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New York Tax Treatment of S Corporations And Their Shareholders

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Introduction

This publication is a basic guide for tax practitioners and S corporation shareholders. It explains the New York tax treatment of S corporations and their shareholders. It is not meant as a technical instruction guide but as a general overview which will help taxpayers determine whether to make the New York S election. Taxpayers who have New York S corporation issues not addressed in this publication should contact the Tax Department. Telephone numbers and addresses are listed in Part XII of this publication.

Since various provisions of New York S corporation taxation became effective at different times, this publication is intended to be used as a guide only for tax years of S corporations and their shareholders that began after 1998.

Part I: Overview

New York permits S corporation treatment to corporations which are federal S corporations. The New York treatment is similar in many respects to the federal treatment. However, there are some significant differences.

At the corporate level, New York S corporation treatment is afforded only to general business corporations (New York State Tax Law Article 9-A corporations), and effective for tax years beginning after 1996, Article 32 banking corporations. It is not afforded to special corporations (corporations taxable under Articles 9 or 33 of the Tax Law).

New York S corporation treatment is elective, not automatic. In some states, the federal election automatically secures state S corporation treatment. In New York, the shareholders must make a separate New York S election. If the separate New York election is not made, the corporation is treated as a C corporation for New York State tax purposes.

The requirements for making and terminating the New York S election are similar to the federal requirements. However, there are some important differences.

At the corporate level, New York S corporation treatment means a reduction in the corporate tax rate to the differential rate, with a fixed dollar minimum tax which is not less than $100 for Article 9-A taxpayers and $250 for Article 32 taxpayers. The differential rate is the difference between the corporate rate under Article 9-A or Article 32 and the Article 22 (personal income tax) equivalent rate. There is not the complete exemption from regular corporate tax that applies at the federal level.

At the shareholder level, S corporation treatment (pass-through of income) applies if the New York S election is made.

At the shareholder level, C corporation treatment (non-pass-through of income, but inclusion of distributions) applies to residents if the New York S election is not made. Nonresident shareholders are not subject to tax.

At the shareholder level, if the corporation is an ineligible S corporation (not eligible to make the New York S election because it is not subject to the Article 9-A or Article 32 taxes), resident shareholders are subject to S corporation treatment (pass-through of income) through conformity with the federal S election, even though New York S corporation treatment is not available at the corporate level.

Note: New York City does not recognize S election status for purposes of its general corporation tax. Accordingly, a federal S corporation that makes the S election for New York State purposes would still be a C corporation for purposes of the city of New York general corporation tax.

Part II: Definitions

These terms apply to the New York tax treatment of S corporations. They will be referred to throughout this publication.

An **S corporation** is a corporation for which the federal S election under section 1362(a) of the Internal Revenue Code (IRC) is in effect for the tax year.

A **C corporation** is a corporation which is not a federal S corporation for the tax year.

A **New York S corporation** is an S corporation subject to tax under Article 9-A or Article 32 of the New York State Tax Law that has made the New York S election under section 660 of the Personal Income Tax Law. (See Appendix A for the rules describing which corporations are subject to tax under Article 9-A or Article 32.)

A **QSSS** is a corporation which is a qualified subchapter S subsidiary as defined in IRC section 1361(b)(3)(B).

An **exempt QSSS** is a qualified subchapter S subsidiary exempt from tax under Article 9-A or Article 32 of the Tax Law. Where a QSSS is an exempt QSSS, all the assets, liabilities, income, deductions, property, payroll, receipts, capital, credits and all other tax attributes and elements of economic activity of the QSSS shall be deemed to be those of the parent corporation. However, for sales and excise taxes, a QSSS is treated as a separate corporation.

A **New York C corporation** is a corporation subject to tax under Article 9-A or Article 32 that is not a New York S corporation. A New York C corporation can be either a federal S or a federal C corporation.

An **ineligible S corporation** is an S corporation which is not eligible to make the New York S election because it is not subject to tax under Article 9-A or Article 32 of the Tax Law. Corporations are ineligible either because they are special corporations (see below) or because they are foreign corporations not subject to New York tax jurisdiction. (See Appendix A for New York tax jurisdiction rules for foreign corporations.)

A **special corporation** is a corporation subject to tax under Article 9 (transportation, transmission, utilities) or Article 33 (insurance) of the Tax Law.

A **New York S year** is a tax year of a New York S corporation.

A **New York C year** is a tax year of a New York C corporation.

A **termination year** is any tax year of an S corporation during which the New York S election terminates on a day other than on the first day of the tax year. The portion of the tax year ending before the first day the termination is effective is called the S short year, and the portion of the tax year beginning on the first day the termination is effective is called the C short year.

A **New York S termination year** is a tax year of the corporation during which the New York S election terminates but the federal S election remains in effect.

New York C corporation modifications. Under the personal income tax, the starting point for determining New York adjusted gross income is federal adjusted gross income, and the starting point for determining the New York itemized deduction is the federal itemized deduction. A shareholder of an S corporation includes the S corporation items of income, gain, loss and deduction in federal adjusted gross income and the federal itemized deduction. If the corporation is a New York C corporation (New York S election not made), New York affords C corporation treatment to the shareholder by means of the **New York C corporation modifications**, which 1) reverse out the S corporation items included in federal adjusted gross income and the federal itemized deduction, and 2) include the distributions from the corporation as C corporation dividends.

Part III: The New York S election

This section describes the qualifications a corporation must meet to make a New York S election, the procedure for making the election, and the date on which the election takes effect.

Qualifications

A corporation may elect to be a New York S corporation only if it meets **all three** of the following qualifications.

- The corporation is already a federal S corporation, or the corporation is making a federal S election at the same time it is making its New York S election.

- The corporation is an eligible corporation. An eligible S corporation is:

  - an S corporation subject to tax under Article 9-A or Article 32 of the New York State Tax Law; or

  - an S corporation which is the parent of a QSSS subject to tax under Article 9-A or Article 32, where the shareholders of the parent corporation make the New York S election (see *Non taxpayer parent* and *Exception: excluded corporation* on page 17).

- All the corporation's shareholders agree to make the New York S election.

Ineligible corporations (special corporations subject to tax under Article 9 or Article 33, or foreign corporations not subject to New York tax jurisdiction) cannot make a New York S election. (See Appendix A for a description of corporations which are subject to tax under Article 9-A or Article 32.)

When to make the election

To be effective for a tax year, the election must be made:

- at any time during the preceding tax year, or

- on or before the fifteenth day of the third month of the tax year to which the election will apply.

However, an election made on or before the fifteenth day of the third month of the tax year will not be effective until the following tax year if:

- The corporation did not qualify as a federal S corporation under section 1361(b) of the Internal Revenue Code on one or more days during the

portion of the tax year prior to the day on which the corporation elected to be a New York S corporation; or

- One or more of the shareholders who held stock in the corporation during the tax year, but before the day on which the corporation elected to be a New York S corporation, did not consent to the corporation being a New York S corporation.

The following rules apply in determining the fifteenth day of the third month:

- If the corporation is organized within New York State and anticipates being a New York S corporation for its first tax year, it must make the federal and New York S elections on or before the fifteenth day of the third month following the **effective date of its certificate of incorporation**.

Example: A corporation's **date of incorporation** in New York State is 6/13/99. The corporation anticipates being a New York S corporation for its first tax year 6/13/99 - 12/31/99. The corporation must make its federal and New York S elections on or before 8/28/99 to be a New York S corporation for the tax year 6/13/99-12/31/99.

- If an S corporation is organized outside New York State, begins to do business in New York State, and anticipates being a New York S corporation for its first New York tax year, it must make its New York **S** election on or before the fifteenth day of the third month following the date it **began doing business in New York State.** The fifteenth day of the third month is determined in the same way as in the example shown above.

A valid election to be treated as a New York S corporation remains in effect for the tax year for which it was made and for all subsequent tax years until it is either terminated or revoked, as explained later in this publication.

How to make the election

An election to be treated as a New York S corporation must be made on Form CT-6, *Election by a federal S corporation to be treated as a New York S corporation.*

If a federal S election and a New York S election are being made for the same tax year, the New York election on Form CT-6 must be submitted no later than the fifteenth day of the third month of the year for which the election is to apply. Form CT-6 must be submitted by that date even if the corporation has not received notice from the Internal Revenue Service that the federal election has been approved. When the corporation receives the federal

approval, it must forward a copy to the Tax Department. If federal S status is subsequently denied, the corporation must immediately notify the Tax Department of the denial.

For more information on making the New York S election, see Form CT-6-I, *Instructions for Form CT-6.*

Summary of late and invalid S election provisions (effective for taxable years beginning after 1982)

- Authority to treat late elections, etc., as timely. (Tax Law section 660(b)(5)):

  - S If an election is made by an eligible S corporation for any taxable year after the election filing deadline for that taxable year, or if no election is made at all, and it is determined by the Commissioner that there was a reasonable cause for the failure to make a timely election, the Commissioner may treat that election as timely filed for that taxable year.

- Inadvertent invalid elections. (Tax Law section 660(e)):

  - S If an election by an eligible S corporation was not valid because the corporation failed to obtain the consent of all the shareholders, and within a reasonable amount of time after discovering the failure the corporation took steps to acquire the necessary consents, the Commissioner may determine that the omission was inadvertent, and may retroactively validate the election. A retroactive validation requires both the shareholders and the corporation to recognize the tax consequences of the election for the retroactive period.

- Validated federal elections. (Tax Law section 660(f)):

  - S When an S election is retroactively validated for federal purposes, pursuant to Internal Revenue Code section 1362(f), then the Commissioner may retroactively validate the New York State election. The validation will apply for any taxable years occurring within the period validated by the Internal Revenue Service. As above, any retroactive validations require both the shareholders and the corporation to recognize the tax consequences of the election for the retroactive period.

Part IV: Terminating or revoking the New York S election

Following is a description of the situations under which a New York S election terminates, the method by which the shareholders may revoke a New York S election, and the effective dates of a termination or revocation.

Termination

An election to be a New York S corporation will terminate:

- On the day the election to be a federal S corporation terminates under section 1362(d) of the Internal Revenue Code; or

- On the day a person becomes a new shareholder of the corporation and that person affirmatively refuses to consent to the New York S election.

If a termination is effective on a day other than the first day of the corporation's taxable year, consult the rules governing the S termination year. (See *Computation of tax in a New York S termination year* on page 19.)

To terminate the election as described in the second condition above, the new shareholder must file Form CT-6.1, *Termination of election to be treated as a New York S corporation*, or send a letter to the Tax Department, to the address shown on Form CT-6. The letter must contain the corporation's name, address and identification number, the name and social security number of the shareholder, and a statement that the shareholder refuses to consent to the New York S election. The shareholder must also send copies of stock certificates or other evidence to show that the person is a new shareholder in the corporation and the date the person became a shareholder.

Revocation

An election to be a New York S corporation may be revoked only if shareholders who collectively own more than 50% of the outstanding shares of stock of the corporation consent to the revocation. The revoking shareholders must hold their stock on the day that the revocation is filed. The revocation is made by filing Form CT-6.1 or a statement with the Tax Department. The statement must contain:

- the name, address and identification number of the corporation;

- the total number of shares of stock (including non-voting stock) outstanding at the time the revocation is made, and the number of shares held by each revoking shareholder;

- the name, address, social security number and signature of each revoking shareholder;

- a statement that the corporation is revoking its election to be treated as a New York S corporation under section 660(c)(2) of the New York State Tax Law; and

- the date on which the revocation is to be effective.

The statement should be signed by an officer authorized to sign the New York S corporation return. The statement should be sent to the address shown on Form CT-6.

A revocation of a New York S election is effective:

- on the first day of the corporation's tax year, if the revocation is made on or before the fifteenth day of the third month of the tax year;

- on the first day of the following tax year of the corporation if the revocation is made after the fifteenth day of the third month of the tax year; or

- on the date specified, if the revocation specifies a date on or after the date the revocation is made.

If a revocation described in this Part is to be effective on a day other than the first day of the corporation's tax year, see *Computation of tax in a New York S termination year,* on page 19.

Re-electing to be a New York S corporation

A termination or revocation of the New York S election does not bar a corporation which continues to be a federal S corporation from making another New York S election for a succeeding tax year. There is no five year disqualification period, as applies for federal tax purposes. However, the corporation must meet the qualifications to make the New York S election in the succeeding year. See *Qualifications* on page 10.

Part V: New York corporate level taxation of federal S corporations

General

This section provides a general overview of a federal S corporation's New York corporate level tax responsibilities. It is not intended as a guide for computing the actual corporate tax liability of a corporation. S corporations should consult the appropriate tax forms and instructions to compute their corporate tax liabilities. (See Appendix C for a list of the New York State forms applicable to S corporations.)

The New York State corporate tax treatment of a federal S corporation depends upon whether the corporation is a general business corporation, a banking corporation, or a special corporation, and if the two former, whether or not the corporation makes the New York S election.

Special rules also apply if a New York S election terminates during the corporation's tax year. The rules applicable to these situations are as follows.

S corporations that are not New York S corporations

A federal S corporation that is not a New York S corporation is subject to the same corporation or franchise taxes that the corporation would incur if it were a C corporation. For example, a general business corporation that is a federal S corporation but a New York C corporation is subject to tax under Article 9-A, using the same rules, rates and bases (including the Metropolitan transportation business tax surcharge) that apply to a general business corporation that is a federal C corporation. In addition, the corporation is entitled to the same Article 9-A credits allowed to a C corporation.

Likewise, an S corporation which is a special corporation, such as one subject to the gross earnings tax on transmission corporations under section 184 of Article 9, would be subject to that tax using the same rules and rates that apply to a federal C corporation under section 184.

S corporations that are New York S corporations

A federal S corporation that is a New York S corporation is also subject to tax under Article 9-A or Article 32 of the Tax Law. However, a New York S corporation is only subject to the tax on entire net income or the fixed dollar minimum tax under Article 9-A or Article 32. The corporation is not subject to the alternative minimum tax or the capital base tax under Article 9-A or the tax on alternative entire net income or the taxable assets tax under Article 32. The Article 9-A or Article 32 tax for a New York S corporation is computed as follows:

Step 1: The corporation first computes a franchise tax on its entire net income, determined as if it were a C corporation. The starting point

for this determination is federal taxable income calculated as if corporation were a federal C corporation. New York entire net income is then computed and allocated using the same rules that apply to corporations that are New York C corporations, but with one exception: In computing the business allocation percentage under Article 9-A, a single weight receipts factor is used instead of a double weight receipts factor. In computing the allocation percentage under Article 32, a single weight receipts factor and a single weight deposits factor are used. The franchise tax rate is then applied. Under Article 9-A, the applicable franchise tax rate which is then applied to allocated entire net income depends upon whether or not the corporation qualifies as a small business taxpayer under Tax Law section 210.1(f).

Step 2: The franchise tax computed in Step 1 is reduced by the Article 22 (personal income tax) tax equivalent reduction. The Article 22 tax equivalent reduction is computed by multiplying the New York S corporation's allocated entire net income computed in Step 1 by the Article 22 tax equivalent rate for the tax year. (For the Article 22 tax equivalent rate for a particular tax year, see the instructions for Form CT-3-S, CT-32-S, CT-3-S-A or CT-32-S-A).

Step 3: The result from Step 2 is compared to the fixed dollar minimum tax that would apply if the corporation were a New York C corporation (except that the $800 fixed dollar minimum applicable to certain dormant corporations does not apply). The corporation must pay the higher of the amount computed in Step 2 or the fixed dollar minimum.

For Article 9-A taxpayers, the franchise tax, generally, cannot be less than the lowest fixed dollar minimum amount of $100. However, the fixed dollar minimum is reduced if the corporation has a short taxable year of not more than nine months.

For Article 32 taxpayers, the fixed dollar minimum tax is always $250. There is no reduction for short periods.

New York QSSS treatment

In most instances, New York will follow the federal QSSS treatment in the Articles 9-A and 32 franchise taxes. When QSSS is followed, the assets, liabilities, income and deductions of the QSSS will be included on the parent’s franchise tax return. However, with regard to other taxes under the Tax Law, such as sales and excise taxes, the QSSS will continue to be recognized as a separate corporation. Under the franchise taxes the following situations may apply:

Parent a New York S corporation - New York will follow the federal QSSS treatment. The parent and subsidiary will be taxed as a single New York S corporation under Article 9-A or Article 32 (and the shareholders of parent will be taxed under the Article 22 personal income tax). This treatment will apply whether or not the subsidiary, viewed on a stand-alone basis, is a New York taxpayer.

Parent a New York C corporation - New York will follow the federal QSSS treatment (a) if the subsidiary is a New York taxpayer, or (b) if the subsidiary is not a taxpayer but the parent makes a "QSSS inclusion election." In both instances, parent and subsidiary will be taxed as a single New York C corporation (and the shareholders of the parent will be treated as shareholders of a C corporation.) On the other hand, if the subsidiary is not a taxpayer and the parent does not elect, the parent will file as a New York C corporation on a stand-alone basis.

Non taxpayer parent - New York will follow the federal QSSS treatment where the subsidiary is a New York taxpayer but the parent is not, if the parent so elects. The parent and subsidiary will be taxed as a single New York S corporation (and the shareholders of parent will be taxed under the Article 22 personal income tax). If the parent does not elect, the subsidiary will file as a New York C corporation on a stand-alone basis.

Subsidiary exempt from tax - In all instances above where QSSS is followed, the subsidiary is exempt not only from the income-based franchise taxes, but also from the fixed dollar minimum tax and from the capital tax (Article 9-A) and the alternative tax based upon assets and the fixed minimum tax (Article 32).

Exception: excluded corporation - Notwithstanding the above rule, QSSS treatment will not be allowed unless parent and subsidiary are both general business corporations or are both banking corporations. That is, within the Article 9-A framework, the parties will have to file on a stand-alone basis if one is an Article 9-A taxpayer but the other is an Article 9 (sections 183, 184, 185 or 186) or Article 32 (bank) or Article 33 (insurance) taxpayer, or is a foreign corporation not taxable by New York State that, if it were taxable, would be subject to tax under any of those sections or articles. Likewise, within the Article 32 framework, the parties will have to file on a stand-alone basis if one is an Article 32 taxpayer but the other an Article 9 (sections 183, 184, 185 or 186) or Article 9-A or Article 33 taxpayer, or is a foreign corporation not taxable by New York State that, if it were taxable, would be subject to tax under any of those sections or articles.

QSSS inclusion election

As indicated above, if the parent of a QSSS is a New York C corporation and the QSSS is not a taxpayer and is not an excluded corporation, the parent may make a QSSS inclusion election to include all assets, liabilities, income and deduction of the QSSS on the parent's New York C corporation return.

This election can be made by submitting a letter to the NYS Tax Department, Corporation Tax Registration, Building 8 Room 409, W. A. Harriman Campus, Albany, NY 12227. In the letter please include the name and employer identification number of the parent and of the QSSS, and state that a QSSS inclusion election is being made. If the QSSS does not have and does not intend to secure an employer identification number, the letter should so indicate.

Article 9-A surcharges

A New York S corporation is **not** subject to the Metropolitan Transportation Business Tax Surcharge under Article 9-A or Article 32.

Corporation tax credits

A New York S corporation may claim the credit for the special additional mortgage recording tax against its Article 9-A or Article 32 franchise tax, except for the fixed dollar minimum. Any unused credit can be refunded or carried forward. For more information concerning the mortgage recording tax credit, see Technical Services Bureau Memorandum TSB-M-94(4)C.

Other Article 9-A or Article 32 tax credits are not allowed against the New York S corporation tax. Rather, the corporation credits for which there are comparable credits under the personal income tax are allowed to the corporation's shareholders on their personal income tax returns. *(See New York State credits of New York S corporation shareholders* on page 25.)

Neither the corporation nor the shareholders may claim any carryover of credits (other than the mortgage recording tax credit above) from a year in which the corporation was a New York C corporation. Credits earned in such years can be used only by the corporation, and then only if the corporation reverts to New York C corporation status within the carryover life of the credit. However, New York S years count for purposes of determining the carryover period. For example, the New York Article 9-A investment tax credit can be carried over for fifteen years after the taxable year in which it is earned. If the credit is earned but not used by a New York C corporation in year one, and the corporation converts to a New York S corporation in year two, the credit carryover will expire unless the corporation reverts to New York C status and can use up the carryover prior to year seventeen.

Exception: If the special additional mortgage recording tax credit is carried over rather than refunded, carryover by the corporation is allowed, both from New York S years to New York C years and vice-versa.

Computation of tax in a New York S termination year

An S termination year is a tax year during which the New York S election terminates on a day other than the first day of the corporation's taxable year. Termination is automatic if there is a federal termination, or there can be a New York termination without a federal termination. In either event, the corporation's tax year is divided into two periods, the S short year and the C short year. Special rules apply for computing the corporation's Article 9-A or 32 tax for these short periods. The rules are similar to the federal rules, which require that income be allocated between the short years by either a pro rata or a *closing the books* method. For more information, see *Termination year* in the instructions for Forms CT-3-S, CT-32-S-ATT, CT-3-S-A and CT-32-S-A

Part VI: New York license and maintenance fee requirements of foreign S corporations

New York imposes license fee and annual maintenance fee obligations on foreign corporations. A foreign corporation is a corporation that is formed outside of New York. These obligations apply equally to S and C corporations. In the context of S corporations, the rules are as follows:

Maintenance fee

If a foreign S corporation is an ineligible S corporation (ineligible to make the New York S election because it is not doing business in New York and therefore is not subject to New York tax jurisdiction), but the corporation is authorized to do business in New York, it is required to file and pay an annual maintenance fee which is generally $300 under section 181.2 of the Tax Law. See Form CT-245, *Maintenance Fee and Activities Return of Foreign Corporations Disclaiming Tax Liability.* A foreign corporation secures authority to do business in New York by applying to the New York Secretary of State, as provided in Article 13 (applicable to foreign corporations generally) or Article 15-A (applicable to foreign professional service corporations) of the New York Business Corporation Law.

Only authorized foreign banking corporations described in section 1452(a)(9) of Article 32 are required to pay the annual maintenance fee. Authorized foreign banking corporations described in sections 1452(a)(2) through 1452(a)(8) are not subject to the fee.

If a foreign S corporation, having secured authority, does in fact do business in New York, New York has tax jurisdiction. If New York tax jurisdiction is under Article 9-A or Article 32, the corporation is eligible to make the New York S election. However, whether the corporation makes the New York S election or chooses to be treated as a New York C corporation, payment of the corporation franchise tax under Article 9-A of at least $300 satisfies the obligation to pay the above annual maintenance fee, and Form CT-245 is not required to be filed. Likewise, if New York tax jurisdiction is under Article 9, Article 32 or Article 33, payment of the corporation franchise tax of at least $300 under one of those articles satisfies the maintenance fee filing and payment obligation. If a foreign authorized corporation's tax is less than $300, the corporation must adjust its payment to satisfy the $300 maintenance fee requirement.

License fee

If a foreign S corporation is in fact doing business in New York, it is subject to New York tax jurisdiction whether or not it has secured authorization under the Business Corporation Law to do business in New York. In addition, a corporation under the jurisdiction of Article 9, Article 9-A or

Article 32, section 1452 (a)(9), is also subject to a license fee under section 181.1 of the Tax Law whether or not it has secured authorization. The license fee is based upon the corporation's capital stock employed within New York, and after the initial fee, it is payable only if there is a change in the corporation's capital stock or the amount of stock employed in New York State is increased. Payment of the corporation franchise tax does not satisfy the license fee obligation, which is payable with Form CT-240, *Foreign Corporation License Fee Report.*

Part VII: Tax treatment of shareholders of federal S corporations

The New York tax treatment of shareholders of an S corporation depends upon whether the corporation is a New York S corporation, and, if not, whether the corporation is a New York C corporation (subject to the Article 9-A or Article 32 franchise tax) or an ineligible corporation. **Note this distinction,** as this is an area of potential confusion. In general, the rules are as follows:

- If the S corporation **is a New York S corporation,** the shareholders, including nonresident shareholders, are subject to New York tax in the same manner as they are subject to tax for federal income tax purposes. That is, they are subject to tax on their pro rata share of the S corporation pass-through items of income, gain, loss and deduction that are includable in their federal adjusted gross income. However, nonresident shareholders are taxed only on the S corporation items derived from New York sources. The source of the S corporation items is determined at the corporate level.

- If the S corporation is a **New York C corporation** (subject to Article 9-A or Article 32 franchise tax), the shareholders are **not** subject to tax on their pro rata share of S corporation pass-through income, etc. Instead, they are taxed as if the corporation were a C corporation. That is, resident shareholders are subject to New York tax only on actual distributions of cash or property that they receive from the corporation, and nonresident shareholders are not subject to tax.

- If the S corporation **is an ineligible corporation,** it is **not** subject to Article 9-A or Article 32 franchise tax because it is either a special corporation or a foreign corporation not subject to New York tax jurisdiction. In either event, the resident shareholders are subject to S corporation tax treatment through New York's conformity with federal adjusted gross income, **as if** the New York S election had been made. That is, they are taxed on their pro rata share of pass-through income, gain, loss and deduction of the corporation. For resident shareholders, this is the same treatment that applies to New York S corporation shareholders. However, nonresident shareholders of these corporations are not subject to tax.

Shareholders of New York S corporations

The following is a detailed discussion of the tax treatment of resident and nonresident shareholders of each of these three types of corporations.

Income and deductions-resident shareholders

S corporation items in federal adjusted gross income - Resident shareholders of New York S corporations include in New York adjusted gross income the same S corporation pass-through items of income, gain, loss and deduction that are included in federal adjusted gross income.

New York modifications to S corporation items - In addition, in computing New York adjusted gross income, resident shareholders must make any of the New York additions and subtractions to federal adjusted gross income under section 612 of the Tax Law (the section 612 modifications) that relate to the S corporation items (see **Note** below). For instance, if a shareholder has an S corporation pass-through deduction for federal ACRS depreciation that is not allowed for New York purposes, the section 612(b)(25) addition modification for the amount of the ACRS deduction and the section 612(c)(26) subtraction modification for New York depreciation would apply.

Note: These modifications do not, however, include the "New York C corporation modifications" which are designed to remove from New York personal income tax the federal S corporation items when the S corporation is a New York C corporation. See *Shareholders of New York C corporations* on page 28.

New York addition modification for federal taxes - In addition, in computing New York adjusted gross income, resident shareholders must make the section 612 addition modification to gross-up the S corporation pass-through income and gain, in those instances where the corporation incurred the federal entity-level taxes on S corporation built-in gains (IRC section 1374) or excess net passive income (IRC section 1375). In those instances, the Internal Revenue Code treats the tax as a reduction in the S corporation income or gain passed through to the shareholder. New York, on the other hand, requires that the income and gain be recognized on a pretax basis.

Note: In this publication, reference to the section 612 modifications, or to modifications that relate to S corporation items of income, gain, loss and deduction, will include reference to this addition modification for federal taxes.

Itemized deductions - In computing the New York itemized deduction, resident shareholders include the same S corporation pass-through items that are included in the federal itemized deduction. For example, the pass-

through of charitable contributions and expenses related to portfolio income would be itemized deductions to the shareholders. In addition, the shareholders must make any of the New York itemized deduction modifications (section 615 modifications) that apply to the federal pass-through items. For example, if the deduction is for an expense related to portfolio interest, and if the portfolio interest is federal bond interest, New York does not allow the deduction. This is because New York does not tax the income. In this event, the section 615 modification subtracts out the deduction from the federal itemized deduction.

Income and deductions-nonresident shareholders

To compute the New York nonresident personal income tax, a nonresident first calculates a tax as if a resident (the base tax). This base tax is calculated on New York adjusted gross income minus the personal deductions, and it is then allocated to New York by an income percentage. The income percentage is determined by a fraction, the numerator of which is New York adjusted gross income from New York sources (New York source income) and the denominator of which is New York adjusted gross income, computed as if a resident. In computing both the base tax and the denominator, New York adjusted gross income is federal adjusted gross income with the section 612 addition and subtraction modifications, computed as if the taxpayer were a resident for the entire tax year (hereinafter *the resident part of the nonresident tax calculation).* On the tax return, Form IT-203, *Nonresident and Part-Year Resident Return*, New York adjusted gross income is computed in the *federal Amount* column, and New York source income is computed in the *New York State Amount* column.

Under the nonresident computation, in the resident part of the nonresident tax calculation, nonresident shareholders of New York S corporations perform the same calculation as do residents; i.e., they include in New York adjusted gross income the same S corporation pass-through items of income, gain, loss and deduction that are included in federal adjusted gross income, with any related section 612 modifications. They also include in the New York itemized deduction the same S corporation pass-through items that are included in the federal itemized deduction, with the related section 615 modifications.

The denominator of the income percentage is the same as the New York adjusted gross income used in determining the base tax.

In determining New York source income (the numerator of the income percentage), nonresident shareholders include the same S corporation items of income, gain, loss and deduction which are included in New York adjusted gross income, but only to the extent the items are derived from New York sources. The determination of the source of S corporation items is made at

the corporation level, using the same allocation methods that apply to a corporation under Article 9-A or Article 32 of the Tax Law. For example, for an Article 9-A corporation, the corporation's business allocation percentage is applied to items of business income, and the corporation's investment allocation percentage is applied to items of investment income.

In addition, the shareholders must also include in the numerator any of the section 612 modifications that relate to the S corporation pass-through items. The New York source of a section 612 modification follows the source of the pass-through item to which it relates. For example, if 35% of the S corporation's business income is derived from New York sources, 35% of the section 612(b)(25) addition modification for federal ACRS depreciation would also be derived from New York sources.

Minimum income tax - resident shareholders

Resident shareholders include in their New York State minimum taxable income their pro rata share of federal items of tax preference attributable to the S corporation. They must also include any New York modifications attributable to those items of tax preference.

Minimum income tax - nonresident shareholders

Nonresident shareholders include in New York minimum taxable income their pro rata share of any federal items of tax preference attributable to the S corporation to the extent those items are derived from New York sources. They must also include any New York modifications that relate to those items of tax preference. The source of the federal items of tax preference and related modifications is made at the corporate level using the same allocation rules that apply to income and deductions under the regular tax.

New York State credits of New York S corporation shareholders

Resident and nonresident shareholders of New York S corporations are allowed the following personal income tax credits derived from the S corporation. The credit is allowed for the shareholder's tax year in which the S corporation's tax year ends.

Economic development zone credits

The economic development zone wage tax credit under section 606(k) of the Tax Law. (See Form DTF-601, *Claim for EDZ Wage Tax Credit*.)

The zone equivalent area wage tax credit under section 606(k) of the Tax Law. (See Form DTF-601.1, *Claim for ZEA Wage Tax Credit*.)

The economic development zone capital tax credit under section 606(1) of the Tax Law. (See Form DTF-602, *Claim for EDZ Capital Tax Credit*.)

The economic development zone investment tax credit under section 606(j) of the Tax Law and the EDZ employment incentive credit under section 606(j-1) of the Tax Law. (See Form DTF-603, *Claim for EDZ Investment Tax Credit and EDZ Employment Incentive Credit.*)

The economic development zone investment tax credit and economic development zone employment incentive credit for the financial services industry under section 606(j) and 606(j-1) of the Tax Law. (See Form DTF-605, *EDZ Investment Tax Credit and EDZ Employment Incentive Credit for the Financial Services Industry.)*

Investment credits

The investment tax credit under section 606(a) of the Tax Law and the employment incentive credit under section 606(a-1) of the Tax Law. (See Form IT-212, *Investment Tax Credit.)*

The investment tax credit for the financial services industry under section 606(a) of the Tax Law and the employment incentive credit for the financial services industry under section 606(a-1) of the Tax Law. (See Form IT-252, *Investment Tax Credit for the Financial Services Industry*).

Other credits

The credit for employment of persons with disabilities under section 606(o) of the Tax Law. (See Form IT-251, *Credit for Employment of Persons with Disabilities.*)

The alternative fuels credit under section 606(p) of the Tax Law. (See Form IT-253, *Alternative Fuels Credit*.)

The farmers' school tax credit under section 606(n) of the Tax Law. (See Form IT-217, *Claim for Farmers' School Tax Credit*.)

The historic barns rehabilitation credit under section 606(a)(12) of the Tax Law. (See Form IT-212-ATT, *Claim for Historic Barns Rehabilitation Credit and Employment Incentive Credit*.)

Note: For tax years beginning on or after January 1, 2000, shareholders of New York S corporations may be entitled to claim the qualified emerging technology company employment credit or the qualified emerging technology company capital tax credit under sections 606(q) and 606(r) of the Tax Law respectively. In addition, for tax years beginning on or after January 1, 2001, shareholders of New York S corporations may be entitled to claim the credit for purchase of an automated external defibrillator under section 606(s) of the Tax Law.

Additional rules

A shareholder cannot claim any of the above credits earned by the corporation in a tax year in which the corporation was **not** a New York S corporation.

If any of the above credits exceed the shareholder's tax for the year, the credits may be carried forward, applying the personal income tax carryover rule applicable to each credit. For example, an investment credit attributable to a New York S corporation may be carried forward for the ten taxable years of the shareholder following the year in which the shareholder derives the credit from the corporation. In addition, the farmer's school tax credit is refundable, and some of the other above credits may be refundable if the S corporation qualifies as a new business.

Recapture of credits

If property of the corporation, for which the alternative fuels credit, the investment tax credit, the investment tax credit for the financial services industry, the economic development zone investment tax credit, the economic development zone capital tax credit, or the economic development zone investment tax credit and employment incentive credit for the financial services industry was granted, is subsequently disposed of or ceases to be in qualified use, the shareholder may be required to recapture some or all of the credit. In addition, if a shareholder's proportionate interest in the New York S corporation is reduced (for example, by a sale or redemption of stock, or by the issuance of additional shares of stock in the corporation), this reduction is treated as a disposition of property for which a recapture of the credit must be made.

Note: For tax years beginning on or after January 1, 2000, the recapture rules also apply to the qualified emerging technology company capital tax credit.

Example: In tax year 1999, a shareholder of a New York S corporation claimed an investment tax credit of $450 for property placed in service by the corporation in January, 1999. The property is subject to 60 month investment credit recapture under section 606(a)(7)(C) of the Tax Law. On September 1, 2000, the shareholder's interest in the corporation is reduced by 20%, from a 50% holding to a 40% holding. The shareholder must recompute 20% of the investment credit originally taken, and recapture, for this 20%, the difference between the credit taken and the recomputed credit. 20% of the original investment credit is $90 (20% X $450). The recomputed credit for actual use is $30, determined by multiplying the original $90 credit by the ratio of the 20 months of actual use to the 60 month recapture period. Accordingly, in 2000, the shareholder must recapture a credit of $60 ($90 - $30).

Shareholders of New York C corporations

An S corporation subject to tax under Article 9-A or Article 32 which does not make the New York S election is a New York C corporation. The resident and nonresident shareholders of a New York C corporation are treated for New York tax purposes as described below.

Resident shareholders of New York C corporations

Resident shareholders are not subject to New York State personal income tax on their pro rata shares of S corporation income included in their federal adjusted gross income. Instead, C corporation tax treatment applies. That is, the shareholders are subject to tax only on actual distributions of cash or other property from the corporation. In addition, these shareholders are not entitled to claim any losses or deductions that flow through from the corporation. Furthermore, they are not subject to the minimum income tax on any items of tax preference from the corporation.

To accomplish this result, resident shareholders must make the following *New York C corporation* modifications.

- **Modifications to federal adjusted gross income**

S The shareholder must **add** to federal adjusted gross income any item of loss or deduction passed through from the corporation that is included in federal adjusted gross income under section 1366 of the Internal Revenue Code (Section 612(b)(19) of the Tax Law). Section 1366 of the Internal Revenue Code relates to pass through items of the corporation which are generally reflected on the shareholder's federal schedule K-1 for the tax year.

S The shareholder must **add** to federal adjusted gross income certain distributions of cash or other property from the corporation (section 612(b)(20) of the Tax Law.) See *Distribution modification/catch-up adjustment* on page 32.

S The shareholder must **subtract** from federal adjusted gross income any item of income or gain passed through from the corporation that is included in federal adjusted gross income under section 1366 of the IRC (section 612(c)(22) of the Tax Law.)

S These New York C corporation modifications remove from the shareholder's New York adjusted gross income the S corporation pass-through items included in federal adjusted gross income. Accordingly, having removed the S corporation pass-through items, the shareholder of a New York C corporation would **not** make any of the other section 612 modifications which relate to such pass-through items.

- **Modification to federal itemized deduction**

S The shareholder must subtract from the federal itemized deduction in computing the New York itemized deduction any S corporation pass-through items of deduction (section 615(c)(6) of the Tax Law.)

- **Modification to federal items of tax preference**

S The shareholder must subtract from federal items of tax preference in computing New York items of tax preference any pass-through items of tax preference from the S corporation (section 622(b)(3) of the Tax Law.)

Nonresident shareholders of New York C corporations

The mere ownership of C corporation stock by a nonresident does not create tax jurisdiction under the New York personal income tax. As previously discussed, an S corporation which is a New York C corporation is viewed as a C corporation for New York tax purposes. Accordingly, nonresident shareholders of such a New York C corporation are not subject to tax on S corporation income. (But see *Exception* on page 30, where the stock in the corporation is held as an asset of another trade or business.)

While the nonresident shareholder is not subject to tax on the S corporation income, the S corporation pass-through items are included in the shareholder's federal adjusted gross income. Accordingly if, for some other reason, the shareholder is required to file a New York nonresident return the S corporation items are dealt with in the New York nonresident tax computation as described below.

- In the New York nonresident tax computation, as discussed on page 24, the base tax is the tax calculated as if the taxpayer were a resident. In this resident part of the nonresident calculation, the S corporation pass-through items are in federal adjusted gross income, and New York C corporation treatment is afforded by means of the New York C corporation modifications. These modifications reverse out the S corporation pass-through items and add in the corporate distributions. A tax as if a resident is calculated on this base. This is the same treatment that is described above for resident shareholders of New York C corporations, in the *Resident Shareholders* section on page 28.

- The S corporation distributions are included in New York adjusted gross income because they are viewed, in effect, as C corporation dividends. However, these distributions are not New York source income. Accordingly, while their inclusion in New York adjusted gross income

requires their inclusion in the denominator of the income percentage, they are **excluded** from the numerator. This treatment effectively factors out the distributions from the New York nonresident tax.

Exception: As discussed earlier, ownership by a nonresident of S corporation stock, where the corporation is a New York C corporation, does not create tax jurisdiction under the New York personal income tax. However, if the stock in the New York C corporation is employed in another trade or business carried on by the shareholder (see Appendix B on page 46 for a description of stock employed in another business), tax jurisdiction is created. In this event, the nonresident shareholder is required to calculate the New York tax by performing the same steps as described above, except that distributions of the New York C corporation now are New York source income and are **included** in the numerator of the income percentage.

Credits for shareholders of New York C corporations

Resident and nonresident shareholders are not entitled to any tax credits derived from a New York C corporation. Credits earned by the corporation can only be claimed on the corporation's franchise tax return.

Shareholders of ineligible S corporations

As discussed previously, the New York S election is not available to ineligible S corporations (i.e., special corporations or foreign corporations not subject to New York tax jurisdiction). However, resident shareholders of these ineligible S corporations are treated, through New York's conformity to federal adjusted gross income, **as if they had made the New York S election for the corporation.** A nonresident shareholder, on the other hand, is not subject to New York tax on income from these corporations unless the stock is employed in some other business being carried on by the shareholder in New York. The New York tax treatment of the shareholders is described in more detail in the following paragraphs.

Resident shareholders

Resident shareholders of ineligible S corporations are subject to New York State tax on the same S corporation pass-through items of income, gain, loss and deduction that are included in federal adjusted gross income. They are also entitled to the federal itemized deduction from the corporation. Furthermore, they are also subject to the New York State minimum tax on their pro rata share of items of tax preference from the corporation. In addition, these shareholders must make any of the New York modifications to federal adjusted gross income, federal itemized deductions, and federal items of tax preference that are related to the S corporation income.

Caution: Since these corporations are not New York C corporations, the shareholders may not make the New York C corporation modifications which

would reverse out the S corporation pass-through items from federal adjusted gross income, federal items of tax preferences and itemized deductions.

Nonresident shareholders

Nonresident shareholders of S corporations that are ineligible S corporations are not subject to tax on any items of income, gain, loss or deduction from the corporation, unless the stock of the corporation is employed in another trade or business carried on by the shareholder in New York (See Appendix B). However, while the nonresident shareholder is not subject to tax on the S corporation income, the S corporation pass-through items are included in the shareholder's federal adjusted gross income. Accordingly, if, for some other reason, the shareholder is required to file a New York nonresident return, the S corporation items are dealt with as follows:

- In the resident part of the nonresident tax calculation, the S corporation pass-through items are in federal adjusted gross income, and are included in New York adjusted gross income with any of the New York section 612 modifications attributable to such items. The nonresident shareholder is not entitled to make the New York C corporation modifications which would reverse out the S corporation pass-through items. Tax is calculated as for a resident, on this base which includes the S corporation pass-through items.

  This is the same treatment that is described above for resident shareholders of ineligible corporations, in the Resident shareholders section on this page.

- As to nonresidents, however, the S corporation pass-through items included in the base are not New York source income. Accordingly, while their inclusion in New York adjusted gross income requires their inclusion in the base and the denominator of the income percentage, they are excluded from the numerator. This treatment effectively factors out the pass-through items from the New York nonresident tax.

If, on the other hand, the stock of the S corporation is employed in another trade or business carried on by the shareholder in New York, the S corporation pass-through items, with the applicable section 612 modifications, are New York source income and accordingly they are **included** in the numerator of the income percentage.

Distribution modification/catch-up adjustment for Articles 9-A and 32 S corporations which were not New York S corporations at all times after 1980 (after 1996 for Article 32 corporations)

Article 9-A corporations

This section applies to resident and nonresident shareholders of Article 9-A S corporations which are presently either New York S corporations or New York C corporations. It applies **unless,** for every taxable year after 1980 that the corporation has been a federal S corporation, it has also been a New York S corporation.

Under the federal S election, the shareholder is taxed on the S corporation income as earned, and accordingly, subsequent distributions of the income by the corporation are tax-free to the shareholder. New York has provided a state-level S election to Article 9-A S corporations since 1981 (or more precisely, for taxable years of the corporation beginning after 1980).

Prior to that time, S corporations were taxed as C corporations under Article 9-A, while the shareholders were taxed, by conformity with federal treatment, as S corporation shareholders under the Article 22 personal income tax. Since the shareholders were taxed by New York as S corporation shareholders for those pre-1981 years, the federal tax-free treatment of distributions attributable to income from those years is appropriate for New York State purposes.

Likewise with the advent of the New York S election after 1980, the federal tax-free treatment of distributions is appropriate for state purposes where the New York S election is made.

However, if the New York S election is not made for any post-1980 year, New York C treatment applies. For those years that New York C treatment applies, the corporation's pass-through income is not included in the shareholder's New York adjusted gross income under Article 22. Accordingly, distributions of such income, while tax-free at the federal level, are taxed by New York. This uncoupling effect comes from the New York C corporation modifications, which: 1) exclude from the shareholder's New York adjusted gross income the S corporation's pass-through income and 2) include in the shareholder's New York adjusted gross income, as C corporation dividends, any distributions from the S corporation.

This inclusion by the shareholder of distributions as C corporation dividends applies regardless of the corporation's present status as a New York S or New York C corporation. For example, it applies in the following instances:

- New York C corporation. At all times since 1980, the Article 9-A corporation has been a federal S corporation but a New York C corporation (the New York S election has never been made);

- New York C corporation. An Article 9-A corporation, when formed in 1985, made the federal and New York S elections. While retaining its federal S election, it terminated its New York S election in 1992. The corporation makes a distribution to its shareholders which is attributable to income earned by the corporation after 1991.

- New York S corporation. An Article 9-A corporation since its formation in New York in 1985 has at all times been a federal S corporation, but did not make the New York S election until 1988. The corporation subsequently distributed income that is attributable to income earned by the corporation before 1988.

Resident shareholders

The following rules apply to the distribution inclusion in these situations.

In computing New York adjusted gross income, the shareholder must **add** to federal adjusted gross income S corporation distributions which:

- are excluded from federal adjusted gross income and

- are attributable to S corporation pass-through income not previously taxed to the shareholder because the corporation was in New York C corporation status.

The subject distributions are those described in:

- section 1368 of the Internal Revenue Code, relating to distributions of pass-through income;

- section 1371(e) of the Internal Revenue Code, relating to cash distributions during a federal S post-termination transition period; and

- section 1379(c) of the Internal Revenue Code, relating to transition rules for distributions of undistributed taxable income following the federal Subchapter S Revision Act of 1982.

If any of these distributions are treated as a capital gain for federal income tax purposes, they will nonetheless be treated as ordinary income for New York purposes.

Nonresident shareholders

In the case of nonresident shareholders, distributions attributable to New York C corporation status are not New York source income. If however, for some other reason, the nonresident is required to file a New York return, the distributions are included in the resident portion of the nonresident tax calculation as provided above for residents. In addition, the distributions are included in the denominator of the income percentage. Nonetheless, the distributions are not included in the numerator of the percentage unless the stock held by the nonresident shareholder in the S corporation is employed in another business carried on by the shareholder in New York.

Article 32 corporations

The rules applicable to Article 9-A corporations also apply to resident and nonresident shareholders of Article 32 S corporations which are presently either New York S corporations or New York C corporations. The rules apply unless, for every taxable year after 1996 that the corporation has been a federal S corporation, it has also been a New York S corporation.

Part VIII: Sale of S corporation stock

This part discusses the New York tax treatment of gains or losses realized by a resident or nonresident upon the sale of stock of an S corporation.

Sale of stock by a resident shareholder

If a resident shareholder sells or disposes of stock in an S corporation, the shareholder's New York gain or loss is the same as the federal gain or loss, when the S corporation is a New York S corporation or an ineligible S corporation.

However, if the S corporation is currently a New York C corporation, or was a New York C corporation at any time after 1980 (after 1996 for Article 32 corporations), the federal and New York bases of the stock have diverged. The federal basis has been adjusted for the S corporation income pass-through and this adjustment is not appropriate for the New York C corporation period. Accordingly, when the stock of the corporation is sold or disposed of, federal adjusted gross income must be modified to reflect the differences in federal and New York bases in the following manner.

Addition to federal adjusted gross income

To adjust for federal basis increases which are not recognized by New York, the shareholder must **add** to federal adjusted gross income the federal basis increases in the shareholder's stock or indebtedness attributable to the S corporation pass-through income. The federal increase is computed for each taxable year **beginning after 1980** for Article 9-A corporations and **after 1996** for Article 32 corporations that the corporation was a New York C corporation, under the following Internal Revenue Code (IRC) sections:

- 1376(a), as that section was in effect for taxable years beginning before 1983, relating to basis increase for undistributed taxable income that was included in the shareholder's federal gross income, and

- 1367(a)(1)(A) and (B), effective for taxable years beginning after 1982, relating to basis increase for S corporation items of income and gain that were included in the shareholder's federal gross income.

Subtraction from federal adjusted gross income

To adjust for federal basis decreases which are not recognized by New York, the shareholder must **subtract** from federal adjusted gross income the federal basis decreases in the shareholder's stock or indebtedness attributable to the S corporation pass-through loss or deduction. The federal decrease is computed for each taxable year **beginning after 1980** for Article 9-A corporations and **after 1996** for Article 32 corporations that the corporation was a New York C corporation, under the following IRC sections:

- 1376(b), as that section was in effect for taxable years beginning before 1983, relating to basis decrease for the shareholder's pro rata share of the corporation's net operating loss, and

- 1367(a)(2)(B) and (C), effective for taxable years beginning after 1982, relating to basis decrease for S corporation items of loss and deduction that were included in the shareholder's federal gross income.

Example

John Jones has been a shareholder in an Article 9-A corporation since it was formed in 1995. The corporation has always been a federal S corporation. For tax years 1996 and 1997, the corporation was a New York C corporation. For years 1998 and 1999, the corporation was a New York S corporation. John had the following adjustments to his stock basis for federal tax purposes for the years 1996-1999:

1996 - $2,000
1997 +$3,000
1998 +$1,000
1999 - $4,000

On December 31, 1999, John sells all his stock in the corporation. In determining his 1999 New York adjusted gross income, he must add to his federal adjusted gross income $1,000. This amount represents the net increase in the federal basis of the stock for the years (1996 and 1997) in which the corporation was a New York C corporation.

In addition, while the S corporation was in New York C corporation status, distributions by the corporation of pass-through income were treated for federal purposes as nontaxable basis reductions under section 1367(a)(2)(A) of the Internal Revenue Code, while New York required their recognition as dividends by the shareholder. (See *Distribution modification/catch-up adjustment* on page 32.) Since the federal basis reduction for tax-free distributions is not appropriate under the New York tax treatment of the distributions, it is not given effect by New York when the corporate stock is sold or otherwise disposed of. To adjust the gain or loss on the stock sale to properly reflect the New York basis, the shareholder should subtract from federal adjusted gross income in the year of sale the aggregate of the New York C corporation distributions which New York required to be added to federal adjusted gross income after 1980.

Sale of stock by a nonresident shareholder

A nonresident shareholder of an S corporation is not subject to New York State tax on gain or loss recognized for federal purposes on sale or disposition of stock in an S corporation unless the stock was employed in another business carried on by the shareholder in New York. This is the case whether the corporation is a New York S corporation, a New York C corporation or an ineligible corporation. If, however, the nonresident shareholder is, for some other reason, required to file a New York return for the year of sale or disposition, the following would pertain:

- If the S corporation is a New York S corporation or an ineligible S corporation, the nonresident shareholder's New York gain or loss on sale of the stock is the same as the federal gain or loss in the resident part of the nonresident tax computation. The gain or loss is not, however, New York source income and is not included in the numerator of the income percentage.

- If the S corporation is currently a New York C corporation, or was a New York C corporation at any time after 1980 (after 1996 for Article 32 corporations), the New York gain or loss on the sale in the resident part of the nonresident computation is adjusted to reflect the divergence of the federal and New York bases in the stock. This adjustment is made in the same manner as described above for residents. Again, however, neither the gain/loss nor the New York adjustment thereto is New York source income and accordingly is not included in the numerator of the income percentage.

On the other hand, if the stock of the S corporation was employed in another business conducted by the nonresident shareholder in New York (See Appendix B), the gain or loss on the sale is subject to New York tax. In this event, the shareholder would include the same gain or loss in New York source income (including the basis adjustment, in the case of a New York C corporation), as is included in the New York adjusted gross income in the resident part of the computation.

Part IX: Resident credit and New York deduction for taxes paid to other jurisdictions

This section discusses various New York provisions that apply to a shareholder of an S corporation that does business in New York, a state other than New York, or both. In some instances, the shareholder may be entitled to a New York State credit for taxes on S corporation items of income, gain, etc., which are paid to another state, a political subdivision of that state or the District of Columbia (non-New York taxing jurisdictions). In other instances, the shareholder may not be entitled to the credit, but may be entitled to a New York deduction for taxes paid to another taxing jurisdiction. A more detailed explanation of these rules follows.

Resident tax credit: shareholder level taxes

New York allows a **resident** individual a credit against the individual's New York State tax for income taxes paid to a non-New York taxing jurisdiction. (See following **Note**.) The taxes paid to the other jurisdiction must be imposed on income derived from the other state, and that income must also be subject to New York State personal income tax.

Note: No credit is allowed for income taxes paid to political subdivisions of this State, that is, New York City or the city of Yonkers.

A resident shareholder of a New York S corporation, or of an ineligible S corporation, is entitled to a resident credit provided all the following conditions are met:

- the corporation conducts business in a non-New York taxing jurisdiction;
- the corporation is treated as an S corporation in the other taxing jurisdiction (it does not matter whether the corporation is treated as an S corporation in the jurisdiction by reason of a separate election or by automatic conformity with the federal S election);
- the other jurisdiction imposes the tax on **the individual shareholder,** and that tax is imposed on the shareholder's items of S corporation income, gain, loss, and deduction derived from the other jurisdiction; and
- the shareholder is personally liable for the tax imposed by the other jurisdiction.

A shareholder who is eligible to claim a resident credit must complete Form IT-112-R, *Resident Tax Credit*. For more information concerning the computation of the resident credit, see Form IT-112-R.

The resident credit is for tax imposed upon **the shareholder.** A shareholder

may not claim a resident credit for tax imposed upon or payable **by the corporation** to another state. This is true even if the corporation is treated as an S corporation in the other state. (See **Note** below.) However, in this instance, the shareholder is entitled to a New York deduction for his or her pro rata share of the taxes paid by the corporation to another state. (See *New York Deduction: Corporation Level Taxes* below.)

Note: For instance, if the other state gives S corporation treatment similar to New York's where separate taxes are imposed on both the shareholder and the New York S corporation, New York's resident credit would apply to the tax of the other state which is imposed on the shareholder, but would not apply to the tax of the other state which is imposed on the S corporation.

On the other hand, a shareholder of an S corporation which is a New York C corporation may not claim a resident credit for taxes paid to another state, even if the shareholder is personally liable for those taxes. This result occurs because the resident credit, by its terms, is not available where the income which is taxed by the other jurisdiction is not also subject to New York income tax. In this instance, the subject income is the S corporation pass-through income, which in the case of a New York C corporation is not subject to New York personal income tax. (See Part VII, *Shareholders of New York C corporations* on page 28.)

New York deduction: corporation level taxes

Ordinarily, New York does not allow a deduction for income taxes, whether of this State or any other taxing jurisdiction, in computing the Article 22 personal income tax. Such taxes which are deducted in determining federal adjusted gross income must be added back in determining New York adjusted gross income. However, the federal deduction is allowed (i.e., the federal deduction is not required to be added back) for S corporation shareholders in certain circumstances.

Resident shareholders

New York S corporation - A deduction is allowed to a shareholder of a New York S corporation for his or her pro rata share of the pass-through deduction for taxes of other jurisdictions on the S corporation income, provided those taxes are **imposed on the corporation.** (This is in lieu of a resident credit, which is allowed where the tax is **imposed on the shareholder.)**

New York S corporation - A deduction is allowed to a shareholder of a New York S corporation for his or her pro rata share of the pass-through deduction for the New York City corporation tax, which tax is imposed on the corporation.

New York S corporation - No deduction is allowed for the New York Article 9-A or Article 32 tax imposed on the New York S corporation.

New York C corporation - No deduction is allowed to the shareholder of a New York C corporation for any pro rata share of the S corporation pass-through deduction for taxes. This includes the New York State Article 9-A or Article 32 franchise tax, the New York City corporation tax, and any franchise or income taxes imposed by non-New York taxing jurisdictions. Under the New York S election system, any such pass-through deductions are reversed out by means of the New York C corporation modifications.

Ineligible S corporations - A deduction is allowed to the shareholder of an ineligible S corporation for his or her pro rata share of the pass-through deduction for: 1) the New York State Article 9 or 33 corporation taxes imposed on special corporations, 2) any New York City corporation tax imposed on special corporations and 3) any franchise or income taxes imposed on a special corporation or a foreign corporation by non-New York taxing jurisdictions.

Nonresident shareholders

The preceding rules for the deduction by resident shareholders also apply to nonresident shareholders in the resident portion of the nonresident tax calculation. In addition, where the pass-through deductions for taxes are from a New York S corporation, the deductions are treated as New York source items and are deductible in determining the numerator of the income percentage. On the other hand, where the pass-through deductions are from a New York C corporation or an ineligible S corporation, none of the pass-through income or deductions of the corporation are New York source, and accordingly, the deduction for taxes is not subtracted in determining the numerator of the income percentage.

Part X: Rules for part-year resident shareholders of S corporations

General

This section discusses the rules that apply to shareholders of S corporations who have a New York State, city of New York, or city of Yonkers change of resident status during the year (part-year residents).

The tax treatment of a shareholder of an S corporation depends on whether the corporation is a New York S corporation, a New York C corporation, or an ineligible S corporation. Having determined the status of the corporation, the tax treatment of the shareholder further depends on whether he or she is a resident or a nonresident. However, if a shareholder changes resident status during the year, the shareholder is considered a part-year resident for the year. The following special rules apply to part-year residents.

Part-year New York State residents

Part-year New York State resident shareholders of a New York S corporation must prorate their federal prorata share of S corporation income, gain, loss and deduction and any New York modifications between the resident and nonresident periods based upon the ratio that the number of days in each period bears to the total number of days in the shareholder's tax year. The total amount prorated to the resident period is fully includable in New York source income (the numerator of the income percentage). The amount prorated to the nonresident period is includable in New York source income only to the extent the items are derived from New York sources (i.e., the corporation's business or investment allocation percentage, whichever is appropriate, is applied to those items). Part-year resident shareholders of an ineligible S corporation use the same proration method that applies to part-year residents of New York S corporations. The amount prorated to the resident period is includable in New York source income. The amount prorated to the nonresident period should not be included in New York source income unless the stock of the S corporation is employed in another business carried on by the shareholder in New York State.

Part-year city of New York and Yonkers residents

Part-year New York City or Yonkers resident shareholders of a New York S corporation or an ineligible S corporation must prorate their federal share of S corporation income, gain, loss and deduction and any New York modifications to the city resident period based upon the ratio that the number of days in the city resident period bears to the total number of days in the shareholder's tax year. The total amount prorated to the resident period is subject to the respective city's resident tax. A proration to the nonresident period is not necessary since the S corporation items described above are not subject to the New York City or Yonkers nonresident earnings taxes.

Part-year resident shareholders of New York C corporations

A part-year resident of a New York C corporation does not have to make the prorations required of other S corporation shareholders. This is because any New York C corporation income, gain, loss and deduction is eliminated from the computation of New York source income (and the computation of the New York City or Yonkers taxes for the resident period) by reason of the New York C corporation modifications.

Exceptions

The above rules do not apply to: 1) distributions of cash or property from corporations which have at any time after 1980 (after 1996 for Article 32 corporations) been New York C corporations *(See Part VII - Distribution modification* on page 32), or 2) sales or dispositions of stock made by S corporation shareholders. (See *Part VIII - Sale of S corporation stock* on page 35.) In the case of distributions, the tax treatment will depend on the resident status of the taxpayer at the time the distribution is made. Likewise, in the case of sales or other dispositions of stock, the tax treatment will depend upon the shareholder's resident status at the time the stock is sold or otherwise disposed of.

In addition, accrual of income rules may apply to distributions, sales or dispositions when a shareholder has a change of resident status. For more information concerning the accrual of income rules, see Technical Services Bureau Memorandum TSB-M-94-(9)I.

Part XI: Group returns for nonresident Shareholders of New York S corporations

A New York S corporation that has any income derived from or connected with New York sources may be granted approval to file Form IT-203-S, *Group Return for Nonresident Shareholders of New York S Corporations.* This return may be filed only if the S corporation has 11 or more qualified nonresident shareholders who elect to participate in the group return for each year. All qualified shareholders who elect to participate in the group return must have the same accounting period.

A group return is considered a group of individual returns that meet the New York State tax return filing requirements. Accordingly, if a qualified shareholder elects to participate in the group return, the shareholder is not required to file an individual New York nonresident personal income tax return for the tax year. For more information, see Form IT-203-S and instructions.

Part XII: How to obtain additional assistance

Need help?

Visit our Web site at ***www.tax.ny.gov***

- get information and manage your taxes online
- check for new online services and features

Telephone assistance

Business Tax Information Center: (518) 457-5342

To order forms and publications: (518) 457-5431

Text Telephone (TTY) Hotline (for persons with hearing and speech disabilities using a TTY): If you have access to a TTY, contact us at (518) 485-5082. If you do not own a TTY, check with independent living centers or community action programs to find out where machines are available for public use.

Persons with disabilities: In compliance with the Americans with Disabilities Act, we will ensure that our lobbies, offices, meeting rooms, and other facilities are accessible to persons with disabilities. If you have questions about special accommodations for persons with disabilities, call the information center.

Appendix A: Articles 9-A and 32 corporations

As previously discussed in this publication, the New York State tax treatment of federal S corporations and their shareholders depends upon whether or not the corporation is subject to tax under Article 9-A or Article 32 of the New York State Tax Law.

Article 9-A corporation

The following is provided as a general guide for determining whether a corporation is subject to tax under Article 9-A and therefore entitled to make the New York S election.

A corporation is subject to tax under Article 9-A of the Tax Law if:

- it is a **general business corporation;** and
- New York has **tax jurisdiction** over the corporation.

General business corporation

A general business corporation includes all corporations **except:**

- **Article 9.** Corporations principally (more than 50%) engaged in a transportation or transmission business, except for corporations principally engaged in a railroad, trucking or aviation business. Such transportation and transmission corporations are subject to tax under Article 9 of the New York State Tax Law. Aviation businesses, however, are subject to tax under Article 9-A. Railroad and trucking corporations are subject to tax under Article 9-A unless they elect to be subject to tax under Article 9.

- **Article 9.** Utility companies and farmers' and agricultural cooperatives which are subject to tax under Article 9 of the New York State Tax Law.

- **Nonprofit.** Nonstock, not-for-profit corporations, including those subject to the unrelated business income tax under Article 13 of the New York State Tax Law.

- **Article 32.** Banking corporations which are subject to tax under Article 32 of the New York State Tax Law.

- **Article 33.** Insurance corporations which are subject to tax under Article 33 of the New York State Tax Law.

New York tax jurisdiction

New York has tax jurisdiction over a domestic corporation (a corporation formed under the laws of New York) by reason of its incorporation under New York law.

New York has tax jurisdiction over a foreign corporation (a corporation formed outside of New York) if the corporation conducts business, employs capital, owns or leases property or maintains an office in New York State.

Article 32 corporations

A corporation is subject to tax under Article 32 of the Tax Law if:

- it is a banking corporation as defined in section 1452(a) of the Tax Law; and
- it is exercising its franchise or doing business in a corporate or organized capacity in New York State.

Appendix B: S corporation stock employed in another business

The New York tax treatment of a nonresident shareholder of an S corporation depends upon whether the stock held by the nonresident is employed in some other business carried on by the nonresident in New York State. The following examples provide guidance concerning those situations in which the stock would and would not be considered employed in another business.

Example 1: John Jones, a nonresident, operates a wholesale poultry business as a sole proprietor in New York State. In order to insure a reliable source of poultry for his business, John purchases a one-half interest (100 shares) in a corporation that raises poultry. The corporation is an S corporation for federal purposes but not for New York purposes. Since the interest (the 100 shares of stock) that John holds in the poultry corporation is an integral part of his wholesale poultry business, that stock is employed in the business carried on by John in New York State.

Example 2: Mary Smith, a nonresident, is a shareholder in an S corporation that is also a New York S corporation. The corporation does all its business in New York State. Mary is also employed by the corporation in New York as its president. Mary does not operate any other business in New York State. Under these circumstances, Mary's stock is not employed in another business carried on by her in New York State.

Appendix C: New York State corporation tax forms for S corporations

The following is a list of the primary New York State corporation and franchise tax forms that apply to S corporations. This is not an all-inclusive list. Taxpayers should consult the instructions for the primary forms to determine what, if any, additional New York State forms or copies of federal forms are required to be filed. When you order forms, a copy of the applicable instructions will also be sent to you.

New York S corporations

Form CT-3-S	New York S Corporation Franchise Tax Return (long form)
Form CT-3-S-ATT	Attachment to Form CT-3-S
Form CT-3-S-A	New York S Corporation Combined Franchise Tax Return
Form CT-4-S	New York S Corporation Franchise Tax Return (short form)
Form CT-32-S	New York Bank S Corporation Franchise Tax Return
Form CT-34-SH	New York S Corporation Shareholders Information Schedule

New York C corporations

Form CT-3	General Business Corporation Franchise Tax Return (long form)
Form CT-3-ATT	Attachment to Form CT-3
Form CT-4	General Business Corporation Franchise Tax Return (short form)
Form CT-32	Banking Corporation Franchise Tax Return

Special corporations: S corporations that are Article 9 corporations

CT-183	Transportation and Transmission Corporation Franchise Tax Return on Capital Stock
CT-183-M	Transportation and Transmission Corporation MTA Surcharge Return
CT-184	Transportation and Transmission Corporation Franchise Tax Return on Gross Earnings
CT-184-M	Transportation and Transmission Corporation MTA Surcharge Return
CT-185	Cooperative Agricultural Corporation Franchise Tax Return
CT-186	Utility Corporation Franchise Tax Return
CT-186-A	Utility Services Tax Return - Gross Operating Income
CT-186-A/M	Utility Services MTA Surcharge Return
CT-186-E	Telecommunications Tax Return and Utility Services Tax Return
CT-186-M	Utility Corporation MTA Surcharge Return
CT- I 86-P	Utility Services Tax Return - Gross Income
CT-186-P/M	Utility Services MTA Surcharge Return

Foreign corporations: other forms

CT-240	Foreign Corporation License Fee Report
CT-245	Maintenance Fee and Activities Return of Foreign Corporations Disclaiming Tax Liability