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Earlier this year, New York State became the latest US state to adopt an economic nexus standard in order to subject an out-of-state corporation to state-level corporate income and franchise tax. New York's bright-line provision, effective for tax years beginning after 2014, imposes a corporate franchise tax filing obligation on an out-of state corporation that derives more than $1 million in receipts from New York State, whether or not the corporation ever had a physical presence in the state. This change is significant: currently, a corporation not incorporated in New York must have some form of physical presence in the state in order to attract income or franchise tax. A Canco that has effectively connected income (ECI) from a US source may now be subject to a New York franchise tax obligation if it meets this new purely economic threshold.

Other rule changes extend the franchise tax's scope. New York State's 2014-15 budget legislation (which was enacted on March 31, 2014 and includes other corporate tax reforms) (1) extends its franchise tax reach over out-of-state and alien corporations; (2) repeals a longstanding nexus safe harbour for a corporation that uses the services of a New York fulfillment service to store inventory and fulfill orders; and (3) establishes that a corporate partner in a partnership that does business in New York can be subject to New York tax, whether it is a general partner, a limited partner, or a member of an LLC that is taxed as a partnership.

Economic nexus. Economic-presence provisions adopted in New York and other states (such as California, Colorado, Connecticut, Ohio, and Washington) make it easier than ever for a US state to assert the corporate income and franchise tax liability of an out-of-state corporation or a non-USco no matter how carefully a corporation has structured its US presence. Under New York's new nexus standard, any corporation "deriving receipts from activity" within New York is subject to franchise tax obligations if its New York receipts total at least $1 million for the taxable year, even if it has no physical presence in the state. However, a non-USco —even if it meets the receipts-based threshold—is subject to franchise tax under the new law only if it also has ECI for federal purposes or if it is a deemed domestic corporation (such as a stapled stock entity) under the Code: otherwise, the non-USco is not subject to tax on its income, and it is not subject to inclusion in a combined reporting group (whether or not it has a physical or an economic

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presence).

Whether a receipt constitutes a New York receipt for the purposes of the receipts-based nexus threshold is determined by the same rules that apply when an out-of state corporation's income is apportioned to New York. The state currently employs a "single sales factor" method of apportionment that looks solely at the ratio of a corporation's New York receipts to its worldwide receipts. The new law retains the single sales factor but adopts market-based sourcing for these purposes: sales of both property and services are sourced to the place where the recipient is located.

A Canco that lacks a US PE currently enjoys protection from US federal income tax under the Canada-US treaty, but treaty protection does not extend to the taxes of an individual state. New York State generally requires that a non-USco with sufficient nexus pay franchise tax on an apportioned amount of its entire net income (ENI). Currently, the starting point for New York ENI is a corporation's US federal taxable income (as actually reported on a US federal return or as would be required to be reported absent a tax treaty). Effective in 2015, only a non-USco's ECI is included in its New York ENI. However, for the purposes of the new economic nexus threshold, it is irrelevant whether the ECI is associated with a trade or business carried on in New York or in other states, or whether the corporation has ever had property, employees, inventory, or any other form of physical presence in New York; the test is whether it has ECI anywhere in the United States.

Thus, after 2014 a Canco whose New York receipts are at least $1 million is taxable in New York (even if it lacks a physical presence) if its contacts in any US state are sufficient to create ECI. However, a Canco that has no US ECI (and is not a deemed domestic corporation under the Code) is not taxed on its income even if it meets the $1 million threshold or otherwise has nexus with New York. In fact, the adoption of ECI as the starting point for New York ENI may benefit a Canco if it maintains some form of physical presence in New York that is not sufficient to create ECI in the United States: even if tax nexus exists vis-à-vis New York, there is no income to apportion under the ENI tax base.

The ECI concept has been largely a non-issue for Cancos: the Canada-US treaty essentially obviated the concept at the US federal level, and ECI was previously not a factor in determining a corporation's New York franchise tax base. Thus, the reintroduction of ECI as a relevant factor for New York franchise tax purposes and the adoption of economic nexus in New York are likely to raise some complicated questions in practice. Unlike the new $1 million threshold, the test for whether a non-USco has ECI is not a bright-line test. And because ECI is generally not an issue for federal income tax purposes for a corporation that is protected under the Canada-US treaty, New York tax authorities are largely left to their own resources to interpret the Code and federal case law in the area.

The new economic-presence standard is also expected to trigger constitutional scrutiny. Although the US Supreme Court has made it clear that a state cannot impose sales tax obligations on an out-of-state corporation that does not have some form of physical presence in the state, the law remains unsettled with respect to whether the physical presence standard governs corporate income and franchise taxes. However, federal law (Interstate Income Act of 1959, Pub. L. no. 86-272) prohibits a US state from imposing a corporate tax based on net income on an out-of-state corporation if (1) its activities are limited solely to the presence of salespeople who solicit orders for tangible personal property and (2) all orders are sent outside the state for approval and are filled from inventory located outside the state. That federal limitation governs regardless of whether a state employs a physical-presence nexus standard or an economic-presence standard. A corporation that is currently protected under Pub. L. no. 86-272 does not lose that protection if it exceeds the new receipts threshold.

But if the same corporation must file as part of a combined New York reporting group, its income and receipts are still included in the group's combined calculations.

Repeal of safe harbour for fulfillment services. The elimination of the exception for fulfillment services in New York may create franchise tax nexus for an out-of-state corporation whether or not its New York receipts reach $1 million. The presence of real or tangible personal property in a state generally serves as a trigger for corporate tax nexus in most US states. To encourage the use of in-state fulfillment services, New York has long provided an exception for an out-of-state corporation that uses those services to store goods and fulfill orders if the service provider is not affiliated with the corporation. The safe harbour is eliminated effective for tax years beginning after 2014. From that time, the maintenance of inventory in New York through a fulfillment service or through owned or leased warehouse space creates franchise tax nexus for an out-of-state corporation, whether or not the corporation meets the threshold of $1 million in receipts.

Nexus through a partnership doing business in New York. A corporate general partner in a partnership doing business in New York is subject to New York franchise tax under the current regulations, regardless of ownership percentages or other factors. A corporation that is a limited partner or a member of an LLC may also be subject to New York franchise tax if the partnership or LLC itself has nexus with New York and certain enumerated thresholds are met. Effective for tax years beginning after 2014, the new legislation clarifies that any corporate partner (general or limited) in a partnership may have nexus with New York if the partnership itself has nexus with the state, including the nexus created by deriving receipts of at least $1 million from New York. The new legislation gives the Department of Taxation and Finance the authority to adopt new regulations to govern corporate partners, which may allow for regulations that apply more broadly than the current ones.

Conclusion. New York State's expanded tax-nexus provisions represent just one aspect of a sweeping set of corporate tax reforms enacted by the state this year. The reforms affect such areas as the requirements for combined reporting of unitary businesses, classification of income and expenses, elements of the tax base, tax rate changes, and apportionment. This article does not attempt to address all of the elements of New York's corporate tax reform, but the new nexus provisions have the potential to subject many Cancos to New York's franchise tax even if their operations and contacts with the United States or New York State have not changed. Cancos should be alert to these changes, which may affect the structure of doing business in New York and in the United States in general.