

2007-08 Executive Budget Tackles Tax Loopholes

The Governor's Executive Budget proposes to eliminate a number of specific corporate tax loopholes. It also proposes to adopt "combined reporting," a systematic approach to preventing the tax avoidance by multistate corporations through the use of transfer pricing. Last year, Texas was the 17th state to adopt "combined reporting" for this purpose. All of the Governor's corporate tax reform proposals are included as parts of S.2110/A.4310, one of the Article VII bills submitted with the Executive Budget.

- **Partnership Tax Abuse.** The Commissioner of Taxation and Finance would have authority similar to that now provided to the Federal Secretary of Treasury to end practices used by New York partnerships to close a loophole that allows nonresidents to avoid New York tax by having their share of New York partnership income paid to an out-of-state entity. **Part Q – Provide the Commissioner of Taxation and Finance with authority to end practices used by New York partnerships to avoid paying personal income.**
- **Taxpayer Use of Corporate Status to Avoid Personal Income Tax.** A proposal would close a loophole that allows resident individuals to place assets into New York C corporations and avoid the personal income tax. This would apply to Federal S corporations with investment income that is more than 25 percent of their federal gross income. It would require these corporations to be S corporations for New York purposes. **Part R – Require certain corporations that are Federal S Corporations to also be New York S corporations to close a loophole that allows resident individuals to place assets into New York C Corporations and avoid paying New York tax**
- **Extension/Restructuring of Fees for Limited Liability Companies (LLCs).** The Budget would restructure the fees imposed on limited liability companies to clearly reflect a company's level of New York activity. The fees due New York are restructured so that entities will pay fees that are commensurate with their New York presence. The restructured fees will continue to provide the Financial Plan with the same level of receipts as in each of the previous three fiscal years. **Part T – Restructure the fees imposed on Limited Liability Companies from a per member fee to one that is based on income to more clearly reflect an LLC's level of New York activity while generating the same amount of revenue as the LLC fees that are in effect through tax year 2006**
- **Tax Shelter Reporting.** The Budget would provide the Department of Taxation and Finance with permanent statutory tools to address the increasing use of abusive tax shelters. Current tools are scheduled to sunset July 1, 2007, including:
 - Requiring the disclosure of information related to transactions that present the potential for tax abuse. These transactions included, but were not limited to, those identified by the Internal Revenue Service as listed transactions.
 - Authorizing New York to promulgate regulations which would require the reporting of New York reportable transactions, including specifically identified

transactions (referred to as New York listed transactions).

- Providing substantial penalties for nondisclosure and the underpayment of taxes due to the participation in such transactions.

- Extending the statute of limitations for assessments relating to these transactions. **Part N – Continue to deter the use of tax shelters by making provisions allowing the Department of Taxation and Finance to require the reporting and disclosure of Federal and New York reportable and listed transactions that may be improper tax avoidance practices (the same provisions would apply to the personal income tax)**

- **Corporation Tax Combined Filing.** This proposal would require corporations that conduct substantial intercorporate transactions with affiliated companies to file a combined, rather than separate, corporate franchise tax return. These affiliates or subsidiaries are created to leave little income or profit in the corporation that is subject to State tax. Currently the Commissioner of the New York State Department of Taxation and Finance can require a corporation to file a combined return by showing, on a return by return basis, that intercorporate transactions result in distortion of the corporation's tax liability. By requiring combination of related corporations only in the presence of substantial intercorporate transactions, New York will remain a separate reporting state that permits or requires combination in appropriate situations but the requirement of combination in the instance of substantial intercorporate transactions will put an end to abuse and litigation concerning whether or not transfer prices were at arm's length. **Part O – Conform to the practices of 17 other states that require corporations that conduct substantial inter-corporate transactions with one another to file a combined, rather than separate, corporate franchise tax return**
- **Qualified Production Activities Income (QPAI) Decoupling.** This Budget would conform New York to the practices of 18 other states that have decoupled from the federal deduction related to qualified production activities and require taxpayers to add back this deduction for New York tax purposes. The deduction was originally intended to provide a tax incentive to manufacturers by preserving and promoting domestic manufacturing jobs and domestic production. However, the deduction is now allowed on a vast array of activities which go beyond the familiar concept of manufacturing. It is possible that a multi-state firm could use the deduction to reduce its New York taxes without having a single production employee in the State. **Part V – Conform to the practices of 18 other states that have decoupled from the Federal deduction related to qualified production activities and require taxpayers to add back income from this deduction for New York tax purposes**
- **REITS and RICS.** A proposal would eliminate the deduction for certain subsidiary dividends received by a parent company from a real estate investment trust (REIT) or regulated investment company (RIC) to ensure that the shareholders of the REIT or RIC pay tax on the income earned by the REIT or

RIC. The current Tax Law excludes from taxable income:

- 100 percent of the dividends derived by a corporation or insurance company from a REIT or RIC subsidiary;
- 50 percent of the dividends received by a corporation or insurance company from a minority interest in a REIT or RIC; and
- 60 percent of the dividends received by a bank from a REIT or RIC subsidiary.

Other states, including California, Connecticut and Massachusetts, have recognized the problems posed by permitting corporate shareholders to exclude REIT or RIC distributions from their income, and have passed legislation requiring such distributions to be included in the taxable income base. **Part H – Close a loophole and conform to Federal rules by eliminating the deduction for certain subsidiary dividends received by a parent company from a real estate investment trust (REIT) or regulated investment company (RIC) to ensure that the shareholders of the REIT or RIC pay tax on the income earned by the REIT or RIC**

- **Grandfathered Corporations.** The Budget would close a loophole that allows banks that use certain subsidiaries to shelter income. The proposal would revoke the election for companies that meet certain conditions, such as those that have become inactive, cease to be a taxpayer under the business corporation tax, or are part of a corporate reorganization. Some banking corporations have placed large portions of their investment portfolios in these corporations so that this part of the banking business is subject to less tax under the corporation franchise tax. **Part I – Close a loophole that allows banks that use subsidiaries to shelter income**
- **Bad Debt Deduction.** This deduction would conform New York to federal rules and the practices of other states that allow certain banks to deduct only bad debts that have been actually written-off rather than amounts placed in reserve. The amount placed in reserve to cover such debt is based upon the historical bad debt experience of the taxpayer. Currently, a bank is allowed to take deductions based on an estimate of debts that are expected to become worthless in the future - providing a deduction for debts before they actually become “bad” or uncollectible. This approach generally inflates the amount of the deduction and thereby reduces taxable income. **Part J – Conform to Federal rules and the practices of other states with respect to banking corporations that allow certain taxpayers to deduct only bad debts that have actually been written-off (the “direct write-off method”)**
- **Bank Subsidiary Capital.** The Budget would require the add back of expenses related to subsidiary capital under the bank tax, and eliminate the 20 percent reduction in the wage factor portion of the apportionment formula to ensure the bank tax appropriately reflects a bank's presence in New York. Eliminating this discounting of the wage factor would ensure a bank's tax liability appropriately reflects that bank's level of activity and presence in New York. Under current law, bank taxpayers are allowed to deduct 17 percent of interest income from subsidiary capital, 60 percent of dividend income and net gains from subsidiary

capital, and 22.5 percent of income from government obligations from income subject to tax. However, unlike corporate taxpayers that are allowed similar deductions, bank taxpayers are not required to add back to income the expenses related to these deductions. In addition, banks use a three-factor formula of wages, deposits and receipts to apportion income to New York. However, under current law, the wage factor is discounted such that only 80 percent (rather than 100 percent) of the bank's total New York wages are included in the apportionment formula. **Part L – Conform to treatment under the corporate franchise tax, by requiring the add back of expenses related to subsidiary capital under the bank tax, and eliminating the 20 percent reduction in the wage factor portion of the apportionment formula to ensure the bank tax appropriately reflects a bank’s presence in New York**

- **Cooperative Insurance Companies.** This proposal would limit the exemption under the insurance tax for cooperative insurance companies. This proposal would ensure that insurance companies that provide the same types of services are treated equally under the Tax Law. It would also deny the insurance tax exemption to companies that have expanded their activities beyond those intended for eligibility for the tax exemption and remove the unfair advantage afforded to these companies under current law. **Part M – Eliminate the competitive advantage afforded to certain cooperative insurance companies that have expanded their activities beyond those intended by limiting the applicable exemption for cooperative insurance companies**
- **Tax Full Cost of Remote Booking of Hotel Occupancy.** The Budget would require travel companies that rent hotel rooms online or by telephone to collect the sales tax on the markups and service fees charged to customers. When the travel company books the room, it pays the hotel for all applicable taxes based on this discounted price and the hotel remits the sales tax to the State. The travel company then places additional service fees and markups on top of this discounted price and bills its customers. No State or local tax is collected on these fees or markups. **Part D – Require travel companies that rent hotel rooms over the Internet to collect the sales tax on the markups and service fees charged to customers**

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For additional information on the Executive Budget proposals for closing tax loopholes and creating a level playing field for all businesses that compete with each other in the New York marketplace, see the Memorandum in Support of S.2110/A.4310, the Article VII bill that contains these proposals. The Memorandum in support is available on the NYS Division of the Budget’s website at <http://publications.budget.state.ny.us/fy0708artVIIbills/REVENUEConsBMwtoc.htm>.