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1997 Tax Changes
—Attempt to Reduce Liability and Burdens of Property Owners

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Many changes have been made during the past few months to the tax laws of New York State and New York City. Some of the changes relate directly to real estate, and others, of broader application, will affect the structuring of real estate transactions and the tax burdens imposed on real estate and related businesses.

The amendments that appear most significant from a real estate perspective are described briefly below.

Property Tax Relief

Residential school property taxes are to be reduced over a period of years commencing with the fiscal year beginning July 1, 1998. To provide comparable tax relief to New York City residents, the City personal income tax rates will be reduced by up to two-tenths of one percentage point over a 3-year period beginning in 1999; in addition, a personal income tax "school tax reduction" credit of up to $125 per year will be phased in over a 4-year period commencing in 1998.

The State is to compensate school districts and the City for reductions in tax revenue attributable to the property tax relief program.

Separately, the real property tax (and commercial rent tax) reductions in the tax incentive program for lower Manhattan have been revised, and the duration of certain benefits under the program has been extended.

"QSSS" Conformity

The Internal Revenue Code as amended in 1996 permits an S corporation to have one or more corporate subsidiaries. If the appropriate election is made with respect to a wholly owned subsidiary, the assets, liabilities, income, and other tax items of such subsidiary—now referred to as a "qualified Subchapter S subsidiary," or "QSSS"—are treated as belonging to the parent S corporation, and the subsidiary is not treated as a separate corporation for purposes of the Code.

The New York State tax law was amended this year to address the treatment of a QSSS for franchise tax purposes, and to make certain other changes relating to the State's S corporation election to conform to recent federal changes. The changes to the franchise tax relating to QSSS's are generally effective for taxable years beginning after 1996.

In most cases, the New York State treatment of a QSSS parallels the federal treatment. Thus, in general, if a corporation which is an S corporation for federal and New York State tax purposes has a subsidiary which is a QSSS, the assets, liabilities, income and other tax items of the QSSS are treated as being those of the parent corporation for purposes of the state franchise tax.

The QSSS election will have those same consequences if the parent corporation has not made an S election for New York State tax purposes, in situations where both the parent corporation and the QSSS are subject to the state franchise tax.

If a parent corporation which is subject to New York State tax but has not made a state S election owns a QSSS which is *not* subject to the state franchise tax, the parent corporation may make a "QSSS inclusion election" to cause the assets, liabilities, income and other tax items of the QSSS to be treated as those of the parent in determining the parent's liabilities under the franchise tax. If the QSSS inclusion election is not made, the parent's entire net income is computed for purposes of the franchise tax as if the federal QSSS election had not been made.

If a parent corporation not subject to the state franchise tax owns the stock of a QSSS which is subject to tax, a New York S election may be made for the parent, in which case the parent will be subject to the franchise tax and the QSSS election will be respected. If the parent S election is not made, the subsidiary will be subject to the franchise tax as a C corporation and its income will be computed as if the federal QSSS election had not been made.

Special rules apply, and QSSS treatment is generally not available if the parent corporation or the relevant subsidiary is a so-called "excluded corporation," that is, a corporation subject to the special state franchise taxes applicable under Articles 9, 32 and 33 of the New York Tax Law to certain "transportation and transmission" corporations and to banks and insurance companies. The new state rules and the procedure for making a QSSS inclusion election are discussed in a Technical Services Bulletin issued by the Department of Taxation and Finance (TSB-M-97(6)C, Sept. 9, 1997).

The consequences of a federal QSSS election under the New York City General Corporation Tax (which does not authorize an election corresponding to the federal and New York State S elections) are not yet clear. There have been informal indications that the Department of Finance will apply the GCT in a manner in general conformity with the federal treatment of QSSS's.

Commercial Rent Tax

Further progress has been made in reducing the City's widely criticized "Commercial Rent or Occupancy" tax. Over the past few years, the maximum effective rate of the tax has been reduced to 4.5%, and tenants of property located north of 96th Street in Manhattan or in any City borough other than Manhattan have been exempted from the tax.

Pursuant to a local law passed by the City Council in June, a tenant with rent for a tax year of less than $100,000 is exempt from the commercial rent tax, for years beginning on or after June 1, 1997. Where the rent for the tax year is at least $100,000 but less than $140,000, a partial credit is allowed equal to a percentage of the tax that would otherwise be due, with the applicable percentage declining in steps from

80%, for rent of less than $110,000, to 20% for rent of $130,000 to $139,999. No credit is allowed if the rent for the tax year exceeds $139,999.

In addition, the effective tax rate to be applied to rents remaining subject to tax has been reduced to 3.9% for periods beginning on or after September 1, 1998.

Vault Charges

The tax on subsurface vaults is buried. Effective June 1, 1998, the City's annual vault charge will cease to be imposed.

Unincorporated Business Tax

The City's Unincorporated Business Tax, or "UBT," has long been imposed at the rate of 4% on the "unincorporated business taxable income," or "UBTI," of unincorporated businesses carried on within the City. Amendments made earlier this year to the New York City Administrative Code effectively increase the minimum UBTI amount below which the tax does not apply.

Specifically, for taxable years beginning after 1996, no UBT will be due if the tax as otherwise computed is not more than $1,800, equivalent to UBTI of $45,000.

If the tax as otherwise computed exceeds $1,800 but is less than $3,200 (equivalent to UBTI of $80,000), a partial credit is allowed. The amount of the credit declines ratably as the tax as otherwise computed increases within the $1,800 to $3,200 range, and no credit is allowed under this provision if the tax as otherwise computed is $3,200 or more.

PIT Credit. The Administrative Code has also been amended to allow a credit against the City personal income tax for a portion of the UBT imposed on a City resident, for taxable years beginning on or after January 1, 1997.

If a resident's City taxable income is $42,000 or less, 65% of the UBT that is imposed on the resident's unincorporated business for the year and paid by the business is allowed as a credit against the resident's City personal income tax liability.

If a resident's City taxable income is greater than $42,000 but not more than $142,000, the percentage of the UBT allowed as a credit is computed by formula, with the percentage declining from 65% to 15% as City taxable income increases within the $42,000 to $142,000 range.

If a resident's City taxable income exceeds $142,000, 15% of the UBT is allowed as a credit. The credit cannot in any event exceed the amount of personal income tax otherwise imposed on the resident for the taxable year.

With respect to each unincorporated business in which the taxpayer is a partner, the portion of the UBT imposed on the partnership which is taken into account in determining the partner's income tax credit is determined, in general, by reference to the "net total" of the partner's distributive share of income, gain, loss and deductions of, and guaranteed payments from, the business.

An equivalent credit against the City nonresident earnings tax for UBT payments was under consideration earlier this year, but was not enacted.

Transfer Tax Deduction for Continuing Liens

For purposes of the New York City Real Property Transfer Tax (as well as the State's Real Estate Transfer Tax), the consideration subject to tax generally includes the amount of any mortgage, lien or other encumbrance assumed or taken subject to. This rule, although generally consistent with the federal tax treatment of liabilities, has long been an obstacle to property transfers even in circumstances where no gain would generally be recognized for federal income tax purposes, such as in connection with transfers between spouses or to a former spouse in connection with a divorce.

The State transfer tax, however, generally excludes from consideration, with respect to (i) a transfer of a one-to-three family house, individual residential condominium unit, or individual residential unit in a cooperative housing corporation and (ii) a transfer for consideration of less than $500,000, the amount of any lien or encumbrance remaining on the property at the time of transfer.

Largely to facilitate transfers between family members, the City transfer tax has been amended to provide that, with respect to any transfer (intra-family or otherwise) of a one-to-three family house or an individual residential condominium unit or cooperative apartment, the amount of any mortgage or other lien or encumbrance on the property that existed before the transfer and remains after the transfer will, in general, be excluded from consideration.

The City exclusion does not apply to any mortgage, lien or encumbrance which is placed on property in connection with or in anticipation of a transfer; to a transfer to a mortgagee or lienor; or to any transfer which qualifies for the special transfer tax provisions applicable to a "real estate investment trust transfer."

The new City exclusion for continuing liens applies to transfers on or after August 28, 1997.

Observations

The changes described above are part of a broader effort by New York State and New York City—reflected as well in the reductions in estate and gift taxes, sales taxes on clothing, utility tax rates and various other taxes—to lessen tax liabilities and tax compliance burdens associated with the ownership or use of property and the conduct of business within the State and the City.
Many of the 1997 changes will not take effect, in whole or in part, until after the current year, and thus may be particularly at risk if the current favorable economic climate changes in the near term and there is a resulting need for "revenue enhancers." Subject to that caveat, the 1997 tax law changes should enhance the attractiveness of the City and the State as places in which to live and do business.