Memorandum Recommending Changes in New York City Income Tax Treatment of Federal S Corporation Shareholders (With a Separate Recommendation Regarding New York City Corporation Tax Treatment of Federal S Corporations That Are the Subject of Internal Revenue Code § 338 Elections.)[1]

This memorandum recommends changes in the New York City income tax treatment of City shareholders of Federal S Corporations that are New York State S corporations to correct the existing disharmony with the treatment of shareholders of Federal S – New York State C corporations. The memorandum also recommends a separate statutory amendment to the New York City Administrative Code provisions relating to corporation taxes to harmonize the New York City corporation tax treatment of Federal S corporations with the Federal treatment where the corporation may be subject to an Internal Revenue Code of 1986 (the "Code") § 338(g) election. The existing disharmony in the New York State and City treatment of S corporations under the personal income tax has been highlighted by proposed amendments to the rules governing the New York City General Corporation Tax and the New York City Banking Corporation Tax issued in July, 2001, with respect to the effect of elections under Code § 338(h)(10) on S corporations at the corporate level.

Background - S Corporations under New York State and New York City Tax Laws

For New York State Franchise Tax or Banking Corporation Tax purposes, the shareholders of a Federal S corporation can make an election that causes it to be a New York State S corporation. Tax Law §§ 208, subd. 1-A, 660 and 1450(f). All shareholders of the corporation must join in the election. Federal S corporations that do not effect a New York State S election are "New York C corporations." *Ibid.* A resident shareholder of a New York S corporation makes the same adjustments to his or her share of S corporation items in arriving at New York taxable income as with respect to items realized directly, Tax Law § 617, but otherwise S corporation items of the shareholder remain subject to New York State personal income tax. A New York S corporation is, in general, subject to tax on its entire net income at the regular franchise tax rate less the Article 22 (personal income) tax equivalent rate. Tax Law §§ 210, subd. 1(g), 1455(c).

In the case of a Federal S corporation that is a New York C corporation, a New York resident individual shareholder makes adjustments in arriving at New York adjusted gross income to subtract items of income, Tax Law § 612 (c)(22), or to add items of loss or deduction, Tax Law § 612 (b)(19), flowing through from the corporation under Code § 1366, and to eliminate any other New York modifications relating to those items. Tax Law § 612(e)(2).

---

[1] This report was prepared by Robert J. Levinsohn with helpful comments provided by Carolyn Lee, Maria Jones, Arthur Rosen, Hollis Hyans, Diana Wollman, Michael Schler, Robert E. Brown and Robert A. Jacobs.

There also is an add-back to adjusted gross income under Tax Law § 612(b)(20) for corporate distributions not included in Federal gross income under Subchapter S, with ordinary income treatment for distributions taxed as capital gain under Code § 1368(b)(2). In arriving at taxable income, the shareholder of a Federal S - New York C corporation must eliminate S corporation deductions included in Federal itemized deductions, Tax Law § 615(c)(6)(A), and must eliminate any other New York modifications relating to those deductions. Tax Law § 615(e)(2). Where gain or loss is recognized for Federal income tax purposes upon the disposition of stock of a Federal S - New York C corporation, the shareholder must add to Federal adjusted gross income the amount of any increase in basis with respect to her stock or indebtedness pursuant to Code § 1367(a)(1)(A) and (B), Tax Law § 612(n)(1), and must subtract from Federal adjusted gross income both the amount of any reduction in basis with respect to such stock or indebtedness pursuant to Code § 1367 (a)(2)(B) and (C), Tax Law § 612(n)(2)(A), and the amount of any corporate distributions added back under § 612(b)(20), *supra* (which would have reduced basis for Federal purposes). Tax Law § 612(n)(2)(B). See Tax Law § 612(b)(21) and (c)(21). All these adjustments are made without regard to whether a portion of the corporation's income is not taxed by New York under the allocation provisions of Tax Law § 210, subd. 3. The intent is to subject the income of a Federal S-New York C corporation to no more than a single New York State tax, at the corporate level.

New York City does not recognize S corporations. For New York City General Corporation Tax purposes, a Federal S corporation is taxed as a C corporation regardless of whether it is a New York S corporation.[2] If the corporation is a New York State C corporation, New York City shareholders get the identical adjustments for New York City personal income tax purposes as described above for New York State C corporation shareholders of a Federal S corporation.[3] On the other hand, a New York City shareholder of a New York S corporation is stuck with the same inclusion in his City taxable income of flow-through S corporation items as in his State taxable income, even though this income is also subject to tax by the City at the corporate level. Adm. Code §§ 11-1712(e)(1), 11-1715(e)(1), 11-1717(a).

Relevant Aspects of Code § 338

There are two elections under Code § 338. The basic Code § 338 election (sometimes referred to as a § 338(a) or § 338(g) election) permits a corporate purchaser of at least 80% of the stock of a target corporation to elect to obtain a stepped-up basis in the target's assets by having the target (denominated as Old Target) treated as if it sold its assets to an unrelated person (the same target corporation denoted as New Target), thus realizing at the

---

[2] Adm. Code § 11-602, subd. 8(ii). There is now no corresponding provision in the City Banking Corporation Tax law. The statutory amendment to conform the Banking Corporation Tax to the General Corporation Tax treatment of S corporations is included in § 47 of the omnibus legislation, currently numbered A.3823, S.1729, which passed the State Senate in both the 1999 and 2001 sessions, and currently remains stalled in the Assembly. See paragraph 4 of our letter of May 17, 2000, Report #975, which recommended enactment of the legislation.

[3] In fact, all of the up and down modifications in arriving at City adjusted gross income are identical to those in the Tax Law, and, on the New York income tax return, the City tax rates are applied directly to the figure for State taxable income. *See,* Adm. Code §§ 11-1712(b)(19), (20) and (21), (c) (21) and (22), (e)(2) and (n), 11-1715(c)(6)(A) and (e)(2).

corporate level any appreciation in the value of its assets.[4] An individual purchaser cannot make a § 338 election.[5] However, individual stockholders can be the sellers of a target corporation eligible for a basic §338 election.[6] Furthermore, there is nothing that precludes an individually owned Subchapter S corporation from being the target of a basic § 338 election.[7] In such case, old target files a return as a C corporation for the acquisition date reflecting the deemed sale, and, for purposes of this return, old target is, with certain exceptions, a component member of the purchasing corporation's controlled group.[8] A Code § 338(g) election has no effect on the taxability of a sale by individual S corporation shareholders *i.e.*, they will compute gain or loss on the sale of their stock in the same manner as if no election had been made.

The second election, under Code § 338(h)(10), which automatically includes a basic Code § 338 election,[9] is made jointly by the selling stockholders and the purchasing corporation. The only sellers eligible for a Code § 338(h)(10) election are a consolidated group, an unconsolidated affiliate, or S corporation shareholders.[10] Shareholders of a target S corporation who do not sell their stock also must consent to the Code § 338(h)(10) election.[11] Although Code § 338(h)(10)(A) provides that the effect of the election is nonrecognition of gain or loss at the shareholder level on the sale of the target corporation stock, the regulations provide for the treatment of the target corporation as if it distributed its assets in complete liquidation and ceased to exist after the deemed asset sale by the corporation, before the close of the acquisition date, and while old target is a member of the selling group or owned by the S corporation shareholders.[12] The continuing corporation, treated as new target, gets a stepped-up basis for its assets (technically adjusted grossed-up basis or AGUB) to the same extent as under the basic Code § 338(g) election, equivalent to the amount for which it is deemed to have purchased all of its assets from old target.[13] Treas. Reg. § 1.338-10(a)(3) (note 8, *supra*) does not apply where there is a Code § 338 (h)(10) election;[14] instead, when target is an S corporation, its S election continues in effect through the close of the acquisition date (including the time of the deemed asset sale and the deemed liquidation).[15] Accordingly, S corporation shareholders (whether or not they sell their stock) take their pro rata share of the corporate level deemed sale tax

---

[4] *See* Treas. Reg. § 1.338-1(a)(1). All references, unless otherwise indicated, are to the final regulations adopted in T.D. 8940, February 12, 2001, 2001-15 I.R.B. 1016.

[5] Treas. Reg. § 1.338-3(b)(1).

[6] Treas. Reg. § 1.338-2(b)(7).

[7] *See* Treas. Reg. §§ 1.338-2(c)(9), 1.338-10(a)(3). *See also* Code § 1362(e)(6)(C).

[8] Treas. Reg. § 1.338-10(a)(3). We assume the contrary provision of Treas. Reg. § 1.338-10(a)(5) is not meant to apply to S corporations where there is no § 338(h)(10) election.

[9] Treas. Reg. § 1.338(h)(10)-1(c)(3).

[10] Treas. Reg. § 1.338(h)(10)-1(c)(1). Code § 338(h)(10) elections were first extended to unconsolidated affiliates and S corporations by final regulations published in T.D. 8515, 1994-1 C.B. 89. *See* preamble at 1994-1 C.B. 90-1.

[11] Treas. Reg. § 1.338(h)(10)-1(c)(2).

[12] Treas. Reg. §§ 1.338-1(a)(1), 1.338(h)(10)-1(d)(4).

[13] Treas. Reg. §§ 1.338-5, 1.338(h)(10)-1(d)(2).

[14] Treas. Reg. § 1.338-10(a)(1).

[15] Treas. Reg. § 1.338(h)(10)-1(d)(3)(i).

consequences into account under Code § 1366 and increase or decrease their basis in target stock under Code § 1367.[16] S corporation shareholders (as well as members of the selling consolidated group or the selling affiliate) who sell their stock, recognize no gain or loss on the sale of the target stock, although they may recognize gain or loss in the liquidation of target.[17] A nonselling S corporation shareholder is treated as acquiring the retained stock of target on the day after the acquisition date for its fair market value, with a holding period starting on that date.[18]

The S corporation shareholders who sell their stock with a Code § 338(h)(10) election, in effect, may receive varying amounts per share from the purchaser (negotiated to compensate the sellers for adverse tax consequences resulting from varying Federal and state tax liabilities they may bear as a result of the election, or for other reasons). This stock purchase price variance will not cause the S corporation to have more than one class of stock that would disqualify the S election as of the acquisition date, provided the varying amounts are determined in arm's length negotiations between the purchaser and selling shareholders.[19]

If a Code § 338(h)(10) election is invalid for any reason, the § 338 election for the target is also not valid.[20]

The New York City Rules

Existing New York City rules governing the General Corporation Tax and the Banking Corporation Tax make no mention of the basic Code § 338 election. Presumably it was thought that no elaboration of the City tax consequences was needed, because they would follow automatically from the use of Federal taxable income as a base,[21] including the consequences of the corporate level deemed sale, with target treated as a C corporation even if it was a Federal S corporation.[22]

With respect to elections under Code § 338(h)(10), existing Rules §11-27(h) and § 3-03(b)(2)(iii) provide that taxable income does not include any gain or loss on the sale or exchange of stock of a target corporation that is not recognized by virtue of the § 338 election

---

[16] Treas. Reg. § 1.338(h)(10)-1(d)(5)(i).

[17] Treas. Reg. § 1.338(h)(10)-1(d)(5)(iii). The overall effect is supposed to be the recognition of net gain or loss equal to the amount of built-in gain or loss in the S corporation stock immediately before the stock purchase. In the case of a selling consolidated group or selling affiliate, it usually will recognize no gain or loss on the deemed liquidation, under § 332. *See* Preamble to Notice of Proposed Rulemaking, REG-107069-97, 1999-2 C.B. 346, 348.

[18] Treas. Reg. § 1.338(h)(10)-1(d)(5)(ii).

[19] Treas. Reg. § 1.1361-1(l)(2)(v), as amended by T.D. 8940.

[20] Treas. Reg. § 1.338(h)(10)-1(c)(4).

[21] Rules §§ 11-27, 3-03(b)(2).

[22] *See* text at note 8, *supra*. Note that the City requires a corporation included in a Federal consolidated group to compute its taxable income on a separate basis. Rules §§ 11-27(h), 3 03(b)(2)(iii).

only if the selling corporation files on a combined report for New York City purposes with the target corporation for the period including the acquisition date.[23]

The proposed rules make the following changes:[24]

(1) In the case of target C corporations, the requirement of filing on a combined report for New York City purposes is eliminated. In the case of Code § 338(h)(10) elections affecting both Federal consolidated groups and affiliated target corporations that are members of a selling affiliated group that does not file a Federal consolidated return, (a) the taxable income of the target corporation will include any gain or loss on the deemed asset sale by the target corporation recognized by virtue of the 338(h)(10) election, and (b) the taxable income (i) of a City taxpayer that is a member of the selling consolidated group or (ii) of an unconsolidated selling affiliate will not include any gain or loss on the sale or exchange of stock of the target not recognized by virtue of the 338(h)(10) election. The possibility under the existing rules that a Federal consolidated group would lose the benefit of the 338(h)(10) election for City purposes because it is not permitted to file a City combined report would thus disappear.

(2) In the case of target S corporations, the proposed rules provide:

(a) Any election pursuant to Code § 338(h)(10) will be deemed to be an invalid election and will not be recognized for purposes of the General Corporation and Banking Corporation taxes.

(b) Where the Code § 338(h)(10) election is thus not recognized, the corresponding election pursuant to Code § 338(g) also will be deemed invalid and will not be recognized.

(c) Accordingly, the basis of the assets of the target corporation will be determined without regard to any adjustments made pursuant to Code § 338(b).

These provisions are stated to be based upon the following rationale:

(d) The starting point for determining the entire net income of an S corporation is the taxable income that the corporation would have been required to report for Federal tax purposes had no S election been made.[25]

(e) Without an S election, a Corporation owned by individuals cannot make a Code § 338(h)(10) election.[26]

---

[23] This provision was adopted January 13, 1992, before the extension of Code § 338(h)(10) elections to unconsolidated affiliates and S corporations by T.D. 8515 in 1994, note 10 *supra*. Combined New York City reports may be filed only where required or permitted by the Commissioner of Finance. Rules §§ 11-91(a) and 3-05(b).

[24] Substantially identical amendments are proposed to the rules both under the General Corporation Tax and the Banking Corporation Tax.

[25] *See* note 2, *supra*.

(f) If a Code § 338(h)(10) election is invalid for any reason, the Code § 338 election for the target is also not valid.[27]

Given the City's treatment of S corporations as C corporations, we concluded that no substantive comment was appropriate on behalf of the Tax Section with respect to these proposed rules. Point (a) seems necessarily to follow from points (d) and (e). Point (b) also would follow from point (f).

The Federal regulations contain only one example of the application of a Code § 338(h)(10) election to an S corporation.[28] Without repeating all the facts here, and putting aside the complications arising from shareholder B's sale of his stock in part for an installment note, we focus on shareholder A, with 40% of the stock and an adjusted basis of $10,000, and shareholder C, with 20% of the stock and a basis of $5,000. A's stock is sold for $40,000 in cash (B also sells). C does not sell, but joins with A, B and the purchaser in making a Code § 338(h)(10) election. Target's sole asset is real estate with a value of $110,000 and an adjusted basis of $35,000, encumbered by purchase money indebtedness of $10,000. In Year 1, old target is deemed to receive $75,000 cash, with $56,250 gain attributable to the sale and $18,750 recovery of basis. The consequences to A and C are described as follows:

> "(v) Under section 1366, A reports 40 percent, or $22,500, of old T's $56,250 gain recognized in Year 1. Under section 1367, this increases A's $10,000 adjusted basis in the T stock to $32,500. Next, in old T's deemed liquidation, A is considered to receive $40,000 for its old T shares, causing it to recognize an additional $7,500 gain in Year 1.
>
> ***
>
> "(vii) Under section 1366, C reports 20 percent, or $11,250, of old T's $56,250 gain recognized in Year 1. Under section 1367, this increases C's $5,000 adjusted basis in its T stock to $16,250. Next, in old T's deemed liquidation, C is considered to receive $20,000 for its old T shares, causing it to recognize an additional $3,750 gain in Year 1. Finally, under paragraph (d) (5) (ii) of this section, C is considered to acquire its stock in T on the day after the acquisition date for $20,000 (fair market value – grossed-up amount realized of $100,000 x 20%). C's holding period in the stock deemed received in new T begins at that time."

Although Example 10 does not spell out the calculation of new target's AGUB, under the rules discussed in the text at footnote 13, *supra*, new target's inside basis in its assets would be stepped up to the grossed-up amount deemed realized on the sale of old target's stock, calculated under Treas. Reg. § 1.338-4(c).

If the proposed rules are adopted, old target's deemed gain of $56,250 will be eliminated for City corporation tax purposes and there will be no step-up in the inside basis of

---

[26] *See* text at note 10, *supra*.

[27] *See* text at note 20, *supra*.

[28] Treas. Reg. § 1.338(h)(10)-1(e), Ex. 10.

new target's assets. If target is a New York C corporation, the adjustments for A and C described above also should be eliminated.[29] A, if a City taxpayer, will report the same $30,000 actual gain ($40,000 selling price minus $10,000 basis) as the total deemed gain ($22,500 plus $7,500) under (v) above. C, who made no actual sale, will have no gain or loss as a City taxpayer.

If target is a New York State S corporation, the shareholders will have no adjustments from Federal treatment for City income tax purposes.[30] A will be no worse off, with the same total reportable gain of $30,000. However, C will be stuck with reporting $15,000 of imaginary gain ($11,750 plus $3,250), compensated for only by an increase in her stock basis from $5,000 to $20,000, but without any increase in the inside basis for City corporation tax purposes of the assets of the corporation in which she remains a shareholder.[31]

Recommendations

The disproportionate New York City tax burden imposed on shareholder C in the Code § 338 example discussed above where a New York State S election is in effect serves to highlight the unfairness of the existing City income tax scheme applicable to City shareholders of New York S corporations. One reason the problem has not been addressed in the past may well be that the City's taxing jurisdiction is limited to administration of the tax at the corporate level, while the City income tax applicable to shareholders is administered by the State.

From an overall perspective, the simplest cure for the disharmony at the shareholder level arising from the difference between the City and State treatment of S corporations at the corporate level would be for the City to recognize State S corporation elections as controlling for City corporation tax purposes. We understand the City has in the past considered repealing, reducing, or providing credits in respect of the corporate-level tax on S corporations, to move closer to State conformity. However, revenue concerns, and in particular, the City's inability to tax nonresidents on income flowing from S corporations, present obstacles to City corporate pass-through treatment that do not exist at the State or Federal level. We appreciate the City's revenue concerns, particularly in the current economic environment. Nevertheless, because we are concerned that the ongoing lack of S corporation conformity may present a barrier to new business development in the City, we suggest that this topic is worth continued exploration. Ideally, from a tax policy and tax simplicity perspective, the City would treat electing S corporations in the same manner as the State taxing statutes do. Assuming that complete State S corporation conformity is currently unattainable, we have two alternative

---

[29] *See* page 2 above. The gain inclusions required under Code § 1366 by the regulations would be eliminated by Adm. Code § 11-1712(c)(22).

[30] *See* page 2 above.

[31] If this result remains in effect, and a City taxpayer in C's situation is well advised, he will not agree to the Code § 338(h)(10) election without compensation for the additional City tax burden he will incur. The consequences as a Federal tax matter of that compensation may not be covered by the discussion in the text at note 19 above. It is true that target could not have become a New York State S corporation in the first place without the consent of all the shareholders, Tax Law § 660(a), but C in the example might have agreed to that election without contemplating the possibility that some day the controlling shareholders might decide to sell their stock without C's participation in the sale.

recommendations for changes to eliminate the duplicative taxes that currently are imposed on New York City residents.

1. The change requiring the least legislative revision would be to extend to City shareholders of New York S corporations the same personal income tax addition and subtraction modifications already available under the State Tax Law to shareholders of Federal S corporations that are New York C corporations. See page 2, *supra*. This "fix" essentially would involve amending sections 11-1712 (b)(19) and (20), (c)(22) and (n), and 11-1715(c)(6)(A) of the New York City Administrative Code to delete the limitations to cases where "the election provided for in subsection (a) of section 660 of the Tax Law has not been made" or "was not in effect". The Administrative Code also should be amended to delete altogether section 11-1712 (b)(18), which provides for the addition to the Federal adjusted gross income of an S corporation shareholder of his pro rata share of the corporation's reduction for taxes imposed on the corporation that are described in Code § 1366(f) (2) and (3), only "where the election provided for in subsection (a) of section 660 of the Tax Law is in effect." Sections 11-1712(e)(2) and 11-1715(e)(2) of the Administrative Code also should be amended to delete the limitations to an S corporation that "is a New York C corporation." Sections 11-1712(e)(1), 11-1715(e)(1) and 11-1717 should be amended to delete all of the references to S corporations and their city resident shareholders. Finally, the sections of the Administrative Code relating to S termination years, sections 11-1712(b)(19)(B), (c)(22)(B), (e)(3) and (s), 11-1715(c)(6)(B) and (e)(3), should be deleted. With these changes, regardless of whether an S election has been made at the State level, proper effect would be given at the New York City income tax level to the circumstance that all Federal S corporations, regardless of their treatment at the New York State level, are treated as C corporations for New York City corporation tax purposes, so that their shareholders should always be taxed in the same manner as is currently applicable to City shareholders of Federal S-New York C corporations.

These Administrative Code amendments will require State legislation, and undoubtedly should be fashioned in consultation with the State Department of Taxation and Finance, because it administers the New York City personal income tax. In order to reflect the resulting differences (plus or minus) between City and State taxable income, which are now identical,[32] no more than two additional lines should be needed on the income tax form, corresponding to lines 21 and 28 of the 2000 Form IT-201.

Because the changes embodying this recommendation (in achieving exact parity of City income tax treatment for all City shareholders of Federal S corporations, whether the latter are New York State S or C corporations) would follow the model applying to New York State C corporations of allowing full elimination of flow-through S corporation items at the shareholder level even where a portion of the corporation's income is allocated outside the City,[33] there could be a net reduction of revenue going beyond that needed to eliminate double taxation whenever the subtraction adjustments exceed the addition adjustments in the aggregate.

2. An alternative avoiding the latter problem would be the allowance of a credit against personal income tax for City S corporation shareholders of a New York S

[32] *See* note 3, *supra*.

[33] *See* page 2, *supra*.

corporation for the latter's corporation tax, modeled on the existing UBT credit, which would require only one more line on Form IT-201-ATT, plus a new form similar to Form IT-219. A full credit would provide substantial equality of treatment with shareholders of New York C corporations, while limiting the shareholders tax reduction to no more than the City corporation tax actually paid by each S corporation. In no event could the severe phasing down for upper income taxpayers now applicable to the UBT credit be justified for this credit, because its purpose would be to eliminate a clearly unsupportable case of double taxation.

3. An additional proposal, having no direct effect on the shareholder income tax problem, would be an amendment to the Administrative Code corporation tax provisions to cure one of the anomalous effects of the City s proposed Code § 338 rule amendments. This amendment would provide that where a Federal Code § 338(h) (10) election is in effect for an S corporation, but is inoperative for City purposes because an unaffiliated C corporation target (which is what the S corporation is in the City s eyes) cannot be a party to the election, then the purchasing corporation can make the same basic Code § 338(g) type election for City corporation tax purposes it could have made in the first instance for Federal purposes had the Code § 338(h)(10) election not been made. This proposal would enable the purchaser to obtain a stepped-up basis for the target's assets for City corporation tax purposes and would involve the least possible departure from the Federal model, conforming the City treatment to the options available to a corporate purchaser of an unaffiliated target C corporation under Federal law. If the second, rather than the first, of the above two alternatives is adopted, the legislation should provide that shareholders of corporations affected by the proposed election that are New York S corporations will be treated for City income tax purposes in the same manner as under the Federal Code § 338(g) rules, with the corporation treated as a C corporation as of the date of sale and the shareholders realizing gain or loss only on the sale of their stock.

NY2:#4443686