REGULATORY IMPACT STATEMENT

DEPARTMENT OF TAXATION AND FINANCE

1. Statutory authority: Tax Law, sections 171, subdivision First; and 1096(a) authorize the Commissioner of Taxation and Finance to make reasonable rules consistent with law that may be necessary for the exercise of the Commissioner's powers and the performance of the Commissioner's duties under the Tax Law. This authority also provides for the adoption of rules that are appropriate to carry out and administer the New York State Franchise Tax on Business Corporations imposed by Article 9-A of the Tax Law.

2. Legislative objectives: The rule is being proposed pursuant to such authority and in accordance with the legislative objectives in order to provide comprehensive guidance regarding the computation of tax under Article 9-A of the Tax Law for corporations that are partners in partnerships or that are members of limited liability companies (LLCs) treated as partnerships under Article 9-A. For purposes of this Regulatory Impact Statement, the term "partnership" also includes an LLC treated as a partnership under Article 9-A and the term "partner" also includes a member of such an LLC.

3. Needs and benefits: It has become more common for corporations to be partners in partnerships. Although an estimate of the number of corporate partners is not available, the number of partnerships and LLCs operating in the State has grown significantly. The number of partnerships has increased from 75,315 in 1980 to 191,287 in 2004. LLCs, a new form of organization in the 1990's, have increased from 19,189 in 1999 to 56,170 in 2005. A partnership or LLC could have many corporate partners and a corporation could be a partner or member in many partnerships or LLCs. It became apparent that corporate partners were taking various filing positions on their returns. This led to requests for advice from the Audit Division, taxpayers and

practitioners regarding the computation of the business corporation franchise tax for a corporate partner. Seeing a need to provide guidance in this area, the Department enlisted the aid of representatives from several large corporations, trade and professional associations, and the New York City Department of Finance, as well as tax practitioners. The proposed rule is the product of a consultative process with this working group and to a large extent reflects a consensus of the working group. The Department also requested comments from the Tax Section of the New York State Bar Association on a draft of the rule. The Tax Section issued a report on March 2, 2006, indicating its general support for the rule. The Department made further modifications to the draft based on this report. Significant alternatives raised by the Tax Section that were not incorporated in the proposed rule are included in the Alternatives section of this Regulatory Impact Statement.

The purpose of the rule is to set forth both existing and new Department policy regarding the computation of tax under Article 9-A of the Tax Law for corporations that are partners. The rule largely conforms to the Federal provisions relating to the taxation of partnerships and their partners. The rule provides that a taxpayer that is partner shall compute its tax with respect to its interest in the partnership under the aggregate or entity method as applicable per the rule. Under the aggregate method, a corporate partner takes into account its distributive share of receipts, income, gain, loss or deduction and its proportionate part of assets, liabilities and transactions from the partnership. Under the entity method, a corporate partner is treated as owning an interest in a partnership entity. The interest is considered an intangible asset that constitutes business capital. In addition, the rule specifies the computation of the tax bases under each method. The rule also makes several clarifying and technical amendments.

The amendments codify both existing and new Department policy regarding the taxation of corporate partners under Article 9-A. The proposed rule will provide taxpayers and practitioners with information about these policies. These amendments will provide a positive impact on taxpayers that are partners in partnerships and practitioners since the rule clarifies how to properly compute the tax. The rule makes it clear that the preferred approach is to use the aggregate method. However, if the corporate partner is unable to obtain the necessary information to use the aggregate method, the rule allows the corporate partner to use the entity method.

The aggregate method of taxation for a corporate partner is existing policy under Article 9-A regulations. The rule further clarifies the computation of the tax bases under Article 9-A for a corporate partner under the aggregate method. This clarification benefits taxpayers and practitioners by providing guidance as to how to compute a corporate partner's tax under the aggregate method.

A change in policy contained within the amendments relates to the treatment of stock of a corporation owned by the partnership. Prior to these amendments, stock of a corporation owned by the partnership was taken into account by a corporate partner in determining whether such other corporation was a subsidiary of the corporate partner and, hence, whether the stock of such corporation was considered subsidiary capital. An existing rule contained in Section 3-6.2(b) of the regulations requires direct ownership of stock when determining whether a corporation is a subsidiary so that stock owned through a corporate structure consisting of tiers of corporations is not considered. The amendments extend this treatment to include stock owned by a partnership. This rule will provide consistency in that direct ownership is required in all cases; it does not matter whether the stock is owned through tiers or chains of corporations and/or partnerships. Neither situation constitutes direct ownership.

The Department recognizes there are certain instances where a taxpayer is unable to obtain the necessary information from a partnership in order to file under the aggregate method. The amendments codify the entity method for these instances. This alternative method helps eliminate confusion and makes it easier for taxpayers to comply with the Tax Law.

4. Costs:

(a) Costs to regulated persons: The rule does not impose any new reporting, recordkeeping or other compliance costs on regulated persons. The rule benefits regulated persons by providing important guidance needed for proper computation and reporting of taxes. Since the changes are largely clarifying in nature, the impact of the rule on tax liability for regulated parties is estimated to be none or minimal. The change in policy regarding the determination of subsidiary capital may have an impact on the tax liability of some taxpayers. The impact of this change on a particular taxpayer, which could be positive or negative, will depend on the specific circumstances of the taxpayer. We estimate that this change will have no net impact on taxpayers as a whole.

(b) Costs to the agency and to the State and local governments for the implementation and continuation of this rule: It is estimated that the implementation and continued administration of this rule will have no costs to this agency, New York State, or its local governments. As indicated, the rule provides guidance on how to compute the tax under Article 9-A for taxpayers that are corporate partners. Since the changes are largely clarifying in nature, the revenue impact is estimated to be none or minimal. The change regarding the determination of subsidiary capital is estimated to have no net revenue impact.

(c) Information and methodology: These conclusions are based upon an analysis of the rule from the Department’s Technical Services Division, Office of Counsel, Taxpayer Services and Revenue Division, Office of Tax Policy Analysis, Office of Budget and Management Analysis, and Management Analysis and

Project Services Bureau. No quantitative information was available to determine the tax liability impact on taxpayers and the revenue impact on the State and local governments. Our analysis relied on discussions with the working group, which included a cross section of industries and interests, on the effect of each aspect of the rule. It was thought that any positive or negative impacts on an individual firm would vary over time and that logically consistent rules applied on a continuing basis would provide fiscal neutrality.

5. Local government mandates: This rule imposes no mandates upon any county, city, town, village, school district, fire district, or other special district.

6. Paperwork: The rule imposes no reporting requirements, forms, or other paperwork upon regulated parties beyond those required by existing law and regulations. The Department has been working on developing a form by which partnerships would furnish information to their corporate partners to facilitate the partners' computation of tax. The Tax Section Report supports development of such a form. This rule does not require such a form, however, and if developed, it will be prescribed under authority apart from this rule.

7. Duplication: There are no relevant rules or other legal requirements of the Federal or State governments that duplicate, overlap, or conflict with this rule.

8. Alternatives: One alternative considered with the working group was to only provide for the aggregate method of taxation. However, it was decided that there are taxpayers that are corporate partners that need another method where they are unable to obtain the necessary information from the partnership in order to use the aggregate method. To address this, the regulation provides for the entity method.

An additional alternative was considered in determining whether a taxpayer needed to use the aggregate method of taxation. The draft rule addressed in the Tax Section Report provided that a corporate partner would be presumed to have access to the information if it had a 1% or greater interest in the partnership. The Tax Section Report suggested that this threshold should be 10% and also suggested a monetary threshold of a $10 million interest in the partnership. The Department considered the suggestion and raised the threshold to 5% and added a monetary threshold of a $5 million interest in the partnership. The Department considers a 5% or $5 million interest to represent a significant interest which should appropriately give rise to the presumption of having information. In any event, it is a presumption, which can be overcome by the taxpayer if it can show that it is unable to obtain the necessary information.

The Tax Section Report also suggested that the stock of a corporation owned by the partnership should be considered in determining whether such corporation is a subsidiary of the corporate partner and whether the stock of such corporation constitutes subsidiary capital. The Department thinks the better view, which is reflected in the rule, is that the stock is not considered. We believe it is important to be consistent with the established rule that a corporation must directly own, not through tiers or chains of corporations, the stock of a corporation for such corporation to be considered its subsidiary (20 NYCRR 3-6.2(b)). Whether the stock is owned though tiers of partnerships or tiers of corporations should not be determinative. If the rule were different depending on whether the entity in the middle of the chain is a partnership or a corporation, there would be both opportunities for manipulation and a trap for the unwary. Furthermore, it is not clear from the Tax Section suggestion how the rule would work if the middle entity were an LLC, which may elect to be treated as a partnership or as a corporation for Federal income (and therefore NYS business corporation franchise) tax purposes. Also, under the Tax Section alternative, there would be significant issues on how to compute expenses directly and indirectly attributed to subsidiary capital or to the income therefrom.

Lastly, another alternative was considered with respect to the entity method of taxation. One practitioner suggested that where it is apparent that the partnership holds almost exclusively items that would qualify as investment capital, there should be an exception to the rule that an interest in the partnership is business capital and allocated by the business allocation percentage. It was agreed that no change should be made to the rule in this regard because it is not feasible to define this type of partnership and because the rule already provides the Commissioner with the authority to make a discretionary adjustment to the business allocation percentage where it does not properly reflect the business income, capital or activity of the taxpayer in New York State.

9. Federal standards: The rule does not exceed any minimum standards of the Federal government for the same or similar subject area.

10. Compliance schedule: The amendments will take effect when the Notice of Adoption is published in the State Register and shall apply to taxable years beginning on or after January 1, 2007.