REPORT #560

TAX SECTION

New York State Bar Association

Proposed Amendments to New York State Tax Law

In Response to the 1986 Federal Tax Law

March 5, 1987

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March 6, 1987

Honorable John J. Marchi
Chair, Senate Finance Committee
Legislative Office Building - Room 913
Albany, NY 12247

Re: Comments on Proposal to
Change the New York State Tax Law

Dear Senator Marchi:

Enclosed is a report on the various proposals that have been made to date for returning the New York tax “windfall” resulting from the 1986 Federal changes, and for restructuring the personal and corporate income taxes to provide the additional tax cuts. The report summarizes on pages 1-36 the proposals that have been made to date by COFEP, Governor Cuomo, the Senate majority, the Comptroller and the Assembly majority.

Our recommendations are set forth beginning at page 37.

Respectfully Submitted,

Donald Schapiro

Enclosure

CC: Mr. Eugene Tyksinski

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March 6, 1987

Honorable Saul Weprin
Chair, Assembly Ways And Means Committee
Legislative Office Building - Room 923
Albany, NY 12248

Re: Comments on Proposal to
Change the New York State Tax Law

Dear Assemblyman Weprin:

Enclosed is a report on the various proposals that have been made to date for returning the New York tax “windfall” resulting from the 1986 Federal changes, and for restructuring the personal and corporate income taxes to provide the additional tax cuts. The report summarizes on pages 1-36 the proposals that have been made to date by COFEP, Governor Cuomo, the Senate majority, the Comptroller and the Assembly majority.

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Respectfully Submitted,

Donald Schapiro

Enclosure

CC: Mr. Carl Carlucci
Mr. Dean A. Fuleihan
Mr. Robert Kurtter

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March 6, 1987

Honorable Warren M. Anderson
Senate Majority Leader
Capitol - Room 300
Albany, NY 12247

Re: Comments on Proposal to
Change the New York State Tax Law

Dear Senator Anderson:

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Respectfully Submitted,

Donald Schapiro

Enclosure

CC: Philip Pinsky, Esq.

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March 6, 1987

Honorable Evan A. Davis
Counsel to the Governor
Capitol - Room 225
Albany, NY 12224

Re: Comments on Proposal to
Change the New York State Tax Law

Dear Evan:

Enclosed is a report on the various proposals that have been made to date for returning the New York tax "windfall" resulting from the 1986 Federal changes, and for restructuring the personal and corporate income taxes to provide the additional tax cuts. The report summarizes on pages 1-36 the proposals that have been made to date by COFEP, Governor Cuomo, the Senate majority, the Comptroller and the Assembly majority.

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Respectfully Submitted,

Donald Schapiro

Enclosure

CC: Wendy Cooper, Esq.

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March 6, 1987

Honorable Clarence D. Rappleyea
Assembly Minority Leaser
Legislative Office Building – Room 933
Albany, NY 12248

Re: Comments on Proposal to
Change the New York State Tax Law

Dear Assemblyman Rappleyea:

Enclosed is a report on the various proposals that have been made to date for returning the New York tax "windfall" resulting from the 1986 Federal changes, and for restructuring the personal and corporate income taxes to provide the additional tax cuts. The report summarizes on pages 1-36 the proposals that have been made to date by COFEP, Governor Cuomo, the Senate majority, the Comptroller and the Assembly majority.

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Respectfully Submitted,

Donald Schapiro

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REPORT # 560

TAX SECTION
New York State Bar Association

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March 6, 1987

Honorable Manfred Ohrenstein
Senate Minority Leader
Legislative Office Building - Room 907
Albany, NY 12247

Re: Comments on Proposal to
<u>Change the New York State Tax Law</u>

Dear Senator Ohrenstein:

Enclosed is a report on the various proposals that have been made to date for returning the New York tax "windfall" resulting from the 1986 Federal changes, and for restructuring the personal and corporate income taxes to provide the additional tax cuts. The report summarizes on pages 1-36 the proposals that have been made to date by COFEP, Governor Cuomo, the Senate majority, the Comptroller and the Assembly majority.

Our recommendations are set forth beginning at page 37.

Respectfully Submitted,

Donald Schapiro

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REPORT # 560

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March 6, 1987

Honorable Melvin Miller
Speaker of the Assembly
Legislative Office Building – Room 932
Albany, NY 12248

Re: Comments on Proposal to
Change the New York State Tax Law

Dear Speaker Miller:

Enclosed is a report on the various proposals that have been made to date for returning the New York tax “windfall” resulting from the 1986 Federal changes, and for restructuring the personal and corporate income taxes to provide the additional tax cuts. The report summarizes on pages 1-36 the proposals that have been made to date by COFEP, Governor Cuomo, the Senate majority, the Comptroller and the Assembly majority.

Our recommendations are set forth beginning at page 37.

Respectfully Submitted,

Donald Schapiro

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REPORT # 560

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March 6, 1987

Honorable Mario M. Cuomo
Governor, State of New York
Executive Chamber
Capitol
Albany, NY 12224

Re: Comments on Proposal to
<u>Change the New York State Tax Law</u>

Dear Governor Cuomo:

Enclosed is a report on the various proposals that have been made to date for returning the New York tax "windfall" resulting from the 1986 Federal changes, and for restructuring the personal and corporate income taxes to provide the additional tax cuts. The report summarizes on pages 1-36 the proposals that have been made to date by COFEP, Governor Cuomo, the Senate majority, the Comptroller and the Assembly majority.

Our recommendations are set forth beginning at page 37.

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REPORT #560

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Proposed Amendments to New York State Tax Law In Response to the 1986 Federal Tax Law

March 5, 1987

This report was written by Gordon D. Henderson. Helpful input was received from John A. Corry, Peter L. Faber, Arthur A. Feder, Michael Hirschfeld, Lawrence Kobrin, Robert J. Levinsohn, James H. Peters, Stanley I. Rubenfeld, Richard Sabella, Donald Schapiro, Michael L. Schler, David E. Watts, and Ralph O. Winger.

PROPOSED AMENDMENTS TO NEW YORK STATE TAX LAW

IN RESPONSE TO THE 1986 FEDERAL TAX LAW

Recognizing that the income tax base broadening then being debated in the Congress would result in a substantial increase in New York tax, last July the Tax Section urged New York State to prepare to adopt legislation to return this windfall to the taxpayers as soon as the Federal law was adopted, preferably in a special session of the legislature last fall.

The Governor announced that the State would return the windfall. He commissioned his Council on Fiscal and Economic Priorities ("COFEP") to study the matter, and to make recommendations to him within sixty days after passage of the Federal law. COFEP delivered its report to the Governor on December 5, 1986. The report focused entirely on the calendar year 1989, the year when the Federal changes would be fully phased in. COFEP's findings and recommendations were as follows:

1. The Governor should assume that in 1989 the personal income tax windfall would be $1.6 billion and the corporate tax windfall, other than from financial institutions such as banks and insurance companies, would be less than $100 million. COFEP could not estimate the windfall from banks and insurance companies. A $1.6 billion personal income tax windfall would represent about a 12% rise in the average personal tax bill. (The estimates of the personal income tax windfall examined by COFEP were: $1.3 billion by the New York State Public Employee Conference; $1.4 to $1.9 billion from the New York Division of Budget and Department of Taxation; $2.5 billion from the New York Comptroller; and $2.9 billion from the New York Senate Finance Committee.) COFEP chose a windfall estimate at the low end of the scale because of New York's need to operate on a balanced budget.

COFEP had Peat, Marwick, Mitchell & Co. review the reasonableness of the assumptions made.

2. COFEP recommended that a formal monitoring mechanism be established to determine the actual amount of the windfall in each of the next several years. Should the windfall prove either smaller or larger than the estimate, the tax would be adjusted to insure that the actual windfall amount was returned to the taxpayers.

3. New York should not follow the Federal approach of shifting some of the personal tax burden to corporations.

4. The windfall should be returned entirely through the income tax, and not through adjustments to the sales tax or the property tax. The reasons are that the Federal changes are income tax changes, and the New York personal income tax is the tax that causes New York its greatest competitive problems.

5. New York should conform to the Federal tax Saw whenever possible, including the new base-broadening provisions.

6. The personal income tax changes should be phased in in steps over the years 1987, 1988, and 1989.

7. New York should not adopt the Vermont and Rhode Island method of computing the State and City tax simply as a percentage of the Federal tax. This would result in a very high nominal rate (40% for New York State taxes alone) and a significant shift in the burden of taxation among income classes (the burden would be increased significantly at both the low and high ends of the income scale.)

8. COFEP estimated that the elimination of the deduction for long-term capital gains will account for at least 40% of the personal income tax windfall. COFEP also estimated that the higher Federal rate on long-term capital gains will cause gains realizations to fall by 30% after 1988 (and by a greater amount in 1987 and 1988.) (This is a conservative estimate. The U.S. Treasury estimate is apparently similar, while Congress' Joint Committee on Taxation estimates a much smaller reduction for years after 1988. Because the method for returning the windfall looks at the amount of State tax collections rather than at the effective tax rate for the taxpayer, this means that part of the "return" of this windfall to capital gains taxpayers estimated by COFEP will be in the form of lower realizations by them, rather than by an adjustment in their tax rate. As COFEP recognized, this is a concept that taxpayers, looking at things from their own perspective, will find difficult to appreciate.)

9. With respect to the personal income tax, COFEP recommended:

(a) All families with incomes below the poverty level should be removed from the State tax rolls. New York should be more generous in removing taxpayers from the tax rolls than the Federal Government. Low income tax relief should be accomplished through the New York low-income allowance, the standard deduction, the New York household credit, and the personal exemption.

(b) The windfall should be returned to middle-income taxpayers by stretching the tax brackets, and by allowing joint filing for married couples.

(c) Both short-term and long-term capital gains should be treated the same as personal service income, subject to a top rate of 9%. (Most of the capital gains taxes paid to New York are paid by taxpayers who also pay the New York minimum tax; but most of the New York taxpayers having capital gains are not subject to the New York minimum tax. In 1986, the top effective rate was 8.67% for those paying the minimum tax on capital gains, and was 5.4% for those not paying the minimum tax. In 1986, the top Connecticut tax rate on long-term capital gains was 2.7%. In New Jersey -- which did not give capital gains a preference -- it was 3.5%. The COFEP proposal will produce a small increase in the capital gains tax rate for those who were paying the minimum tax, and a greater increase for those who were not. COFEP proposed to treat short-term and long-term gains alike because it assumed that the Federal return will not distinguish between the two types of capital gains after 1987.)

(d) The maximum rate on unearned income should be reduced to 12% or below by 1989.

(e) Withholding tables should not be changed for 1987. This would disrupt the State's cash flow and the Federal base-broadening reforms do not increase the withholding amounts.

10. With respect to the corporate franchise tax, COFEP recommended that for corporations other than financial institutions New York should adopt the franchise tax reform proposals that have been pending in the New York legislature since 1985. These include:

(a) Reduction in the top rate from 10% to 9%, with a lower rate for small corporations.

(b) Reduction in the investment tax credit from 6% to 5%.

(c) A new alternative minimum tax with a 3% rate.

(d) A relaxation of the provisions restricting interest deductions for interest paid to shareholders.

(e) Repeal of the "income plus compensation" alternative tax base.

11. For banking and insurance corporations, COFEP recommended that the windfall be returned to banking and insurance companies largely through uncoupling from the Federal reforms for such companies, such as decoupling from the elimination of bad debt reserves for certain banks.

12. COFEP also concluded that merely returning the windfall in accordance with the foregoing plan was not enough. It said that New York must as a second step do more than return the windfall. It must make a concerted effort to reduce its spending and provide a meaningful tax cut. With New York's State and local tax claims on every dollar of income being 140% of the levels in Connecticut and New Jersey and in the nation as a whole, COFEP concluded that significant tax reductions are necessary for New York to be competitive. COFEP recommended that the long-term goal with respect to the personal income tax should be a revised tax structure that reduces the maximum tax rate on all income to 8% or below, that makes no distinctions between different types of

income, that eliminates the standard and most itemized deductions, that targets expanded tax credits for low-income families, and that streamlines tax forms so that most taxpayers could use a simple one-page form. (In 1984, COFEP had recommended such a tax system, which it labeled the “simple tax”.)

13. COFEP also recommended that the gross receipts tax on energy, transportation, and telecommunications companies should be shifted as soon as possible to a net income tax. This would help New York reduce its excessively high cost for utility services

Following his receipt of the COFEP report, the Governor asked the legislature to deal with the windfall issue in its special session in December. The Governor proposed a bill for this purpose. His bill followed the COFEP recommendations for the return of the windfall, but did not deal with the COFEP recommendation for a tax cut. The New York Senate Republican majority introduced their own bill, which did go beyond the return of the windfall to add a significant tax cut. In early January, the Comptroller made his own recommendations. Finally, as this report was being written, (1) the Governor on February 20 released a revised draft of his windfall bill, which made some significant changes from his December version, (2) the Governor at the same time announced that he would also be presenting additional provisions that would add a significant tax cut, and (3) the Assembly Democratic majority announced on February 26 that it would be submitting its own proposals for returning the windfall and making a significant tax cut, differing from both the Senate majority proposal and the Governor's proposal. These matters are summarized below. Our recommendations are contained at the end of this report.

A. Governor's December and February Proposals

1. Personal Income Tax

Allocation of Windfall Return. The Governor estimated the personal income tax windfall at $1.68 billion. The way the Governor's proposal distributes the return of the windfall among income classes in 1989 is reflected in the following table:[1]

[1] This table is taken from the memorandum of December 10, 1986 to the Governor from R. Wayne Diesel, Director of the Division of the Budget.

CHANGE IN TAX LIABILITY OF NEW YORKERS

REFORM PLAN COMPARED TO CURRENT LAW

New York Adjusted Gross Income	Percent Change in Tax Liability: Change Including Tax Loophole Closing	Change Excluding Tax Loophole Closing
$ 10,000 - $ 15,000	-7%	-7%
15,000 - 20,000	-2	-2
20,000 - 30,000	-1	-1
30,000 - 50,000	-3	-3
50,000 - 100,000	+1	0
100,000 - 200,000	0	-2
200,000 - 500,000	+3	-2
500,000 - 1000,000	+3	-2
1,000,000 +	+2	-1

NOTE: The State Tax Reform Act of 1986 will not return the State taxes generated by the closing of loopholes to the taxpayers who will be paying them. This is consistent with one of the major features of the federal tax reform which is to close the loopholes by which some individuals were paying little or no taxes.

It can be seen from the middle column in this table that the-windfall is not distributed evenly among the income classes. The lower income classes receive a small tax cut, while the upper income classes are left with a small tax increase. The increase for the upper income classes is partly attributable to the Federal reduction in tax shelter deductions. No effort has been made to return the benefit of these deductions to the particular taxpayers losing them, which seems appropriate. However, some of the resulting windfall is also shifted out of the income classes where it arises into lower income categories, which is more controversial.

Rate Changes and Joint Return Filing. New rate tables would be adopted for each of 1987, 1988, and 1989. The 1987 and 1988 tables would phase in more bracket stretch on all income, whereas the only difference between the 1988 and 1989 tables is in the rates on unearned income. Couples filing joint Federal returns would be required to file joint State returns. The top rate on earned income would be 9%; long- and short-term capital gains would be treated the same as earned income; the top rate on unearned income would be 13% in 1987, 12-1/2% in 1988, and 12% in 1989.

The structure for distinguishing between earned and unearned income would be changed. Instead of pulling earned income out as a separate item to compute the maximum tax on earned income, an additional surtax would be applied to unearned income. The surtax on unearned income would only apply to taxpayers having total New York taxable income over $100,000. In computing the unearned income on which the surtax is imposed, Section 61 of the Governor's proposal appears to allow the taxpayer to deduct all interest expense and Section 212 deductions attributable to such income, without regard to the limitations imposed on such deductions under Federal law. The Federal limitations would still apply, however, in computing the basic New York tax on all taxable income.

The proposed surtax on unearned income would graduate based on overall taxable income. For example, in 1987 the surtax on unearned income is .5% if the taxpayer's total taxable income of all kinds is over $100,000 but not over $120,000, and is 1.3% if the taxpayer's total taxable income is over $120,000 but not over $140,000. This structure of the tax creates a curious notch effect, whereby the receipt by a taxpayer of an extra dollar of income could subject him to many times that amount in tax liability. To illustrate, suppose a taxpayer has $120,000 of taxable income, all of which is unearned. His surtax would be .5% of $120,000 or $600. If he receives one more dollar of unearned income, he would move up into the next surtax bracket and would have to pay a 1.3% surtax on all $120,001 of his unearned income, or $1,560.01. His extra $1 of income will have cost him $960.01 of tax -- an effective tax rate on the $1 of 96,000%. Similarly, his first dollar of income over $100,000 would have cost him $500 in extra tax. Where only a small portion of the taxpayer's income is unearned income, the result is less extreme, but still dramatic. For example, if only $10,000 of the foregoing

taxpayer's income was unearned income, the first dollar (whether earned or unearned) that takes him above the $100,000 taxable income threshold will cost him $50 in additional tax; the first dollar that takes him above the $120,000 threshold will cost him $80 in additional tax.

Under present law, married couples may choose to file either joint or separate returns in New York. Where both spouses have income, the ability to file separate New York returns can be beneficial to the extent both spouses have income because it allows the couple to obtain the benefit of two graduated rate scales and to allocate certain deductions between the spouses. This adds to complexity, however, because it means that many couples must compute their tax on both a joint and separate New York return basis in order to determine which is the more favorable. The Governor's proposal to mandate joint returns for those filing Federal joint returns, when coupled with the new rate schedule he proposes for joint returns, would result in a relative tax decrease for those couples having only one spouse with income. However, for two-income families, a joint return rate schedule can produce a relative tax increase -- or "marriage penalty" -- unless the rate schedule assumes a 50/50 income split. The Federal joint return rate schedule is understood to have been based on an assumed 80/20 income split between the married individuals at most income levels, and created a marriage penalty. The proposed New York joint return rate schedule is understood to be based on an assumed 60/40 split, and so creates less of a marriage penalty. The marriage penalty that remains is partly ameliorated by allowing a two-earner deduction equal to 10% of up to $50,000 of earned income of the lower-earning spouse. This contrasts with the Federal elimination of such a deduction. The two-earner deduction would not benefit couples where one of the spouses has mainly unearned income.

A comparison of the present rate schedule for married couples with the proposed 1989 schedule is shown in the following table:[2]

[2] This table is taken from the memorandum of December 20, 1986 to the Governor from R. Wayne Diesel, Director of the Division of the Budget.

COMPARISON OF TAX RATE SCHEDULES

FOR MARRIED COUPLES

UNDER CURRENT LAW AND THE OMNIBUS TAX POLICY ACT OF 1986

Current Law - 1986

Taxable Income		
Over	But Not Over	The Tax is:
$ 0	$ 1,000	$ 0 - 2%
1,000	3,000	20 - 3%
3,000	5,000	80 - 4%
5,000	7,000	160 - 5%
7,000	9,000	260 - 6%
9,000	11,000	380 - 7%
11,000	13,500	520 - 8%
13,500	16,000	720 - 9%
16,000	18,500	945 - 10%
16,500	21,000	1,195 - 11%
21,000	23,500	1,470 - 12%
23,500	26,000	1,770 - 13%
26,000		2,095 - 13.5%

Note: If New York personal service taxable income is more than $16,000, you qualify for a New York State maximum tax rate of 9.53 on personal service income.

Omnibus Tax Policy Act 1989 Schedule

Taxable Income		
Over	But Not Over	The Tax is:
$ 0	$ 2,000	$ 0 - 2%
2,000	5,000	40 - 3%
5,000	8,000	130 - 4%
8,000	12,000	170 - 5%
12,000	15,000	445 - 6%
15,000	22,000	555 - 7%
22,000	34,500	1,110 - 8%
34,500		2,070 - 9%

Additional Tax on Unearned Income Other Than Capital Gains

Taxable Income		
Over	But Not Over	The Tax is:
$100,000	$120,000	0.5%
120,000	140,000	1.0%
140,000	160,000	1.5%
160,000	180,000	2.0%
180,000	200,000	2.5%
200,000		3.0%

At the low income end of the scale, the Governor's proposal would remove more taxpayers from the State's tax rolls than the Federal tax reform does at the Federal level. The adjustments at the low income end are accomplished through a combination of the New York low income allowance, the standard deduction, the personal exemption, the household credit, and the circuit breaker. None of these conform with the Federal law. The Governor's proposal would also provide an increased standard deduction for the elderly and the blind, similar to the pattern established in the new Federal law. A comparison of the Federal and proposed New York points at which taxpayers would be taken off the tax rolls is shown in the following table:[3]

[3] This table is taken from the memorandum of December 10, 1986 to the Governor from R. Wayne Diesel, Director of the Division of the Budget.

TAKING WORKING PEOPLE

OFF THE TAX ROLLS

POINT OF NO LIABILITY

Filing Status	1987 New York	1987 NY Reform	1987 Federal	1989 NY Reform	1989 Federal
Single	$ 5,999	$ 6,825	$ 4,440	$ 6,875	$ 5,000
Head of Household:					
1 Dependent	8,433	9,225	6,340	9,275	8.400
2 Dependent	9,750	11,125	8,240	11,175	10,600
Married Couple:					
0 Dependent	8,766	9,567	7,560	9,766	9,000
1 Dependent	10,166	11,800	9,460	11,875	11,000
2 Dependent	11,566	13,700	11,360	13,775	13,000
3 Dependent	12,966	15,850	13,260	15,925	15,000
4 Dependent	14,366	17,500	15,100	17,575	17,000

POINT OF ZERO PERSONAL INCOME TAX LIABILITY
AS A PERCENT OF THE POVERTY LEVEL
1987 AND 1989

FAMILY	1987 New York	1987 NY Reform	1987 Federal	1989 NY Reform	1989 Federal
Single	101	115	75	106	--
Head of Household:					
1 Dependent	107	117	81	108	98
Married Couple:					
0 Dependent	115	126	99	117	108
1 Dependent	111	128	103	118	110
2 Dependent	100	118	98	109	103
3 Dependent	95	116	98	107	101
4 Dependent	94	115	99	105	102

Notes:
1 Current New York Law.

2 Proposed State Omnibus Tax Policy Act of 1986.

New Alternative Minimum Tax. The present New York add-on minimum tax would be changed to conform with the Federal alternative minimum tax. The New York AMT rate would be 6%, the same rate that applies under the present add-on minimum tax.

Depreciation and Investment Credit. The personal income tax provisions for depreciation and investment credit would be the same as those proposed for corporations. These are discussed below in connection with the corporate franchise tax.

P.C. Pension Add back. The Governor's proposal adopts the Tax Section's recommendation that shareholder-employees of professional corporations need not add back into their income any portion of the corporation's pension deduction that is allowable as a deduction under Federal law, or the corporate FICA tax or insurance items.

S Corporation Shareholders. At present, a New York corporation or a corporation doing business in New York that is a Federal S corporation has the choice of being a New York S corporation or a New York taxable corporation. A separate New York S election is required if New York S status is desired. Moreover, the New York S election can destroyed if new shareholder affirmatively acts to end the election.

The Governor's bill would take away the separate New York elective mechanism and would mandate New York S treatment for Federal S corporations that do business in New York. S status would apply, however, only to New York resident shareholders. The corporation would be required to pay New York corporate franchise tax on the portion of its New York income that is attributable to non-resident shareholders. The reasons for this change are said to be (1) simplification, by eliminating the need for a separate New York election filing and (2) reform, by preventing S shareholders from having an election not available to partners.

Estimated Tax. New York would conform to the new Federal requirement that estimated tax payments should equal 90%, rather than 80%, of the total tax due.

2. Corporate Franchise Tax

Allocation of Windfall. Following the COFEP proposal, the franchise tax reform is intended to return an estimated windfall of less than $100 million, and involves a substantial restructuring of the franchise tax along the lines of the legislation that had been proposed in the Assembly and the Senate in the last couple of years. No information has been given by which one could separate the windfall aspect from the restructuring aspect of this proposal.

Rate Changes. The rate would be reduced from 10% to 9% immediately. For "small business taxpayers" the Governor's December bill provided that the rate would be 8% on the first $40,000 of income, and would graduate thereafter to become 9% on income over $200,000. His February bill provides that the rate is 8% on the first $200,000 of income, and becomes 9% on all income once income reaches $240,000. A "small business taxpayer" would

mean one that is a small business corporation as defined in Section 1244(c)(3) of the Internal Revenue Code; which is not part of a Section 1504 affiliated group; and which has had average net income for the taxable year and the four preceding years of not more than $240,000.

New Alternative Minimum Tax. New York would adopt an alternative minimum tax conforming with the Federal corporate AMT. The New York rate would be 3%. The AMT would apply not only to regular taxable corporations, but also to the portion of the income of S corporations that is attributable to non-resident shareholders. The AMT could not be reduced by any credits.

Elimination of "Income Plus Compensation" Alternative Tax Base. One of the present alternative New York income tax bases for corporations is one which requires compensation paid to officers and shareholders to be added back to income. The Governor's proposal would eliminate this tax base.

Computation of Capital. The Governor's proposal would permit long-term liabilities, in addition to the short-term liabilities allowed by present law, to be deducted in computing investment capital, business capital, and subsidiary capital. Real estate and marketable securities would be valued at fair market value (as under the present law), but personal property other than marketable securities would be valued at its book value as determined for accounting (not tax) purposes (rather than fair market value as under the present law).

Allocation Formula. For purposes of determining the allocation of income between New York and other sources, the statute would be amended to include tangible personal property that is leased to the taxpayer in the property factor. The

taxpayer may elect a five-year phase-in for this change, if the election is made for its first post-1986 tax year. The statute would also be amended to provide that the value of the taxpayer's real and personal property for purposes of the allocation formula would be its cost of acquisition, except that the taxpayer would have a one-time revocable election to use fair market value for all of its property, if the election was made for its first post-1986 tax year. The present regulations require that the valuation for allocation purposes should be the same as for computing business and investment capital.

New York has applied a double weight to the receipts factor in its three-factor formulation, making it in substance a four-factor formula. The bill would retain this provision, but would give only a single weight to the receipts factor in computing the 3% AMT. Thus, a different allocation formula would be used for the AMT than for the regular franchise tax.

Investment Allocation Percentage. In response to the Forbes decision, the statute would be amended to include both Federal and New York obligations in the denominator of the investment allocation formula, and would provide that where the investment allocation percentage is zero, only bank interest (and not New York or Federal interest) would be subjected to the business allocation percentage rather than the investment percentage.

Disallowance of Deduction for Income Taxes of Other States. Unlike many States, New York presently allows corporations a deduction for income taxes paid to other States. Because the New York tax applies only to the portion of the corporate income that is attributable to New York, such a deduction is not necessary to avoid double taxation. The bill would eliminate a deduction for the income taxes of other States.

Modification of Interest Disallowance Rule. The Governor's December proposal contained a complicated provision designed to liberalize the present disallowance of interest paid to shareholders. It raised the safe harbor from $1,000 to $10,000 of interest, the tainted shareholder percentage from 5% to 50% (except that it also covered any group of shareholders owning 50% or more of the stock if debt had been issued proportionately to stock holdings), and exempted conduit loans where the parent borrows money and relends it on essentially the same terms to the taxpayer. The conduit loan provision contained a number of detailed requirements that would increase audit complexity and create traps for the unwary. The Governor's February bill abandoned this approach: it raises the safe harbor from $1,000 to $10,000 (as did the December bill), but it would repeal the interest disallowance rule entirely for tax years beginning in 1989. In the meantime, it would require information to be supplied (with a $500 fine for noncompliance) about interest paid to any one or more stockholders owning in the aggregate over 50% of the stock.

Depreciation. The Governor's December bill provided that New York would recouple (both for personal and corporate franchise tax purposes) with the Federal depreciation rules for property placed in service after 1986. The Governor's February proposal abandons this approach and would leave New York

uncoupled from the Federal depreciation rules. This is one of the most significant differences between his two proposals.

Investment Tax Credit. New York would retain (both for personal and for franchise tax purposes) its present investment tax credit. The rate would be reduced, however, from 6 to 5 %, although it would be raised to 9% for R&D property.

Employment Credit. The bill substitutes a two-year 2% additional credit for the present three-year, 3% employment credit.

Bank Tax. The Governor's December proposal does not give banks any relief from the Federal disallowance for large banks of the reserve method of computing bad debts, except to make adjustments in the phased addback of reserves into income for differences between the reserves accumulated in the past as computed for State and City and for Federal purposes. This adjustment would apply to the New York City tax as well. The Governor's February bill goes beyond this. While it does not allow banks to continue the same bad debt reserve method that they used before the Federal changes, it does allow large banks to use a six year moving average experience loss reserve method.

Life Insurance Companies. The proposal would return the windfall to life insurance companies by decreasing the rate of the tax they pay on premiums written in New York.

3. Real Property Transfer Tax and Gains Tax

The Governor's February bill contained a number of proposed changes in the real property transfer tax and gains tax.

These will not be described here, but are dealt with at the end of the Recommendations portion of this report.

4. Monitoring Commission

The Governor's bill would establish a special monitoring commission early in 1987. The Governor, the Senate majority leader, the Assembly speaker, and the Comptroller would each choose one of the members, and the Commissioner of Taxation and Finance would serve as Secretary to the Commission. The Commission would monitor State tax collection and report to the Governor, the legislature and the Comptroller not less than annually through 1992 as to whether the windfall was properly being returned to the taxpayers If the windfall has not been fully returned and the legislature does not return it in the next budgetary season, the windfall would automatically be diverted by the Comptroller to a “tax reform escrow fund” out of which rebates would be paid to the taxpayers.

B. The Senate Majority Proposal

1. Personal Income Tax

Allocation of Windfall and Tax Cut. The Senate majority's bill is based on an estimated windfall of $2.4 billion for 1989, coupled with a tax reduction of $2.1 billion. No data has been supplied as to the way the Senate bill would allocate these amounts among income classes. The bill would allocate the aggregate of $4.558 billion as follows: $4.1 billion to income tax reductions; $300 million to elimination of the sales tax on clothing purchases at or below $75; and $150 million to corporate franchise tax reductions.

Rate Changes. Separate rate schedules would be established for each of 1987 and 1988, with the top rate being 8.5% in 1987 and 7% in 1988. Beginning in 1989, the personal income tax would have only two rates: 4% on taxable income up to $24,000, and 7% on the excess. Low income relief would be granted by enlarged standard deductions and personal exemptions. Neither capital gains, nor other earned income, would be treated differently than earned income.

Minimum Tax. The structure of the present add-on minimum tax would not be changed. The rate would, however, be changed immediately in 1987 to the same 4% and 7% rates that apply (beginning 1989) for purposes of the basic tax.

Joint Returns. The present New York treatment of joint or separate returns would not be changed.

P.C. Pension Add-Back. Like the Governor's bill, the Senate bill would adopt the Tax Section's recommendation to eliminate the present provision that disallows the full benefit of a pension deduction to professional corporation shareholders, although the language used for this purpose is different. The Senate bill does not deal with the FICA or insurance add-backs.

S Corporations. The bill contains no special provision for S corporations.

Depreciation and ITC. The bill contains ITC provisions that are essentially the same as in the Governor's bill. The Senate bill contains depreciation provisions that are essentially the same as in the Governor's December (but not his February) bill -- that is, it would recouple with the Federal depreciation rules for property placed in service after 1986.

Quick Form or "Postcard" Tax Option. Commencing in 1987, the bill would give every taxpayer the option each year to pay his tax under a "postcard tax" option instead of under the regular personal income tax. The "postcard tax" would be a flat rate applied to an amount equal to his adjusted gross income, less Federal interest, certain pension and annuity income, and personal exemptions. No itemized deductions would be allowed. The rate would be 5.5%. A taxpayer electing to pay the postcard tax would still be subject to the minimum tax, except that only those tax preference items excluded in calculating adjusted gross income would be taken into account. A married person could not elect to apply the postcard tax unless his or her spouse did so as well, and spouses must file a joint postcard tax return if they file a joint Federal tax return.

Alternate Tax. If a taxpayer elects to use the "postcard tax" option, the Senate bill requires the Tax Department to compute an alternative tax for that taxpayer. The alternative tax consists of applying the regular tax rate schedule to a base that is (1) the base for the "postcard tax", less (2) the standard deduction. The taxpayer is required to pay only the lesser of the "postcard tax" or the alternate tax. If the alternate tax is the lower of the two, presumably the Tax Department would have to refund the difference -- unless the taxpayer's AMT produced a larger number. In substance, the alternate tax would represent a third basic income tax computation (the first being the regular

tax, and the second being the "postcard tax" for New Yorkers, in addition to the AMT.

2. Corporate Franchise Tax

The corporate franchise tax changes proposed in the Senate bill are essentially similar to those in the Governor's December bill (including elimination of the "income plus compensation" alternative tax base, and disallowance of a deduction for income taxes of other States), with the following exceptions:

Elimination of Capital Tax Base. One of the alternative tax bases in the present New York franchise tax base is a tax on capital. The Senate bill would eliminate this alternative measure of the tax.

Disallowance of Interest Paid to Shareholders. The Senate bill would eliminate entirely the disallowance of a deduction for interest paid to shareholders.

Graduated Rate for Small Corporations. The Senate bill would apply the small business 8% rate to income up to $200,000. It would define a small business company as a company that is a small business corporation within the meaning of Section 1244(c)(3) of the Internal Revenue Code, and which either has (1) less than $290,000 of income for the taxable year or (2) less than 20 individuals employed in full-time jobs. Corporations that are part of a Section 1504 affiliated group are not disqualified.

Allocation Formula. The Senate bill would determine the value of the taxpayer's real and tangible personal property for purposes of the allocation formula as being its adjusted Federal

income tax basis (as distinguished from the acquisition cost contained in the Governor's bill and the fair market value required by present law) with a one-time opportunity to elect fair market value for all property, provided the election is made for the first post-1986 tax year.

Alternative Minimum Tax. The Senate bill imposes a 3% minimum tax on corporations. It does not, however, adopt the Federal AMT base or any other special base. The only difference between the regular tax and the minimum tax is that the sales factor is given only a single weighting in applying the allocation formula for the minimum tax, and credits cannot be used to reduce the AMT.

Bank Tax. The Senate bill decouples from the Federal disallowance for large banks of the reserve method for bad debts and also provides more favorable bad debt treatment for savings institutions.

C. Comptroller's Suggestions

Early in January, the Comptroller issued a report in which he made the following suggestions:

1. The Comptroller's estimate of the 1989 personal income tax windfall is $2.5 billion. About half the difference between this number and the estimate made by COFEP and the Governor is attributable to reliance by the Comptroller on the assumptions used by the Federal Joint Committee on Taxation, whereas COFEP and the Governor used more conservative assumptions regarding changes in taxpayer behavior.

2. The State should base its windfall return legislation on a less conservative estimate than that selected by COFEP and the Governor. A reasonable number to use for the personal income tax windfall would be $2 billion.

3. In addition to return of the windfall, there should be a tax cut of at least $300 million.

4. The Governor's December proposal is deficient because:

(a) It would result in tax increases for taxpayers whose incomes exceed $50,000, largely because the Governor proposed to remove all taxpayers with income below the poverty level from the State tax rolls, a measure which goes well beyond the comparable change in Federal tax law. Such a change, even if desirable, should be done only as part of a package of tax cuts, not as part of return of the windfall.

(b) The Governor has not proposed further tax cuts.

5. The Senate proposal would move the State in the right direction, but is deficient because it does not include a program of spending cuts.

6. A strong effort must be made to curtail spending in New York. New York has been falling behind its neighbors and the nation in terms of growth, yet its spending has been increasing in the last five years in relation to its neighbors and the U.S. average. New York’s spending has risen much faster than the rate of inflation. It rose at three times the rate of inflation in 1985 and 1986 and is projected to rise at a higher rate in relation to inflation in 1987. New York's tax burden exceeds that of other progressive States -- including California, Massachusetts, Wisconsin, and Minnesota -- by an average of 48%. While New York's population has been declining, public employment has been rising. And New York's taxing and spending levels have been worsening in relation to other States. The Comptroller concludes that New York’s State and local governments spend and tax excessively beyond the amounts needed to provide excellent services.

D. Governor's Tax Cut Announcement

On February 20 the Governor announced that he was amending his proposal to include a tax cut of $1.7 billion. The tax cut element of his proposal would be separate from the windfall proposal, and would phase in over three years beginning in 1988 and ending in 1990. The top rate on earned income and capital gains would fall to 8%, and on other unearned income to 11%, by 1990. In addition, there would be more bracket stretch than under the windfall proposal. At the time this report was written, this tax cut proposal had not yet been issued in bill form.

E. Assembly Majority's Proposal

As the time this report was written, this proposal had not yet been submitted in bill form. Only the sketchiest information was available. This is summarized below.

1. Personal Income Tax

Allocation of Windfall and Tax Cut. The Assembly majority's proposal is based on an estimated windfall of $2.4 billion in 1989, coupled with a tax reduction of $2.0 billion. At this writing we have no information as to how this would be allocated among corporations and individuals, or between income classes.

Flat Tax. By 1989, the personal income tax would become a flat tax with a single 6.75% rate on all income. The tax would be called the “Fair and Simple Tax” (FAST). There would be an exemption of $900 per dependent child, and a standard deduction of $8,000 for single taxpayers ($16,000 per married couple). The standard deduction would be reduced by $185 for each $1,000 of income over $75,000. No itemized deductions would be allowed except for property taxes.

2. Corporate Franchise Tax

Elimination of Capital Tax Base. Like the Senate proposal, the Assembly proposal would eliminate the capital tax base.

Elimination of “Income Plus Compensation” Alternative Tax Base. The Assembly proposal would eliminate this base.

Disallowance of Interest Paid to Shareholders. The Assembly proposal would eliminate the disallowance of a deduction for interest paid to shareholders.

Rate. The rate would be reduced to 6.75%, the same rate applicable to individuals.

Alternative Minimum Tax. The Assembly proposal would adopt the Federal corporate AMT, with a 3% rate.

Investment Tax Credit. The proposal would make the same changes in the investment tax credit and employment credit that would be made in the Governor's proposal and the Senate proposal, and it would limit a taxpayer's annual use of the credits to $10 million.

F. RECOMMENDATIONS

We have the following comments and recommendations:

1. General

(a) We commend the Governor for his early announcement that New York would return the windfall, for his commissioning of COFEP to study and make recommendations about the issue, and for his submission to the special session of the legislature in December of a bill that would implement the COFEP approach. Because the Governor's bill was intended only to deal with the windfall, it did not address the further question, which is presented in the COFEP report, the Senate majority's bill, the Comptroller's recommendations, and the Assembly majority's proposal, of a substantial tax cut. By his February 20 announcement, the Governor has now begun to address that issue as well, which we also approve.

(b) We agree with the suggestions of COFEP, the Comptroller, the Senate and Assembly majorities, and now the Governor, to the effect that a mere return of the windfall is not enough. New York must recognize that high tax rates have a very adverse effect on its economy.

2. Personal Income Tax

With respect to the various proposals for changes in the personal income tax, we have the following specific recommendations:

(a) We approve the concept of requiring joint return filing in New York to conform with Federal joint return filing, so long as the rate schedule that is adopted does not (when combined with the two-earner deduction) produce a significant marriage penalty.

(b) We support the proposal to eliminate the P.C. pension and other add-backs from the personal income tax.

(c) We would like to point out that the law contains a different defect relating to pensions for self-employed persons that should also be corrected. Section 612(c)(3) grants an exclusion for private pension payments up to $20,000. (New York State and local government pensions are 100% excludable.) The language used to describe the exclusion for employees includes payments from both qualified and nonqualified plans, whereas the language used to describe the exclusion for self-employed persons is limited to payments from qualified plans. This may be a drafting oversight. The provisions should be parallel, and payments from nonqualified plans should qualify for the exclusion for self-employed persons just as they do for employees.

(d) We believe the S corporation proposals contained in the Governor's bill should not be adopted. The imposition of a New York franchise tax on the portion of the S corporation income attributable to non-resident shareholders would

reduce the net worth of the New York resident shareholders as well. In addition, the IRS is likely to hold that the deduction of the corporate franchise tax for Federal income tax purposes could not be marshalled against the income of the non- resident shareholders. Compare Rev. Rul. 87-14. Moreover, we see no reason why the shareholders of the corporation should not be able to make a separate S election at the State level. The analogy to a partnership is not appropriate. A partnership does not have the ability to elect corporate tax treatment. On the other hand, a qualifying corporation has the option to be taxed as a corporation or to make an S election. Merely because the corporation makes a Federal S election, it does not follow that it should have to make a State-S election.

The simplicity objective of the provision could be achieved in a different way, simply by allowing a corporation which has properly made a Federal S election to make its State election as late as the time it files its first State S return (to which the consents of all the shareholders could be attached).

(e) We object to the portion of the Senate bill that would keep the present add-on form of the New York minimum tax. The Governor's proposal would conform the minimum tax to the Federal AMT which we regard as preferable if a minimum tax is to be retained in New York. In addition, the Federal AMT disallows all deductions for all State and local taxes. If New York adopts an AMT, we do not believe it is appropriate (because of New York's strongly held belief that deductions should be allowed for State and local taxes) for New York to conform to this aspect of the statute. Although income taxes should not be deductible in computing the AMT,

other State and local taxes should be and, as in the case of the regular tax, a credit should be allowed for the income taxes of other States.

(f) The personal income tax rate schedules in the Senate majority proposal of 4% and 7% are noticeably lower than those proposed by the Governor. Such lower rates would help make New York more competitive. The rates proposed by the Senate majority for its "postcard tax" of 5.5% and by the Assembly majority for its "FAST" tax of 6.75% are lower still (although the Assembly's proposed phase-out of the standard deduction means that its effective rate on income above $75,000 will actually be higher than 6.75%), but they achieve that result by turning the tax in part into a gross income tax. The COFEP proposal for a "simple tax" was similar, though it did not call for such a low rate. A system such as these "postcard", "FAST", or "simple" taxes would disallow the deduction of interest and other expenses involved in earning investment income. New Jersey has such a tax system, which it candidly describes as a "gross income" tax. We recommend against such an approach because we believe the income tax should be a net income tax rather than a gross income tax. We also note that these proposals would disallow deductions for such items allowed by the Federal law as charitable deductions, medical expenses, home mortgage interest and property taxes (except for the Assembly proposal, which would allow a deduction for property taxes).

(g) The Senate majority's "postcard tax" appears only as an optional alternative to the regular income tax and not as a substitute for it (as COFEP and the Assembly majority have proposed). We recommend against this optional aspect.

We object to the complexity of any system that would require the taxpayer to compute his tax under two alternative forms. We also object to the further complexity that would be created by the "alternate tax" included in the Senate bill.

(h) We disagree with the preservation in the Governor's proposals of a separate additional tax on unearned income. This separate high-rate tax should be eliminated. Moreover, the "notch" effect in the Governor's proposal would produce anomalous results (which are described above) and should in any event be changed.

3. Corporate Franchise Tax

With respect to the corporate franchise tax, we generally approve of the approach taken in the Governor's and Senate's bills (including specifically their proposed repeal of the "income plus compensation" alternative tax base, and their proposed disallowance of a deduction for income taxes of other States), with the following exceptions:

(a) Should a decision be made to provide a special lower rate for "small business taxpayers", as is proposed in the Governor's and the Senate bills, the narrower definition of a small business corporation that is contained in the Governor's bill (which aggregates members of an affiliated group) is preferable to the broader definition contained in the Senate bill. Consideration might also be given to narrowing the provision still further with respect to commonly controlled corporations, as the Internal Revenue Code does in Section 1561.

(b) The Governor's bill would value property differently for purposes of the capital tax than for

purposes of the allocation formula. Although this adds a level of complexity to the law, we recognize that if the capital tax is retained this may be justified because of the different purposes of the two computations. With respect to the allocation formula itself, the Governor's and the Senate's proposals would include leased tangible personalty in the allocation formula. We believe this is a desirable change. However, the two proposals contain different valuation methods for all property in the allocation formula. The Governor's bill would value real and tangible personal property at acquisition cost whereas the Senate bill would value it at adjusted tax basis. We understand that acquisition cost is the valuation used in the Uniform Law (UDITPA) and thus is used by many other states. In choosing the UDITPA valuation for the allocation formula, the Governor's proposal would create greater uniformity and is preferable.

(c) We support the Senate's immediate repeal of the rule that would disallow interest paid to shareholders rather than the Governor's delayed repeal. In general, we think any system of arbitrary disallowance of a deduction for interest is not appropriate.

(d) We prefer the approach in the Senate bill (and the Governor's December, but not his February, bill) to recoupling with the Federal depreciation system. Conformity with the Federal system would simplify taxpayer compliance and Tax Department audits.

(e) Now that the Federal government has eliminated the investment tax credit, we question the wisdom of

retaining any kind of investment or employment credit in New York. The New York credits benefit only a narrow band of taxpayers. We are inclined to think that New York's competitive status would be improved if the credit were eliminated and the resulting tax saving was applied to reduce the corporate tax rate for all taxpayers.

(f) Consideration should be given to including in the New York tax law a provision corresponding to the new Federal provisions relating to "real estate mortgage investment conduits" (REMICs). This is a new type of pass-through entity, analogous to a regulated investment company or partnership, designed to hold interests in real estate mortgages. If the entity (which may in form be a corporation, partnership or trust) meets the statutory requirements and elects REMIC status (a) the entity itself is generally exempt from Federal income tax, (b) holders of so-called "regular interests" in the entity are taxed as debtholders in the entity, and (c) holders of so-called "residual interests" in the entity are taxed as partners in the entity. We believe the State's treatment of a REMIC and its owners should conform to the Federal treatment. The general conformity rules may be sufficient to assure conformity at the holder level (although further study would be required to be certain of this), but a new provision will be required to assure that the REMIC itself is not subject to State income or franchise tax.

(g) Another new provision that has been added to the Federal law is Section 501(c)(25) of the Internal Revenue Code, dealing with real estate ownership for exempt organizations. An anomaly in the New York law has been its absence of exemption provisions like those in Section 501 of

the Internal Revenue Code. The New York law should be amended to provide explicitly for exemptions for non-business corporations comparable to those provided by Section 501 of the Internal Revenue Code. The status of such corporations presently depends upon an implied nonapplicability of the corporate franchise tax to a corporation that does not have a business purpose. Although the status of an operating charitable organization may not be in doubt, there is a clear need to add to the New York law counterparts to Section 501(c)(2) and to new Section 501(c)(25) of the Internal Revenue Code. They are necessary in order to facilitate investment in New York real estate or other investment property by pension trusts and other exempt organizations through stock corporations that can insulate the other assets of exempt organizations foam potential liabilities such as those associated with real estate ownership. A bill passed by the New York legislature in 1966 would have rejected the illogical position of the tax regulations that the qualification for exemption under New York law of a Section 501(c)(2) corporation depends upon whether or not stock is issued. This bill was vetoed on the ground that such a specific exemption was incongruous in the context of a statute that had no general exemption provision. Thus, there is a pressing need for statutory clarification of the requirements for exemption from the franchise tax, and such clarification could be simply accomplished by statutory reference to the relevant Internal Revenue Code provisions.

(h) Banks and insurance companies are each taxed in New York under separate tax provisions that differ from the regular corporate franchise tax. We are not in a position to comment in detail here on the differing provisions in the

Governor's two bills and the Senate bill with respect to banks and insurance companies. We believe, however, that with respect to return of the windfall, the governing notion should be that the windfall from the banking industry should be returned to that industry (and the structure of the change should take into account the fact that New York disallows net operating loss carryovers for banks), and the windfall from the insurance industry should be returned to the insurance industry.

(i) We recommend that consideration be given to liberalizing the rules governing the ability of parent corporations to elect to file combined New York returns with their subsidiaries.

4. Sales Tax

We note that the Senate majority's bill would exempt clothing sales of $75 or less from the sales tax. We point out that this type of change can foster tax avoidance or evasion and makes audits more difficult. Adoption of such a change may also lead to pressures from others for additional exemptions. This would narrow the base of the sales tax without reducing its rate. Such base narrowing tends to perpetuate high rates -- indeed a major purpose of the 1986 Federal tax reform was to reverse this process in the case of the income tax -- and we believe that in the case of the sales tax as in the case of the income tax, the effort should be to resist the narrowing of the base and to focus tax reduction efforts on reducing the rate.

5. Real Property Transfer Tax and Gains Tax

The Governor's February bill would greatly expand the impact of the New York State Real Property Transfer Tax. As

revised, the tax would apply to acquisitions of control of entities holding real property in New York State; to transfers of contracts or options for the acquisition of real property; to the grant of certain long-term leaseholds; and to the assignment of virtually any leasehold.

The real property transfer tax changes are complex and deserve careful study before enactment. We question whether their enactment is sufficiently urgent that they should be put forward as part of the legislation that makes major amendments to the income tax law. They are unlikely to receive the attention they deserve if they are included in the current legislation, given the time pressures on enactment of income tax changes. If the real property transfer and gains taxes are to be amended in such major fashion the amendments should be brought forward in a separate bill so that they can be studied, discussed and commented on by professional and business groups who will be affected by the bill and responsible for its day to day practical administration.

There are now three separate standards for taxing transfers of real estate in New York State: those applicable under the real property gains tax; those applicable under the New York City property transfer tax; and those applicable under the proposed bill. The great majority of all transfers in New York State, at least if measured by value, are probably those in New York City. Persons having to deal with real estate in New York City are now faced with three separate statutory standards. This is expensive, complicated and frustrating. It seems to us important that at the earliest possible time a single standard for defining a taxable transfer should be developed to be applied under all three taxes.

Although we have had very little time to review the real property tax provisions in the Governor's February 20 bill, we have the following additional specific comments:

(a) The bill includes a "grandfather" provision that would prevent the application of the amended statute to transactions carried out pursuant to binding written contracts in existence on April 1, 1987. However, the new acquisition of control provisions may apply to reorganizations or acquisitions currently in process. Such transactions are frequently carried out pursuant to plans that are not contracts or binding agreements. We would therefore suggest that these provisions should not apply to any transaction that has been approved by the board of directors of one or more corporations involved in the transaction prior to April 1, 1987.

(b) Amended Section 1401(c) would include rights and specifically "air development rights" in the definition of real property interests. There has been considerable discussion over whether transferable development rights are real estate interests and the proposed amendment would appear to be the first legislative statement on this issue. The Gains Tax definition under Tax Law Section 1440 does not now make reference to air rights or development rights. It may be appropriate to state that this proposed definition is not intended to have real property law consequences.

(c) The definition of "consideration" in Section 1401(d) is modified to define the consideration given in connection with the creation of a leasehold interest. The definition provides that "consideration shall include but not be limited to the value of the rental and other

payments. "The words "but not be limited to" seem to us unnecessary and likely to cause confusion. We do not know of any consideration other than rent given in connection with the creation of a leasehold that is properly to be considered in determining the value of a lease. The bill also provides that "in the case of a controlling interest in an entity that owns real property, consideration shall mean the fair market value of the real property or interest therein" apportioned to the percentage interest acquired. This provision combined with the deletion of the exemption for donative transfers, may be read to create an unwarranted and unintended difference between acquisitions of entities and direct acquisitions of real property in gift or bargain sale transactions.

Example: If father transfers unencumbered Blackacre to son for no consideration, no transfer tax would be due. If father transfers all the stock of Corporation X, whose sole asset is Blackacre, to son for no consideration, it appears that a transfer tax would be due on the entire value of Blackacre.

We would therefore recommend that the exemption for donative transfers be restored in order to correct this technical problem.

(d) New Section 1401(d)(iii) provides for an apportionment of partnership interest transfers on the basis of percentage interests. Many real estate partnerships provide for variable percentage interests under different circumstances of cash flow, net return, or periods of time. It must be clarified how the percentage calculations would be made in such cases. In addition, guidance will be

necessary for quantification of contingent partnership interests.

(e) New Section 1401(e)(i) provides that conveyances will include leases or subleases only where they affect "substantially all of the premises." Where the real property consists of a large complex and a series of net leases or ground leases cover segments or quadrants of that property, is it intended that they not be affected by the tax? This problem also presents itself under the Gains Tax.

(f) The proposed amendments would extend the real property transfer tax to the creation of a leasehold for a term of more than 49 years where the leasehold or subleasehold includes "substantially all of the premises constituting the real property." This is likely to cause serious interference with standard real estate transactions. We do not believe that in a typical commercial situation a grant of a leasehold of more than 49 years represents a transfer of the real property. It is merely a mechanism for the owner of the property to realize the income stream attributable to the property. The imposition of tax in such cases will simply make it more difficult to develop properties in New York since the tax must be paid at the time of the grant of the leasehold. Typically such leases are granted where the tenant is going to improve the property and wants a long term lease because of the amount and the extent of its investment in the improvements. If this tax must be paid when the lease is granted, the lessor is likely to pass the cost of this tax along to the lessee by increasing the rent payments. This in turn will increase the cost of occupancy for the ultimate tenants, making it more expensive to do business in New York. We simply do not

agree with the premise that a grant of a lease for more than 49 years is in effect a transfer of the real property itself. If the fair rent on a ground lease is 9% of the value of the ground and a fee interest is worth $1,000,000, a grant of the lease for 60 years (for example) at $90,000 a year is simply a way for the landlord to receive the income stream attributable to the ownership of the property. At the end of the term of the lease he will still own t h fee interest.

Let us assume further that the real property taxes on X's property are $15,000 a year and that, as is common in ground lease transactions, a term of the lease requires Y to pay the real property taxes imposed on X, i.e., Y agrees to make an annual net rent payment to X of $90,000 a year. Under these circumstances, if X grants to Y a 60 year lease the gross value of the rental payments will be $1,264,000. Thus, X will pay a transfer tax on a value substantially in excess of the actual tax that would be imposed if he had disposed of the fee interest in the property for fair market value.

If the concern here is that grants of long term leases can be used to avoid the imposition of the transfer tax by coupling a high-rent lease with a bargain option to purchase, we do not understand why a grant of a lease for more than 49 years should be treated as a transfer where the grant is not combined with an option to purchase the property. There are in particular three reasons why this proposal is more objectionable than the very similar provision contained in the gains tax. First, unlike the gains tax, the grantee must pay the transfer tax if the grantor is exempt. Imposing a stiff tax at the outset on a

long-term leasehold may make it more difficult for state agencies and other exempt grantors to grant long-term leases to developers and others. Second, unlike the gains tax, the transfer tax is based on gross, rather than net, income (albeit at much lower rates). Third, there is no provision for installment payments of transfer tax (as there is for the gains tax).

(g) The proposed amendment to Section 1404 would impose the tax as the joint and several liability of the grantor and grantee. Is this intended to mean that the tax need not be asserted against the grantor in the first instance or that the Commission may proceed immediately against the grantee? Does it give a paying grantee a right of subrogation against its grantor?

(h) The tax should not apply to a conveyance pursuant to a foreclosure sale or to a transfer in lieu of foreclosure, or to a comparable transaction where the conveyance is of stock or interests in a partnership. Alternatively, the exclusions provided in new Section 1401(e) or in 1401(f) or (g) should clarify whether a foreclosing mortgagee is responsible for the tax. Note that Tax Law Section 1440(7) covering the Gains Tax definition specifically excludes mortgage release or modification transactions.

(i) The draft statute eliminates the exemption for deeds or conveyances without consideration, including deeds conveying realty as bona fide gifts. We are concerned that if this exemption is eliminated the transfer tax may apply in connection with the transfer by a decedent to his estate or by an estate or testamentary trust to its beneficiaries

upon termination. We note that the gains tax does provide specific exemptions for transfers by devise, bequest, or inheritance. We suggest a similar exemption here.

(j) The proposed amendment to Section 1405(b)(4) would provide for exemption where the "consideration" for acquisition of a controlling interest is less than $500,000. The exemption should probably relate to the property value and not to the stock or partnership interest value. The exemption should be applied separately to each individual property owned by the entity, as is the case now in the Gains Tax, and should not apply to the total value of property owned by the entity.

(k) A particularly annoying feature of both the gains tax and the New York City "Pan-Am" legislation is the application of both taxes to corporate takeover acquisition and merger transactions where the ownership of real estate is a minor incident to a transaction motivated primarily by the desire to acquire a corporation or to merge existing corporations. It is our understanding that the extension of the real property transfer tax to acquisitions of control is designed primarily to prevent the avoidance of the transfer tax. We would therefore urge that an exemption be provided in connection with acquisitions of control where the value of the real property located in New York State is less than some fraction, perhaps 1/3, of the total value of the assets of the corporations or partnership with respect to which there has been an acquisition of control.

(l) The amendment to Section 1405(b)(6) would leave unclear whether a corporate merger or dissolution continues to be covered by exemption from tax. The transmitting memorandum simply recites that a change has been made but leaves unclear whether the new "change of form" exception is intended to continue to be applicable to a corporate merger or dissolution. Although we approve the addition of an exception for conveyances consisting of a mere change of identity or form of ownership or organization, we believe the deletion of the exemption from the tax for mergers, dissolutions and consolidations could lead to double tax in some situations. For example, assume that corporations A and B are each worth $1,000,000 and that each corporation has as its sole asset New York State real property. Assume that corporation A merges into corporation B with A's shareholders receiving stock of corporation B in connection with the merger. This transaction would appear to result in an acquisition of control of 50% of the stock of corporation B by the shareholders of corporation A and an acquisition of control of 50% of corporation A by the shareholders of corporation B. Presumably both these transactions will be subject to transfer tax. However, if the exception for mergers is eliminated from the statute it would seem that corporation A might also be considered subject to tax with respect to its transfer of real property to corporation B. If this is not the intended result the statute should be clarified in this respect. We would suggest that the simplest method of clarifying the statute is to restore to the draft the exemption for conveyances arising from mergers or consolidations of corporations.

(m) We believe that the proposed "phase-out" of the credit in Section 1405-A for tax paid with respect to a

leasehold is wrong and results in a multiple taxation of the consideration paid in a transaction. For example, assume that X owns a fee interest worth $1,000,000 and that the fair rent for the property is $90,000 per annum. Assume that he grants a 60 year lease with respect to the property to Y and that the lease provides for an option to purchase the property at the end of 40 years for $1,000,000. The discounted value of the rental payments in this situation is $1,083,000 and consequently X will pay a real property transfer tax on that amount. If on a subsequent sale the credit is only allowed with respect to 1/3 of the tax paid at the time the lease was granted X will have paid a total transfer tax on 1-2/3 times the value of the property.

(n) Proposed new Section 1409(b) implies that all party participants in grantor and grantee must sign the return, even though a return signed by one representative might be (reluctantly?) acceptable. Signature by one party participant for each side to the transaction should be permitted with specified continuing liability by all.

(o) Proposed new Section 1411, which discusses the assessment procedure, should make clear that notice of a proposed assessment will be sent simultaneously both to grantor and grantee. Since the grantee may become liable, it should have the right to intervene or participate earlier in the proceedings.

(p) Proposed new Section 1415(d) gives the commissioner the right to judge whether a particular transaction format was used to avoid the tax rather than for "adequate business purpose." This is a vague and meaningless standard. Query

also whether this is an improper substitution of business judgment for that of the participants?

(q) Proposed Section 1446(e) modifies and amends the real property gains tax to require the payment of interest with respect to deferred installments of tax. The provision would seem to require the payment of interest at a floating rate which would be two percentage points above the rate charged on tax deficiencies as in force from time to time. We would suggest that as a matter of simplification and fairness the rate charged -- if interest is to be charged at all -- should be the rate in force for deficiencies at the time the transaction is entered into. The rate called for under this proposed amendment is in effect two percentage points above the commercial prime rate with interest being compounded daily. It is our experience that in many real property sales where deferred payments are provided for the interest rates charged are not equal to commercial arms-length rates. In other words sellers of real property frequently charge rates lower than the commercial arms-length rate that would be charged by a lender in a comparable transaction.