

INSTRUCTIONS TO FORMS NYC-4S, NYC-3L, NYC-3A, NYC-1 AND NYC-1A

New York City Tax Implications of Federal S Elections by Banking Corporations and New York City Tax Treatment of Qualified Subchapter S Subsidiaries

Federal law: Section 1308(b) of P.L. 104-188 amended section 1361(b)(3) of the Internal Revenue Code ("IRC") to allow an S corporation to own a Qualified Subchapter S Subsidiary ("QSSS") without jeopardizing its S election for federal income tax purposes for taxable years beginning after 1996. A QSSS must meet the requirements to make an S election as if it were owned directly by the shareholders of the parent S corporation and must be 100 percent owned by the parent S corporation. The parent S corporation must make the election to treat a subsidiary as a QSSS. In general, a QSSS is not treated as a separate corporate entity for federal income tax purposes. Instead, all of its assets, liabilities, and items of income, deduction and credit are treated as belonging to the parent S corporation. IRC §1361(b)(3)(A)(ii).

Section 1315 of P.L. 104-188 also amended section 1361(b)(2) of the Internal Revenue Code to allow banks that do not use the reserve method of accounting for bad debts to qualify to make an S election for taxable years beginning after 1996.

New York City Law:¹ Section 11-602.8(ii) of the Administrative Code of the City of New York (the "Ad. Code") provides that for purposes of the New York City General Corporation Tax ("GCT"), entire net income means:

total net income from all sources, which shall be presumably the same as the entire taxable income ... which the taxpayer would have been required to report to the United States treasury department if it had not made an election under subchapter s of chapter one of the internal revenue code....

The effect of this provision is to disregard the federal S election (and any New York State S election) and to treat the corporation as if it were a C corporation for federal income tax purposes.

Ad. Code Section 11-641(a) does not contain a comparable provision expressly disregarding a federal S election for purposes of the New York City Banking Corporation Tax because, prior to 1997, banks were ineligible to make a federal S election. Ad. Code Section 11-641(a)(1) provides that for Banking Corporation Tax ("Bank Tax") purposes, entire net income is the

¹ New York State has enacted legislation addressing the issue of QSSSs for Franchise Tax and Bank Tax purposes (Ch. 389, Laws of 1997) however, that legislation does not apply to New York City business income taxes.

entire taxable income that the taxpayer is required to report to the United States treasury department. As of the issuance of these instructions, the IRS has not provided details as to how bank S corporations are to calculate taxable income.

New York City Tax Treatment:² A corporation that has made a federal S election and has a QSSS should treat the QSSS as a separate corporation for New York City tax purposes.

General Corporation Tax. If either the parent S corporation or the QSSS would be subject to the GCT based on its separate activities, it must file a separate GCT return. A parent S corporation and its QSSS necessarily will meet the stock ownership test for combined reporting. Provided the other requirements for combined reporting are met, a parent S corporation and its QSSS may be permitted or required to file a combined return.

Bank Tax. A banking corporation doing business in New York City that has made a federal S election should file its Bank Tax return as if no S election had been made. If a QSSS would be subject to the Bank Tax based on its separate activities, it must file a separate Bank Tax return. However, notwithstanding the preceding sentence, a parent S corporation and its QSSS will meet the stock ownership test for combined reporting and may be required to file a combined Bank Tax return under the applicable statutory provisions. If the parent S corporation and its QSSS are not required to file a combined Bank Tax return under the applicable statutory provisions, a parent S corporation and its QSSS nevertheless may be permitted or required to file a combined Bank Tax return in the discretion of the Commissioner if the requirements for combined reporting are met.

Utility Tax. A parent S corporation and its QSSS will be treated as separate corporations for purposes of determining whether the QSSS or its parent S corporation is subject to the New York City Utility Tax as a "utility" supervised by the New York Public Service Commission or as a vendor of utility services. A QSSS and its parent S corporation will also be treated as separate corporations for purposes of determining their separate liabilities for the Utility Tax.

Applicable Tax. A QSSS and its parent S corporation will be treated as separate corporations for purposes of determining which City taxes apply.

Subsidiary Capital Treatment. In general, because a QSSS is to be treated as a separate corporation for City tax purposes, the sale or other disposition of stock of a QSSS should be treated as the sale or other disposition of stock of a subsidiary. Similarly, the other

² These instructions have been developed in light of guidance available as of the issuance of these instructions regarding the federal treatment of QSSSs and, therefore, are subject to modification as additional federal guidance becomes available. For updated information, call Citytax Dial at (718) 935-6736 or see the Department of Finance page on the City's website at <http://www.ci.nyc.ny.us/finance>.

provisions applicable in a parent/subsidiary situation will apply, e.g., the attribution of expenses, the taxation of subsidiary capital and the exemption of income therefrom. Because a QSSS is to be treated as a separate corporation for City tax purposes, the termination or revocation of a QSSS election and the making of a QSSS election for an existing corporation should be disregarded for City tax purposes.