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NEW YORK STATE'S PROPOSED CORPORATE TAX REFORM: A HEADQUARTERS STATE NO LONGER?

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The New York State Department of Taxation and Finance (the "Department") has recently disseminated a comprehensive corporate tax reform proposal (the "Proposal") and is soliciting comments from practitioners and the business community at large on its proposed massive overhaul of the state's corporate tax regime.[1] The Proposal is intended to be revenue-neutral and has not been included in the Governor's Executive Budget for 2010–2011.

The primary goal of the Proposal is to merge the Article 32 tax on banking corporations and the Article 9-A franchise tax applicable to general business corporations. The Proposal also significantly changes a number of areas of the existing law, including economic nexus, the treatment of subsidiary capital, the "entire net income" tax base, sourcing of receipts, net operating losses ("NOLs"), and combined reporting.

As a trade-off, the Proposal provides a lowered corporate tax rate—6.5%. Time will tell whether that sticks.

The 300-page Proposal has been several years in the making, going back to 2008 when the Department formed a working group to address the possibility of merging Article 32 and Article 9-A. The stated goals of the Proposal are to achieve horizontal equity for taxpayers, economic efficiency, simplicity, ease of compliance and administration, and revenue stability and to create a foundation for economic growth.[2] An additional long-term goal is for the City of New York eventually to follow suit and conform to the Proposal to the greatest extent possible. At this point, however, the city's plans are unclear.

Given the ongoing chaos in Albany, it is difficult to predict where this legislation will go. Passage of the Proposal, however, would signal the end of an era in which New York State's overriding tax policy goal was to attract corporate taxpayers to establish their headquarters in the state. As explained below, the Proposal eliminates certain unique aspects of the existing state tax

[1] New York State Department of Taxation and Finance, Corporate Tax Reform Proposal, draft dated February 26, 2010. At the time of this writing, no bill number had been assigned to the Proposal.

[2] The New York State Department of Taxation and Finance, Office of Tax Policy's Broad Principles of Corporate Tax Reform, dated February 2010.

regime that were created as incentives for corporate taxpayers to establish commercial headquarters in New York State.[3] At the same time, the Proposal modernizes many aspects of the corporate tax, striving to reflect the business models of the 21st century.

Corporations Covered

The Proposal merges Article 9-A, the tax on general business corporations, and Article 32, New York's tax on banks. In doing so, the Proposal eliminates many of the anomalies/planning opportunities that have long been part of New York's tax law. For banks in particular, the disappearances of "grandfathered 9-A's" and of the Gramm-Leach-Bliley transitional rules[4] should offer significant simplification.

Economic Nexus

Not surprisingly, in the ever-expanding quest to broaden the tax base, the Proposal introduces a number of thresholds that, if met, would subject an out-of-state corporation to the New York corporate franchise tax. These thresholds are not entirely novel; a similar, albeit somewhat narrower, version currently exists under Article 32.[5] Because these thresholds can be met without the physical presence of the corporation, it is evident that the Department is officially adopting economic nexus, departing from New York's history to the contrary.

Under the Proposal, an out-of-state corporation would be considered "doing business" in New York if (i) "it has receipts within this state of one million dollars or more in the taxable year"; (ii) "it has issued credit cards to one thousand or more customers who have a mailing address within this state as of the last day of its taxable year"; (iii) "it has merchant customer contracts with merchants and the total number of locations covered by those contracts equals one thousand or more locations in this state to whom the corporation remitted payments for credit card transactions during the taxable year"; or (iv) the "sum of the number of customers" described in subparagraph (ii) of this paragraph plus the "number of locations covered by its contracts" described in subparagraph (iii) "equals one thousand or more."[6]

A corporation would be considered doing business in New York if it meets these thresholds by itself or if the thresholds are met as the result of the total activities of corporations in a combined group.[7]

Also, under the Proposal, the use by an out-of-state corporation of a fulfillment service located in New York will no longer be an exception to "doing business" in the state.[8]

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[3] For example, the broad exclusion of income from subsidiary capital in computing entire net income would be significantly changed under the Proposal.

[4] The Governor's 2010–2011 Budget has proposed the extension of these rules, however, offering relief while the Proposal wends its way through the legislative process.

[5] N.Y. Tax Law § 1451(c)(1) (relating to credit card companies).

[6] Proposal § 8.

[7] *Id.*

Changes to the Tax Base

Under the Proposal, the income tax base will generally follow traditional Article 9-A principles. However, there are a number of very significant changes to the corporate tax base. First, under the Proposal there will be only two baskets of income: business and investment. The treatment of income from subsidiaries would be significantly changed. Specifically, the blanket exemption for income from subsidiary capital would be eliminated. Instead, dividends from, and gains and losses on, the stock of nonunitary subsidiaries would be classified as investment income if held for more than six months. Income from subsidiaries' debt instruments, from subsidiary stock held for six months or less, and from the stock of unitary subsidiaries would be treated as apportionable business income. Dividends from unitary but noncombined subsidiaries would not be taxed, and associated interest expense would not be deductible; however, a 60/40 election (see below) would be permitted.

"Investment income," defined generally to include dividends but not interest from unrelated or nonunitary corporations, will not be taxed at all, and related interest expense would not be deductible. Special rules will similarly address investments made through partnerships. In lieu of tracking disallowed expenses, taxpayers would be allowed to exclude 60% of investment income from entire net income and treat the 40% balance as taxable business income. Income from cash would be considered business income.

For non-U.S. corporations, New York State income will generally follow federal concepts. Thus, a non-U.S. corporation with a permanent establishment in the U.S. would start its New York State income computation with federal (rather than worldwide) income, whether determined under the Internal Revenue Code or a U.S. tax treaty. A non-U.S. corporation without a permanent establishment would base its New York State income on (apportioned) effectively connected income, presumably also incorporating any applicable federal treaty protections. New York's modifications would then be applied to the federal starting point.

Banking corporations would, subject to some special rules, lose the special New York bad-debt deductions and instead follow the federal rules.

Apportioning Business Income

New York was among the wave of states that moved to a single-receipts-factor formula in recent years; it began using a single receipts factor for sourcing business income under Article 9-A in 2007.[9] The intricacies and nuances of New York's receipts-sourcing rules have therefore become extremely important. While under the Proposal the rules for sourcing will remain

(continued…)

[8] *Id.*

[9] N.Y. Tax Law § 210.3(a)(10)(A)(ii).

relatively unchanged for certain receipt categories, [10] there are notable changes for certain types of receipts.[11]

Like those of many other states, New York's sourcing rules were created before today's technological advances and streams of electronic commerce. In order to update its sourcing rules, New York has amended certain rules, over time, to reflect an increasingly market-based approach.[12] The Proposal takes these sourcing rules a significant step further in that direction, using customer- or market-based rules for even broader categories of receipts.

For example, under the Proposal, receipts from services will be sourced to New York if the customer is located within New York. Currently, receipts from services are sourced based on where the services are performed.[13] Similarly, receipts from digital products[14] will be sourced to New York if the product is used in the state, as determined under a four-level hierarchy (*i.e.*, the delivery destination, the billing address of the purchaser, the ZIP Code or other geographic indicator of the purchaser, or the percentage of the taxpayer's receipts within the state under the digital product rules for the preceding taxable year).

Other notable provisions of the Proposal include rules regarding the sourcing of receipts from electricity and from financial instruments. Receipts from the sale of electricity are to be sourced based on the point of delivery. As for sourcing receipts from financial instruments, the rules in the Proposal are more complex.

The first step is to categorize the instrument as either "qualified" (*i.e.*, financial instruments marked to market under I.R.C. § 475, except for loans secured by real property and physical commodities) or "nonqualified" (*i.e.*, financial instruments not within the definition of "qualified financial instrument"). For receipts from qualified financial instruments, taxpayers make an irrevocable, annual election to use a customer-sourcing method or a fixed-percentage

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[10] The sourcing of receipts from the following categories of transactions will continue to be based on the existing rules: sales of tangible personal property (point of destination); rental of real and tangible personal property (location of the property); royalties from the use of patents, copyrights, and similar intangible property; services (management, administration, or distribution) provided to regulated investment companies (the domicile of the shareholders); broker/dealer activities; receipts of special industries, such as railroad, trucking, air freight forwarding, and aviation services; advertising (based on the location of the customer, viewer, or listener); transportation or transmission of gas through pipes (transportation units, defined as one cubic foot of gas over a distance of one mile, located within and without the state); and credit card and similar activities (the mailing address of the cardholder or the address of the merchant).

[11] Proposal § 14.

[12] For example, in 2001 the rules for sourcing certain receipts earned by a registered securities or commodities broker or dealer were changed. As of 2001, such receipts were sourced based on the domicile of the shareholder. N.Y. Tax Law § 210.3(a)(2)(B).

[13] 20 N.Y.C.R.R. § 4-4.3.

[14] "Digital products" are defined in § 14 of the Proposal 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" and include "audio work, audiovisual work, visual work, book or literary work, graphic work, game, information or entertainment service, storage of digital products and computer software by whatever means delivered."

method (currently pegged at 8% and applicable to all members of a combined group).[15] For receipts from nonqualified financial instruments, customer-based sourcing is required. A detailed analysis of this aspect of the Department's Proposal is imperative for affected taxpayers.

Finally, it should come as no surprise that the Proposal includes a rule giving the Department discretion to alter the statutory apportionment rules where their application does not result in a proper reflection of a taxpayer's business income or capital with the state.

Combined Reporting

The Proposal would make substantial modifications to the current[16] combined reporting requirements. The major feature of combined reporting under the Proposal is its fundamental shift away from the caveated "distortion" or "substantial intercompany transaction" rules New York has historically applied to limit combination to the adoption of unitary combination with a 50% ownership threshold, and a water's-edge limitation.[17]

Specifically, under the Proposal a group would be required to file a combined report if it met: (i) a unitary business test and (ii) a more-than-50% stock ownership test.[18] The unitary business test replaces the current "substantial intercorporate transactions" test.[19] The more-than-50% stock ownership test would be met by owning, being owned by, or being under common ownership with corporations satisfying the test.[20] This would replace the "substantially all the capital stock," or 80%, ownership rule currently in place.[21]

A combined group would include all domestic corporations and, significantly, all alien corporations that either are "deemed" domestic corporations or have federal taxable income.[22] It would also include certain captive REITs, captive RICs, and captive overcapitalized insurance companies.[23] Excluded corporations would include those taxed under Article 9 (generally, utilities) or 33 (generally, insurance), REITs or RICs that are not captive, and S corporations.[24]

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[15] The Department's explanation of the 8% figure is as follows: "The eight percent is based on New York's approximate contribution to gross domestic product, it would be fixed in statute and not subject to periodic revision." Again, time will tell.

[16] N.Y. Tax Law § 211.4.

[17] Proposal § 16.

[18] Proposed N.Y. Tax Law § 210-c (draft proposed legislation of February 26, 2010).

[19] N.Y. Tax Law § 211.4(a).

[20] Proposed N.Y. Tax Law § 210-c.2(a).

[21] N.Y. Tax Law § 211.4(a); Department, TSB-M-07(6)C (6/25/2007).

[22] Proposed N.Y. Tax Law § 210-c.2(c).

[23] *Id*. Current exclusions for groups with assets under $8 billion would be eliminated.

[24] *Id.* § 210-c.2(d).

The combined business income for the group would equal all the combined business income from the group apportioned to the state, minus any group NOL deduction.[25] Federal consolidated return principles would be applied and dividends eliminated. The capital base would likewise equal the combined capital base of the group apportioned to the state.[26] Apportionment would be based on receipts of each taxable and nontaxable member.[27]

A group of corporations not specifically excluded from combined reporting, if under common ownership, could elect combined reporting for successive seven-year periods.[28] After the seven years, the election would be automatically renewed unless affirmatively revoked.[29] This election would be made on the original return, be irrevocable, and waive any objection to inclusion in the group.[30] Given the drop in the ownership threshold from 80% to more than 50% and the economic consequences (good and bad) of combination, minority shareholders may want to pay particular attention to this aspect of the Proposal.

The entire unitary business would be treated as a single entity, jointly and severally liable for the entire tax liability.[31] Intercompany transactions and debt would be eliminated for computing income.[32] Credits, NOLs, and capital losses would also be applied against the combined tax of the group, rather than only the corporation qualifying for the credit or producing the loss.[33] Each group would designate an agent corporation to handle tax matters relating to the combined report, or such duties would default to the parent corporation.[34]

Net Operating Losses

The Proposal seeks to simplify the operation of the New York NOL deduction, and it largely accomplishes this goal. The new NOL provisions, however, would also limit the taxpayers' ability to use NOLs accrued prior to 2011 and would have other potentially negative consequences.

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[25] *Id.* § 210-c.2(a).

[26] *Id.*

[27] *Id.* § 210-c.5.

[28] *Id.* § 210-c.3(a)–(b). Any corporation acquired during the seven-year period would similarly be included in the group.

[29] *Id.* § 210-c.3(c).

[30] *Id.* § 210-c.3(b)–(c).

[31] *Id.* § 210-c.4, .6.

[32] *Id.* § 210-c.4(b)(i)–(ii). The federal rules for deferred intercompany transactions would generally be applied.

[33] *Id.* § 210-c.4(d)–(f).

[34] *Id.* § 210-c.7.

The new NOL rules would apply only to the NOLs incurred in tax years beginning on or after 2011.[35] The NOLs incurred in 2010, as well as any unused NOLs that were eligible for carryover into 2011, will be converted to a tax credit, determined by multiplying the corporation's (or the combined group's) 2010 business allocation percentage by the available New York NOLs.[36] Taxpayers other than small business corporations (as defined in IRC § 1244(c)(3))[37] are eligible to use 1/15 of the total amount of this new credit in each year, for the next 20 years.[38] The Department explains this curtailment of pre-2011 NOLs as stabilizing "their value for financial accounting purposes."[39]

Under the Proposal, the NOL carryforward rules conform to the federal carryforward period, currently 20 years.[40] No carryback is permitted.[41]

The Proposal also continues the prior rule that prohibited taxpayers from deducting the NOLs sustained "during any taxable year in which the taxpayer was not subject to the tax" in New York.[42] Although the logic behind this rule is understandable, because the Proposal expands New York's definition of "nexus" and revises the combined reporting rules, many out-of-state corporations would unfortunately become New York taxpayers without the benefit of NOL deductions from prior years.

On a positive note, the Proposal would eliminate a provision which states that the New York NOL deduction "shall not exceed the deduction for the taxable year allowed under section one hundred seventy-two of the internal revenue code."[43] Under the existing provision, in any given tax year, taxpayers are permitted to deduct only the New York NOLs that were sustained in the same year as the federal NOLs, and only to the extent that the New York NOLs do not exceed the federal NOLs. If the New York NOLs do not match the federal NOLs, the current provision creates tracing difficulties, as well as the possibility that a taxpayer could lose its New York NOLs because it already exhausted its federal NOLs. The elimination of the current limitation would significantly simplify the New York NOL rules.

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[35] Proposal § 13.

[36] Proposal § 15.

[37] Under IRC § 1244(c)(3), a corporation qualifies as a "small business corporation" if its aggregate capital does not exceed $1 million.

[38] Proposal § 15.

[39] Broad Principles, Corporate Tax Reform, Feb. 2010.

[40] Proposal § 13; IRC § 172(b)(1)(A)(ii).

[41] This is consistent with the current Article 32 treatment. Under Article 9-A, a $10,000 carryback is permitted to the preceding two taxable years. N.Y. Tax Law § 208(9)(f).

[42] Proposal § 13.

[43] N.Y. Tax Law § 208(9)(f)(3).

Alternative Tax Bases

The fixed-dollar minimum tax would be capped at $200,000. The alternative tax on capital would be capped at $10 million. The tax on subsidiary capital would be repealed. The MTA surcharge would conform to the state tax base, "while maintaining revenue neutrality for the MTA."

PLEASE STAND BY! The passage of "corporate tax reform" in New York State continues to depend upon many things, including politics, policy, and fate.

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