareholder level will still be available in New York.[30] Indeed, the vast majority of states have adopted S corporation election conformity. However, as mentioned in our report on last year's budget,[31] eliminating the option for hybrid S corporation status could have unintended consequences for certain businesses, including QNYMs and corporations with carryover state tax credits. First, a qualified manufacturing company that has elected federal S corporation status would lose any advantage of locating in New York, thereby undermining the incentive of the zero percent tax rate enacted with corporate tax reform. Second, whereas a hybrid S corporation could capitalize its New York State tax credits (e.g., a film

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[28] *In the Matter of the Petitions of Albert R. Lepage, Francoise O. Lepage, Ronald A. Jalbert, Mariette Jalbert, and Andrew P. Barowsky,* New York Tax Appeals Tribunal, DTA Nos. 828035, 828036, 828037 and 828038 (Article 78 appeal pending).

[29] FY 2023 New York State Executive Budget, Revenue Article VII Legislation, available at https://www.budget.ny.gov/pubs/archive/fy23/ex/artvii/revenue-bill.pdf.

[30] Tax Law § 620(d).

[31] NYSBA Tax Section Report No. 1460, available at https://nysba.org/app/uploads/2022/03/1460-NYSBATS-Report-Comments-on-2022-2023-NYS-Exec.-Budget.pdf.

production credit) and monetize them strategically, such treatment would no longer be possible where the credits are passed to the shareholders and no longer "belong" to the corporation that earned them. A hybrid S corporation may have valued certain tax credits (particularly refundable credits) on the basis of their use by the corporation rather than the shareholder for purposes such as obtaining bank financing, seeking a buyer, or attracting investors. Eliminating the hybrid model could change the value of those credits once they are in the hands of shareholders, potentially undermining business plans based on corporate-level tax credits.

We commend the Budget Bill for ameliorating the impact of conformity on QNYMs. The proposal would permit S corporations that satisfy the requirements of a QNYM to be treated as New York C corporations and thereby take advantage of the QNYM zero percent tax rate. To be treated as a New York C corporation, an eligible S corporation must make an election "at any time during the preceding taxable year of the corporation or at any time during the taxable year of the corporation and on or before the fifteenth day of the third month of such taxable year."[32] According to the proposal, if after making the election, the corporation fails to satisfy the requirements of a QNYM, the corporation will revert back to being treated as a New York S corporation.[33] We believe this is a reasonable requirement for allowing a QNYM to be treated as a New York C corporation.

While we commend the Budget Bill for preserving the ability of federal S corporations to receive the benefit of the QNYM zero percent rate available to C corporations, and while we support the proposed legislation, we recommend that consideration might also be given to other corporations that would be detrimentally affected by the elimination of the hybrid option (e.g., monetized tax credits).

[32] Proposed Tax Law § 658(c)(2).
[33] Proposed Tax Law § 660(d).