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New York Budget Bill Proposes Many Corporate Tax Changes

by Christopher L. Doyle, Timothy P. Noonan, and Elizabeth Pascal

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In this article, the authors examine the corporate tax reforms proposed by Gov. Andrew Cuomo (D). They note that reform proposals have been taking shape for several years and say the time is finally ripe for action.

For the first time since 1987, New York is proposing substantial reforms to its corporate tax structure. In 1987 the impetus for change was external: The passage of major tax reform at the federal level in 1986 increased the tax base, which required attention at the state level. The impetus this time around is more internal: Tax policy experts in state government want to simplify and modernize New York's confusing and antiquated corporate tax system, enhanced by a desire to remove or amend provisions in the scheme that are widely considered to impede economic growth in the Empire State. The reform proposals have been in the works for several years, but conditions were not considered ripe for a wholesale change. Now, the view is that reform is both a tax policy priority and an economic imperative.

For the most part, businesses and practitioners have welcomed the corporate tax proposals in Democratic Gov. Andrew Cuomo's executive budget for fiscal 2014-2015, which range from repeal of the bank tax to new apportionment rules. The corporate tax reform spans more than 320 pages of the revenue budget bill (S 6359, A 8559), which the governor submitted to the New York State Legislature on January 21 for consideration. Many of the provisions emerged from the reports of the two commissions put together by Cuomo last year: the New York State Tax Reform and Fairness Commission and the New York State Tax Relief Commission. (That's how we roll in New York — relief *and* reform. Why form one commission when two can be just as fun?)

If the budget is passed on time, as it has been for the last three years, the reforms (subject to amendments and revisions[1]) discussed here will become law in April, with most provisions taking effect in the tax year beginning January 1, 2015. Some reforms, such as the repeal of the article 32 bank franchise tax, will simplify the corporate tax structure. Others, such as new categories and definitions of what constitutes taxable income, will substantially shift the locus of discussions and negotiations between businesses and the New York State Department of Taxation and Finance as to how much income is properly taxable by New York. Proposals such as new economic nexus rules will likely generate debate regarding where the line should be drawn in a state's ability to tax business activity.

But one thing is certain: Tax practitioners better read up. There's a lot of meat to the changes.

I. Big Picture Reforms

A. Bank Franchise Tax Repeal

As expected, Cuomo's budget would repeal the article 32 banking corporation franchise tax and make banking corporations and financial services subject to the article 9-A franchise tax, along with most other corporations. The article 32 tax was similar to the article 9-A tax, but taxed financial businesses using a three-factor formula (payroll, property, and receipts). Consequently, the tax was considered a disincentive for banks to locate more jobs and invest capital in New York. Further, changes in federal regulations that permit cross-ownership of corporate and financial companies meant the law's separation between those types of entities no longer reflected the reality of corporate structures.[2]

B. New Economic Nexus Standard

The proposed budget would broaden the nexus standard in Tax Law section 209.1(a) to impose the corporate franchise tax on businesses that derive receipts from New York totaling at least $1 million in a tax year, subject to adjustment for inflation. Economic nexus provisions like those — based solely on a business's economic activity in a state rather than its physical presence — have been popping up all over the country as states seek to address Internet sales and the 21st century business model that often does not require

[1]The 30-day amendments, which were published too late to be discussed in this article, make changes to the proposed corporate tax reform.

[2]New York State Tax Relief Commission Final Report (Dec. 2013).

a physical presence in a state to generate sales. Those provisions are being tested in courts and have been struck down in several recent cases as insufficient to meet the constitutional requirement of substantial nexus.[3] Unless the U.S. Supreme Court decides to enter the nexus fray, it's likely that New York's new economic nexus standard will face a similar test in court, should it become law.

The budget bill would eliminate the exception from nexus for out-of-state businesses that use a fulfillment service to hold inventory in New York and deliver it to customers on behalf of the business. But that is only in the context of corporate tax reform. For sales tax purposes, where the same fulfillment nexus rule applies, that special exemption appears safe for now.

C. New Corporate Income Tax Base

The proposed changes to the classification of income would substantially simplify the current rules. Under franchise tax rules, corporations calculate the tax based on its entire net income, which is federal taxable income with some modifications. Article 9-A treats income and dividends from subsidiary capital and other investment capital as separate classes of income, removing income from subsidiary capital from business income, allocating investment income using a unique approach, and creating a separate add-on tax for subsidiary capital.[4] Article 9-A businesses then pay tax on the highest of four alternative tax bases of income apportioned to New York (entire net income, business and investment income, minimum taxable income, or a fixed dollar minimum) with the add-on tax for subsidiary capital. Alien businesses are required to use their worldwide income as the tax base from which to apportion income to New York. The current system makes it complicated for businesses to classify income, attribute expenses to the various income categories, and calculate their highest tax base.

The new rules would simplify the system and eliminate what are considered significant loopholes in calculating the tax base. For U.S. corporations, the starting point for business income would still be federal taxable income. The alternative minimum tax base would be eliminated, as would the add-on tax on subsidiary capital. Alien corporations would now start with effectively connected income under IRC section 882, thereby harmonizing their federal and state tax bases.

More significantly, the budget bill would classify income based on whether it is taxable business income or nontaxable income. Business income is now defined as entire net income minus exempt and investment income. The definition of investment income (now a nontaxable class of income) would be substantially narrowed to include only income from stocks of non-unitary corporations held for more than six consecutive months (whether or not that period crosses tax years). To determine what constitutes a unitary versus a non-unitary corporation, a 20 percent ownership test would be used, with only voting stock used to determine whether the ownership test is met.

A new category of other exempt income would include income from a controlled foreign corporation (subpart F income) that is conducting a unitary business with the taxpayer but is not part of the combined group. Exempt income also would include dividends received from a unitary business that is not part of the combined group because the business is 1) taxable under another article of the tax code, 2) an alien corporation with no effectively connected income, or 3) a corporation that is less than 50 percent directly or indirectly owned a member of the combined group. Exempt income would, of course, include any income not apportionable under the U.S. Constitution.

Taxable business income would include categories of income that are exempt under existing law. Most significantly, the proposed provisions would eliminate the wholesale exemption for income from subsidiary capital and 50 percent of dividends from non-subsidiaries. That income would be classified according to the new definitions of business income, investment income, and other exempt income to determine whether it is subject to tax. In other words, dividend income from subsidiary capital could still be exempt from tax if the subsidiary is engaged in a unitary business with the taxpayer and the six-month holding requirements are met. Business income would also include interest income and gains and losses from debt instruments and other obligations (so long as the income is apportionable) and cash.

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Consistent with the new income classification system, the budget would revise the attribution of expenses, so that deductions for expenses attributable to investment income or other exempt income would be disallowed. As a shortcut for computing deductible interest expenses, taxpayers can elect to reduce investment and other exempt income (with corresponding increases in taxable business income) by 40 percent.

D. New Corporate Tax Rate

In conjunction with an expansion of the tax base, the proposed budget reduces the corporate franchise tax rate from 7.1 percent to 6.5 percent, effective for tax years beginning on or after January 1, 2016. The 6.5 percent rate would also apply to small businesses. Rates for qualified New York manufacturers would fall from 5.7 percent in

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[3] *See, e.g., Scioto v. Insurance Co. v. Oklahoma Tax Commission,* 279 P. 3d 782 (Okla. 2012); *Griffith v. ConAgra Brands,* 728 S.E. 2d 74 (W.Va. 2012).

[4] N.Y. Tax Law section 210.1.

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2015 to 4.875 percent in 2018, and qualified upstate manufacturers would benefit from a 0 percent tax rate through 2018. Tax rates on the business capital base and the fixed dollar minimum base for manufacturers would be similarly decreased between 2015 and 2018.

E. Metropolitan Transportation Authority Surcharge

The budget bill would make permanent the surcharge imposed on income apportioned to locations within the Metropolitan Transportation Authority. It would apply the new economic nexus standard to determine whether a taxpayer is subject to the surcharge. The budget proposes to increase the surcharge from 17 percent to 24.5 percent (calculated before credits are applied). The increase in rate is intended to maintain the revenue stream from the surcharge, which would be affected by the decrease in the franchise tax rate, new apportionment rules, and elimination of the AMT base.

II. Allocation/Apportionment Reforms

The reforms that could generate the most discussion are the new customer-based sourcing rules. Under current rules, taxpayers selling tangible property source receipts based on the customer's location.[5] Under the tax department's audit policy, however, receipts from services are sourced based on the location of the taxpayer's activities that generate the receipts.[6] According to the Tax Relief Commission, the rules create a disincentive for service providers to locate jobs in the state because it increases their business allocation percentages to New York. Further, with the advent of so many types of electronic service providers, for instance, there has been much debate and litigation regarding the proper classification of receipts (as services or as other business receipts, which have been apportioned using a destination-based approach).

The proposed law would create a new section 210-A and apply customer-based sourcing for receipts from sales of tangible personal property and electricity shipped to or destined for New York; rentals of real and tangible property in New York; royalties from the use of patents, copyrights, and similar intangibles within New York; services provided to a regulated investment company; railroad and trucking activities; aviation; and advertising. Most importantly, the customer-sourcing rules would extend to services — receipts from the performances of services would be allocated based on the location of the customer. That is a huge change, and would put New York on a growing list of states moving toward customer-based sourcing for services.

The proposed rules also address sourcing for digital products, another area of controversy, creating rules for determining when the products are used in New York or elsewhere. A digital product is defined as "any property or service, or combination thereof, of whatever nature delivered to the purchaser through the use of wire, cable, fiber-optic, laser, microwave, radio wave, satellite, or similar successor media, or any combination thereof."[7] In addition to defining digital products based on how they are delivered, the proposed definition specifies that digital products include an audio work, audiovisual work, book or literary work, graphic work, game, information or entertainment service, storage of digital products, and computer software by whatever means delivered.

The proposed digital products sourcing rules would create a hierarchy to determine whether the customer is located in New York. That hierarchy starts with various methods to determine the location of the purchaser or user of the digital product. If no location information is available, the hierarchy includes the possibility of using the apportionment percentage for the past or current year.

Notably, the taxpayer may not choose from the various methods to apportion digital products' receipts. Instead, the proposed law would require that a taxpayer use due diligence to determine whether the first method in the hierarchy can be used before rejecting it and moving onto the next one in the list. Moreover, if a customer invoice for a digital product includes both services and property, the taxpayer cannot separate the charges and apportion them under different methods, regardless of whether the charges are separately stated.

The proposed reforms would also create new sourcing rules to apportion income from some financial instruments. A qualified financial instrument is defined as either securities or commodities that are marked to market under IRC section 475 or section 1256, but does not include loans secured by real property.[8] For qualified financial instruments, taxpayers can use one of two sourcing methods. For income that is not tax exempt, taxpayers can use customer-based sourcing. Taxpayers can also elect to treat all income from qualified financial instruments as taxable business income and apportion a fixed percentage of the net income from that stream to New York. The fixed percentage would be 8 percent (not subject to periodic revision) based on New York's approximate contribution to national gross domestic product. Businesses that choose to make that election must do so annually. The election would be irrevocable and apply to all members of the combined group that receive income from qualified financial instruments.

III. Combined Reporting Changes

New York has been fiddling with its combined reporting rules for the last decade. For many years, the state has had permissive combined reporting, leaving the tax department

[5]N.Y. Tax Law section 210.3(a)(2)(A).

[6]N.Y. Tax Law section 210.3(a)(2)(B).

[7]Cuomo budget part A, section 16; prop. Tax Law section 210-A.4(a).

[8]Cuomo budget part A, section 16; prop. Tax Law section 210-A.5(a).

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with discretion to force combination or decombination. Related corporations with common ownership engaged in a unitary business are permitted or required to file on a combined basis if there are substantial intercompany transactions among the group. Even if related corporations meeting the common ownership and unitary business requirements do not meet the substantial intercompany transaction test, the tax department has construed the law as giving it the discretion to permit or require corporations to file on a combined basis if filing separately would improperly reflect the business's activities giving rise to the taxable income in New York.

The combination rules Cuomo has proposed would bring New York's rules more in line with other mandatory unitary combined reporting states.

In 2007 New York revised its combined reporting law and abandoned the provision that permitted combination in the absence of substantial intercompany transactions if distortion could be proved. Under the new law, substantial intercompany transactions could be demonstrated by showing that at least 50 percent of a company's receipts were from a related company, that 50 percent of its expenditures were either to a related company or for the direct or indirect benefit of a related company, or that there was a substantial asset transfer to a related company.[9] The tax department then issued TSB-M-08(2)C laying out a multistep process to determine what companies should file a combined return in New York. New regulations containing many of the policies in the memorandum were issued in 2012.[10]

The 2007 changes and subsequent regulations did little to simplify reporting rules for corporations; in fact, they basically made things worse. Decombination audits became standard fare for multijurisdictional corporate families, with every step of determining what companies could file on a combined return and what constituted substantial intercompany transactions in dispute between taxpayers and audit.

The combination rules Cuomo has proposed would bring New York's rules more in line with other mandatory unitary combined reporting states, such as Arizona, Massachusetts, and Minnesota. Under proposed Tax Law section 210-C, combined reporting would be required for all water's-edge corporations. That would include domestic corporations (excluding S corps); alien corporations treated as domestic corporations under IRC section 7701 or having effectively connected income in the tax year at issue; captive real estate investment trusts or RICs, unless they are required to file on a combined report under article 33 of the Tax Code; and captive insurance companies, if they are permitted to file on a combined report. The proposed law thus would expand the number of REITs, RICS, and captive insurance companies eligible for combination by eliminating the exceptions for captive REITs and RICs with assets under $8 billion and captive insurance companies that don't meet the overcapitalization requirements.

The proposed legislation would reduce the common ownership test from 80 percent to 50 percent and require combination for all commonly owned eligible corporations that are engaged in a unitary business. Thus, the reform would eliminate the concepts of substantial intercompany transactions and distortion and focus the inquiry on what constitutes a unitary business, a concept not defined in the proposed legislation. In addition to mandatory combination, taxpayers may elect for a commonly owned group of corporations that are eligible for combination to file a combined return. The election would be irrevocable for all members for a seven-year period and would be made when the original return is timely filed.

Once a combined group is required or elected, the group would be treated as a single entity for tax purposes. Tax credits, net operating losses, and capital losses would be available to the combined group, rather than just the corporation that generated the credit or loss. All members of the combined group would be liable for the full amount of tax the group owes, rather than just the entity's pro rata share.

IV. Other Changes

Cuomo's budget proposes a few additional changes that are worth mentioning but do not substantially alter the corporate tax landscape.

A. NOL Provisions

The budget bill includes a short-term measure to address the significant NOLs corporations carry on their books as deferred tax assets. With the corporate tax rate set to be lowered under the proposed budget, the value of those assets would correspondingly decrease for future years.

The budget bill would make several changes to address the effects of the proposed rate change. First, taxpayers would no longer be permitted to carry back NOLs to offset income in prior years. Instead, taxpayers would be able to carry the NOLs forward 20 years, like under federal law. For all NOLs incurred before 2015, a credit would be available, rather than the deduction under current law. The credit would be calculated by multiplying the total value of NOLs incurred before 2015 by the taxpayer's (or the combined group's) business allocation percentage and tax rate for the 2014 tax year. For tax years beginning on or after January 1, 2015, taxpayers would be eligible to use up to 10 percent of the total amount of credit against current-year tax, so long as the tax is computed on business income (rather than, for example, the fixed dollar minimum tax). Taxpayers would be permitted to use the credit before the 2035 tax year.

[9] Tax Law section 211.4(a).

[10] 20 NYCRR sections 6.2.1-6.2.8.

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Apportioned NOLs incurred for years beginning on and after January 1, 2015, would again be available as a deduction against apportioned business income under rules similar to the existing rules.

B. Revisions to the Royalty Addback Provision

Last year, New York substantially reformed its royalty addback provision, closing the loophole that permitted a New York taxpayer with a higher business allocation percentage in New York to deduct a royalty payment received from a New York taxpayer with a lower allocation percentage.[11] Cuomo would make one minor revision to that law. Among the four exceptions to the addback requirement is if the payment was made to an alien taxpayer subject to a comprehensive tax treaty with the United States and the royalty income was subject to tax in that country at an effective rate equal to or higher than New York's rate. The proposed legislation would eliminate that exception, leaving the conduit, subject-to-tax, or alternative adjustment exceptions. That change is consistent with other proposed reforms that would potentially subject to tax alien corporations with effectively connected income.

[11] *See* Timothy Noonan and Elizabeth Pascal, "Changes to New York's Royalty Addback Rules," *State Tax Notes*, Sept. 30, 2013, p. 837.

C. Changes to the Investment Tax Credit

The budget bill also proposes to substantially revise the investment tax credit. The proposal would limit the universe of corporations eligible to claim the credit to qualified manufacturing, agricultural, and mining businesses. Credits would not be allowed for property for which a credit had previously been claimed. Assets also would be required to produce goods for sale. The for-sale requirement isn't in the current credit statute, even though it is in the sales tax exemption for production equipment.[12] The ITC proposal would expand the equipment for which credits could be claimed by qualified businesses to all facilities used in the production operations.

V. Conclusion

New York's proposed tax reform represents a bona fide effort to modernize the state's corporate tax structure. If it passes, there will certainly be growing pains, which will likely be addressed through litigation and future technical changes, but the proposal is an excellent start toward a more modern approach. ✰

[12] *Compare* Tax Law sections 210.12(b)(i) and 1115(a)(12).

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