New York State Department of Taxation and Finance

Taxpayer Services Division

Technical Services Bureau

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(8) Corporation Tax
(11) Income Tax
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Taxation of S Corporations and Their Shareholders 1983-1984 Legislation

Chapter 606 of the Laws of 1984 signed into law on July 27, 1984, amends the corporate franchise tax and personal income tax laws pertaining to the tax treatment of S corporations and their shareholders in light of significant changes in federal S corporation taxation. The amendments are effective for taxable years of corporations beginning on or after January 1, 1983, except as otherwise noted.

ELECTION

A corporation can become art electing New York S corporation if all of the following requirements are met:

1) It is an S corporation for federal income tax purposes.

2) It is a corporation subject to tax under Article 9-A of the New York State Tax Law, relating to franchise tax on business corporations.

3) All of its shareholders make the election under section 660(a) of the personal income tax law.

An election to be treated as a New York S corporation must be made on Form CT-6. To be effective for the taxable year the election must be made:

1) At any time during the preceding taxable year, or

2) Within the first 75 days of a taxable year beginning in 1983, or

3) On or before the fifteenth day of the third month of the taxable year to which the election will apply. An election filed on or before the fifteenth day of the third month of the taxable year will not be effective until the following taxable year if, during the taxable year but prior to the date of election:

   a) the corporation did not qualify as an S corporation for federal tax purposes, under section 1361(b) of the Internal Revenue Code, on one or more days, or

   b) one or more of the shareholders who held stock prior to the date of election did not consent to the corporation being an S corporation.

Note: When federal and New York S elections are intended to apply to the same taxable year, the New York election must be made by the fifteenth day of the third month of the corporation's New York taxable year, even though the corporation has not yet received notice by the Internal Revenue Service that the federal S election has been accepted for the taxable year.

An election under section 660(a), to be treated as a New York S corporation is effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation until it is terminated under section 660(c) (see Termination on page 6).

Special Transitional Election Rules

Any election made under section 660, as it was in effect for taxable years beginning before January 1, 1983, shall be treated as an election made under section 660(a), as amended. Accordingly, the election of an existing New York S corporation will continue to be in effect until terminated under the provisions of this legislation. See "Termination" on page 6 of this memorandum.

Section 40 of Chapter 606 of the Laws of 1984, a noncode provision, provides that, notwithstanding any provision of section 660 of the Tax Law to the contrary, an election can be made at any time before October 25, 1984 for taxable years of an S corporation beginning after December 31, 1982. The election must be made on Form CT-6 and must indicate the first taxable year for which the election is to be effective. All provisions of section 660 shall apply in the case of this special election period to the extent not inconsistent with section 40.

Effect of Election on S Corporation

If all the shareholders of an S corporation have made an election under section 660(a) of the Tax Law, the New York S corporation will be exempt from the franchise tax under Article 9-A. However, the S corporation will continue to be subject to the following fee or recaptures:

1) Section 181.2 imposes an Annual Maintenance Fee of $200.00 upon foreign corporations that are authorized to do business in New York State. The maintenance fee is paid on Form CT-3S.

2) The tax from recomputing a prior year investment tax credit and/or retail enterprise tax credit pursuant to section 210.12(g). This tax applies only if the corporation claimed the investment tax credit and/or retail enterprise tax credit in a taxable year when it was not an electing New York S corporation. The recaptured tax is computed on Form CT-46 which must be attached to Form CT-3S, and the amount recaptured paid at that time.

3) The tax from recomputing a prior year research and development tax credit pursuant to section 210.18(f). This tax applies only if the corporation claimed the research and development tax credit in a taxable year when it was not an electing New York S corporation. The recaptured tax is computed on Form CT-42 which must be attached to Form CT-3S, and the amount recaptured paid at that time.

Credits arising from a year in which the election is not in effect can only be carried forward to other years in which the election is not in effect.

In a year in which it is taxable under Article 9-A a corporation may not apply a net operating loss derived from a year in which an election to be treated as an S corporation for New York was in effect.

Section 658(c) requires every electing New York S corporation to file an information return showing all items of income, loss, deduction and other pertinent information. The information return is filed on Form CT-3S. The return is due on or before the fifteenth day of the third month following the close of each taxable year. Failure to file the information return or failure to include the information requested will result in a penalty, imposed pursuant to section 685(h)(2). The penalty, to be paid by the S corporation, is $20.00 per shareholder per month or fraction of a month that the failure continues, not to exceed five months. All shareholders of the S corporation during any part of the taxable year who were subject to the New York State personal income tax must be counted. The penalty may be waived if it is shown that the failure is due to reasonable cause and not due to willful neglect. The penalty is effective for returns or statements due after December 31, 1984 (determined without regard to extensions).

Effect of Election on S Corporation Shareholders

Shareholders of electing New York S corporations must include their pro rata share of the S corporation's items of income, loss and deduction to the extent included in federal adjusted gross income for the taxable year. In addition, section 612(b)(18) requires the shareholders to increase their federal adjusted gross income by an amount equal to their pro rata share of the corporation's reduction for taxes pursuant to section 1366(f)(2) and (3) of the Internal Revenue Code, relating to the federal minimum tax, tax on certain capital gains and tax on certain passive investment income. If the federal reduction for taxes affects the determination of a net capital gain, the add-back required by section 612(b)(18) is limited to forty percent of the reduction for taxes.

Nonresident shareholders of electing New York S corporations include the above items in income to the extent derived from or connected with New York State sources. Section 637(a)(2) provides that in determining the amount derived from or connected with New York sources the corporation's business allocation percentage determined under Article 9-A is to be used.

In determining New York adjusted gross income, section 617(a), relating to resident shareholders, and section 637(c), relating to nonresident shareholders, require shareholders of electing New York S corporations and resident shareholders of foreign S corporations (not incorporated or doing business in New York State) to make any of the modifications in section 612(b) and 612(c) that relate to an S corporation item of income, loss or deduction in accordance with their pro rata shares. Nonresidents would make the modifications only to the extent the items are derived from or connected with New York sources. In addition, section 617(a) requires resident shareholders of both electing New York S corporations and foreign S corporations to make the modifications required by section 612(d), relating to the fiduciary adjustment, in accordance with their pro rata share of S corporation items of income, loss or deduction.

In determining the New York itemized deduction, section 617(a) and section 637(a)(3) provide that resident and nonresident shareholders of electing New York S corporations and resident shareholders of foreign S corporations must make the modifications described in section 615(c) and section 615(d)(2) and (3) which relate to their pro rata share of S corporation items.

Section 617(b) and section 637(e)(2) provide that the character of each item of S corporation income, loss or deduction for the shareholder will be the same for New York personal income taxes as it is for federal income tax purposes. If an item is not characterized for federal income tax purposes, the item will have the same character for the shareholder as if realized directly from the source from which it was realized by the S corporation, or incurred in the same manner as incurred by the S corporation.

Section 606(a)(9) was repealed (this section related to the flow through of investment tax credit property) and a new subsection (i) was added to section 606 to provide that a credit will be allowed to shareholders of electing New York S corporations after allowance of all other credits permitted under sections 606, 620, 621 and 640. The amount of the credit shall be the shareholders' pro rata share of the following credits determined for the electing New York S corporation's taxable year ending with or within the shareholder's taxable year:

1) The investment tax credit determined under section 210.12.

2) The retail enterprise tax credit determined under section 210.12(k).

3) The special additional mortgage recording tax credit determined under section 210.17.

4) The research and development tax credit determined under section 210.18.

In no case can the shareholder's pro rata share of the credits include a credit arising from property placed in service in a taxable year in which the corporation was not an electing New York S corporation.

Section 606(i)(2) provides that if the amount of the shareholder's tax credits exceeds his tax for the taxable year, the excess may be carried over and deducted from his tax in the following year or years. However, if the S corporation qualifies as a new business, as defined in section 210.12(j) of Article 9-A, the shareholder may, at his option, have the excess credit which relates to his pro rata share of the corporation's investment tax credit and/or retail enterprise tax credit refunded, provided the shareholder has not previously received a refund of any investment tax credit and/or retail enterprise tax credit.

Section 606(i)(3) provides that if the property for which the investment tax credit, retail enterprise tax credit or research and development tax credit was allowed to shareholders is disposed of or ceases to be in qualified use, and a redetermination of the credit is required pursuant to section 210.12(g) or section 210.18(f), each shareholder who was allowed the credit pursuant to section 606(i) will be attributed a pro rata share of the recaptured credit. If a shareholder's proportionate stock interest is reduced, it will be treated as a disposition of property for which a redetermination of credit is required for such shareholder.

The credits allowed the shareholder of an S corporation pursuant to section 606(i) cannot be applied against the following taxes:

1) The separate tax on the ordinary income portion of a lump sum distribution.

2) The separate tax on qualified higher education funds.

3) The minimum income tax on residents.

4) The minimum income tax on nonresidents.

Effect on Shareholder Where Election is Not Made

When the election provided for in section 660 can be made for the S corporation but it is not made, the shareholder must subtract from his federal itemized deductions, pursuant to section 615(c)(6), an amount equal to any S corporation items of deduction included in his federal itemized deductions to arrive at his New York itemized deduction. In addition, the following modifications are required for resident shareholders only:

I. Section 612(b)(19) provides that a shareholder of a non-electing New York S corporation must add to his federal adjusted gross income any item of loss or deduction of the corporation included in his federal gross income pursuant to section 1366 of the Internal Revenue Code. If any such item of loss or deduction affects the determination of a net capital gain for federal income tax purposes, the addition is limited to forty percent.

II. Section 612(b)(20) provides that any S corporation distributions must be added to the shareholder's federal adjusted gross income, to the extent not included in federal gross income for the taxable year because of Internal Revenue Code section 1368, relating to distributions, section 1371(e), relating to cash distributions during post-termination transition period, and section 1379(c), relating to transitional rules for distributions of undistributed taxable income, which represent amounts not previously subject to New York personal income tax because the election under section 660 had not been made. If any such distribution is treated as a capital gain for federal income tax purposes, the distribution shall be treated as ordinary income for New York personal income tax purposes.

III. Section 612(c)(22) provides that a shareholder of a non-electing New York S corporation must subtract from his federal adjusted gross income any item of income of the corporation included in his federal gross income pursuant to section 1366 of the Internal Revenue Code. If the item of income affects the determination of a net capital gain for federal income tax purposes, the subtraction is limited to forty percent.

IV. Sections 612(b)(21) and 612(c)(21) provide that an amount must be added to or subtracted from federal adjusted gross income upon the disposition of stock of a corporation which was a federal S corporation for any taxable year beginning after December 31, 1980. The amount to be added or subtracted, as the case may be, is determined under section 612(n). If the disposition affects the determination of a net capital gain for federal income tax purposes, the adjustment is limited to forty percent.

Section 612(n) provides for a shareholder to make the following adjustments in the taxable year he disposes of stock or indebtedness of an S corporation where gain or loss is recognized for federal income tax purposes:

1) The shareholder must add to his federal adjusted gross income an amount equal to the increase in the basis of his stock or indebtedness in the S corporation, for each taxable year after December 31, 1980 that the S corporation did not have an election under section 660 in effect, required by Internal Revenue Code section:

   a) 1376(a) (As such section was in effect for taxable years beginning before January 1, 1983) relating to amounts of undistributed taxable income that was required to be included in the shareholder's federal gross income.

   b) 1367(a)(1)(A) and (B) relating to S corporation items of income that were required to be included in the shareholder's federal gross income.

2) The shareholder must subtract from his federal adjusted gross income an amount equal to the reduction in the basis of his stock or indebtedness in the S corporation, for each taxable year after December 31, 1980 that the S corporation did not have an election under section 660 in effect, pursuant to Internal Revenue Code section:

   a) 1376(b) (As such section was in effect for taxable years beginning before January 1, 1983) relating to the shareholder's pro rata share of the corporation's net operating loss.

   b) 1367(a)(2)(B) and (C) relating to S corporation items of loss and deduction that were required to be included in the shareholder's federal gross income.

3) The shareholder must subtract from his federal adjusted gross income an amount equal to the sum of any modifications made with respect to his stock pursuant to section 612(b)(20).

A resident shareholder of a foreign S corporation (not incorporated or doing business in New York) is required to make any modification in section 612(b) and 612(c) that relate to the S corporation's items of income, loss and deduction. See page 3 of this memo. However, such shareholder is not required to make the modifications described in I through IV above.

Termination

Once made an election to be treated as an S corporation for New York purposes remains in effect until it is terminated pursuant to section 660(c).

Section 660(c) provides that an election to be treated as a New York S corporation will cease to be effective:

1) On the day an election to be treated as an S corporation for federal income tax purposes ceases under section 1362(d) of the Internal Revenue Code.

2) If shareholders owning a majority of the shares revoke the election. (See the discussion on revocation below.)

3) On the day a person becomes a new shareholder and such shareholder affirmatively refuses to consent to the section 460 election. In the case of a termination under this provision that is effective on a day other than the first day of the S corporation's taxable year, see the discussion of S termination year on page 8 of this memo.

Revocation

The revocation of an election to be treated as a New York S corporation is effective:

1) On the first day of the tax year if the revocation is made on or before the fifteenth day of the third month of the tax year

2) On the first day of the following tax year if the revocation is made after the fifteenth day of the third month of the tax year.

3) On the date specified if the revocation specifies a date on or after the date the revocation is made. In the case of a termination under this provision that is effective on a day other than the first day of the S corporation's taxable year, see discussion of S termination year on page 8 of this memo.

New York S corporation status may be revoked only if shareholders who collectively own more than 50% of the outstanding shares of the S corporation's stock consent to the revocation. The consenting shareholders must own their stock in the S corporation at the beginning of the day the revocation is filed. Pending the promulgation of regulations by the Tax Commission, the revocation must be made by filing a written statement with the Tax Commission containing the following information:

1) Name, address and ID number of the corporation.

2) The total number of shares of stock (including nonvoting stock) that is outstanding at the time revocation is made and the number held by each consenting shareholder.

3) Name, address, social security number and signature of each consenting shareholder.

4) A statement that the corporation is revoking its election to be treated as an S corporation under section 660(c)(2) of the New York Tax Law.

5) The date on which the revocation is to be effective.

The statement of revocation must be signed by an officer who is authorized to sign the S corporation return.

Special Transitional Termination Rules

Section 40 of Chapter 606 of the Laws of 1984, a noncode provision, provides that notwithstanding any provision of section 660 of the Tax Law to the contrary, a revocation by a majority of the shareholders can be made at any time before October 25, 1984 for taxable years of an S corporation beginning after December 31, 1982. The revocation must be made by filing a written statement with the Tax Commission containing the information detailed in "Revocation" above. All provisions of section 660 will apply in the case of this special revocation period to the extent not inconsistent.

S TERMINATION YEAR

An S termination year is the taxable year of a corporation in which the election to be treated as an S corporation for New York purposes ceases on a day other than the first day of such taxable year. When an S termination year occurs, the corporation is treated as a New York S corporation for part of the tax year and a corporation that is not an S corporation for the balance of the tax year.

The S termination year is divided into two periods. These periods do not affect the overall tax year of the corporation. They are only used for filing the two tax returns for the tax year for which the S corporation status is terminated and for allocating the shareholder's income between the periods. These periods are known as a CT-3S short year and a CT-3 short year.

Effect on Corporation

For corporate franchise tax purposes, entire net income is determined as if the federal subchapter S election had not been made. Entire net income is allocated to the CT-3 short year by multiplying entire net income by the following fraction:

$$\frac{\text{number of days in CT-3 short year}}{\text{number of days in S termination year}}$$

An exception to this rule of allocation occurs if all the shareholders make an election under section 612(s) to use normal accounting rules.

In no event will the tax for the CT-3 short year be less than the minimum tax. If the minimum tax applies it is based as follows:

1) If the CT-3 short year is more than nine months, the minimum tax is $250.

2) If the CT-3 short year is more than six months but not more than nine months, the minimum tax is $187.50.

3) If the CT-3 short year is six months or less, the minimum tax is $125.

Effect on Shareholder

For personal income tax purposes, an equal portion of the S corporation items of income, loss and deduction included in the shareholder's federal adjusted gross income, itemized deductions and any modifications attributable to such items are allocated to the CT-3S short year by multiplying such items by the following fraction:

$$\frac{\text{number of days in CT-3S short year}}{\text{number of days in S termination year}}$$

However, if all the shareholders during the CT-3S short year elect, the income allocated to the CT-3S short year will be determined based on normal accounting rules.

The shareholder's pro rata share of the S corporation items of income, loss and deduction is to be included in his tax year that includes the last day of the corporation's federal tax year.

After the shareholder has determined his pro rata share of the S corporation items allocated to the CT-3S period, including his allocated pro rata share of reduction for taxes required to be added back by section 612(b)(18) described earlier under "Effect of Election on S Corporation Shareholders", he must treat the balance of his pro rata share of the S corporation items included in his federal adjusted gross income and itemized deductions as attributable to the CT-3 short year and make the modifications in the following sections which pertain to shareholders of non-electing New York S corporations:

1) 612(b)(19) and (20)

2) 612(c)(22)

3) 615(c)(6)

Estimated Tax Penalty

Section 41 of Chapter 606 of the Laws of 1984, a noncode provision, provides that the penalty for underpayment of estimated tax will not be imposed on the portion of the underpayment attributable solely to provisions of this act. This provision only applies to installments due prior to July 27, 1984. For an underpayment to be considered attributable to a provision of Chapter 606 of the Laws of 1984, the provision must make a change in the law that substantially changes the tax treatment of an S corporation item. For example, for tax years beginning in 1982 shareholders of electing New York S corporations did not have to make any of the modifications in section 612 that relate to their pro rata shares of S corporation items of income, loss or deduction. Since this act now requires shareholders to make the modifications, the penalty will not be imposed for that portion of the underpayment attributable to such modifications.

City of New York

The Administrative Code of the City of New York, Title T, has been amended to conform with the amendments made to Article 22.

Cross References

The following Technical Services Bureau memorandums are obsolete for tax years beginning in 1983:

1) TSB-M-81- (11) Corporation Tax

- (11) Income Tax

2) TSB-M-83-(2.1) Income Tax