S.8009 / A.9009 (Budget), Part R

STAFF CONTACT : Ken Pokalsky | Vice President | 518-694-4460

BILL S.8009 / A.9009 (Budget), Part R
SUBJECT Treatment of Federal Sub-S Corporations
DATE February 08, 2022
OPPOSE

The Business Council opposes this legislation that will eliminate flexibility under the State's Tax Law **to the detriment of small businesses**. The Legislature rejected similar language proposed in the FY 2022 Executive Budget, and we urge the Legislature to again preclude this proposal from the final budget agreement for FY 2023.

In short, this amendment would eliminate the ability of federal S-Corporations to make a choice regarding its treatment under New York State tax law.

Here is some quick background:

- Under the Internal Revenue Code, a corporation that meets specific criteria (including but not limited to having only certain individuals, trusts and estates as shareholders; having no more than 100 shareholders; having only one class of stock) can elect to be treated as an S-corporation. This election is made under Subchapter S of Chapter 1 of the Internal Revenue Code, and was adopted in 1958 for the benefit of small incorporated businesses.
- In general, S corporations do not pay income tax at the entity level. Instead, the corporation's income and losses are divided among and passed-through to its shareholders, and the individual shareholders pay tax on this business income under the personal income tax. In contrast, C-corporations pay entity-level income taxes at both the federal and New York State level. In addition, corporate earnings paid out to shareholders as dividends are also subject to both federal and state income taxes.

Unlike most states, New York does not automatically accept a business' federal S-corporation election. Instead, the business must (with a limited exception for investment corporations, see below) apply to, and be approved by, the state Department of Taxation and Finance for S-Corporation status at the state level. Under provisions of this legislation, however, New York would automatically treat any federal S-Corp as an S-Corp for state tax purposes.

Therefore, this legislation would eliminate the ability of a federal S-Corp to, in effect, elect either C- or S-Corporation treatment under New York State tax law.

The Executive Budget asserts that this amendment would “simplify corporation and shareholder New York tax filings” and “eliminate potential tax avoidance schemes.”

Importantly, New York taxpayers are not calling for this form of simplification, nor do they support the elimination of this state-level election. (If changes to encourage simplification are merited, New York taxpayers would most prefer automatic recognition of federal S-corporation status and an election to opt-into state-level C-corporation status.)

Further, removing the election would not be “simplification” for the nonresidents of New York whose only taxable connection to New York is through the ownership of stock in a federal S corporation that has not elected into New York S status. If the proposal is passed, those shareholders would for the first time be required to file returns in New York to report any income or loss passed-through to them from the corporation.

Moreover, the state’s Sub-S election provisions were already amended significantly in 2014 to eliminate a tax loophole identified by the Tax Department that allowed resident individuals to avoid New York State personal income taxes by placing assets from a Federal S corporation into a New York C corporation. As result of those amendments, it is already mandated that entities with more than 50 percent of their earnings from investments be treated as an S-corporation under New York Tax Law.

As a final point, the shareholders of a federal S/New York C corporation are permitted to deduct for federal income tax purposes the New York C corporation taxes paid by the corporation even if no PTET election is made. This is yet another benefit a separate New York S election provides to shareholders that does not impact the State’s revenues.

In summary, this amendment would have a limited impact on state revenues but would have a significant impact on certain small businesses operating in New York.

For these reasons, The Business Council urges the Senate and Assembly to reject S.8009/S.9009, Part R.