NAVIGATING STATE TAXATION IN A GLOBAL BUSINESS ENVIRONMENT

Beyond New York Tax Reform: What Really Happened?

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Overview

Budget Bill – Passed March 31, 2014

- Bill containing the tax reforms signed by Governor Cuomo on March 31, 2014
- Most provisions are effective for tax years beginning on or after January 1, 2015

Main components

- Nexus
- Tax Rates
- Tax Bases
- Classification of Income
- Apportionment
- Combined Reporting
- Net Operating Losses
- Tax Credits

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Nexus

New Bright-Line Nexus Standard

- $1M or more of receipts included in numerator of apportionment factor
- Current economic nexus standards for certain credit card companies

New Rules for Combined Reporting Groups

- Receipts for every company in a combined group with at least $10,000 of New York receipts are to be aggregated
- Nexus established if aggregate New York receipts of at least $1M

Fulfillment Services Exception Repealed

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Nexus

Nexus for companies with no physical presence in New York if New York source receipts meet the $1M threshold

- Corporations selling digital products primarily used in New York
- Corporations selling services with benefits received in New York
- Corporations receiving interest on loans secured by New York real property
- receipts from “qualified financial instruments” using fixed percentage or based on customer location

Sourcing rules may even trigger nexus for companies that do not have customers in New York, for example:

- 8% rule for sourcing receipts from certain financial transactions

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Nexus

Corporate Partner Nexus

- Current regulations limit corporate partner nexus:
  - General partners in a partnership doing business in the state
  - Limited partners in a partnership doing business in the state (except portfolio investment partnerships) if one of ten circumstances met
    - Ownership of more than a 1% limited partnership interest with basis greater than $1M

New Law Grants Department of Taxation and Finance Expanded Regulatory Authority

- May adopt regulations subjecting a corporation to tax if it is a partner of any type in a partnership doing business in New York (or that has economic nexus with New York)

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Tax Rates

New Rates, Caps, and Brackets

- Tax rate on entire net income (ENI) base reduced from 7.1% to 6.5% for tax years on or after January 1, 2016
- Lower rates for certain taxpayers (e.g., qualified New York manufacturers)
- Capital base tax rate of 0.15% phased down to 0% for tax years beginning on or after January 1, 2021
- Cap under capital base tax increased from $1M to $5M
- Additional brackets under fixed dollar minimum tax
  - Current top bracket (receipts > $25M) = $4,500 of tax
  - New top bracket (receipts > $1B) = $200,000 of tax
- Phased in reduction of fixed dollar minimum tax for qualified New York manufacturers and qualified emerging technology companies

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Tax Base

- Article 32 bank tax repealed. Banking and financial institutions are subject to the general corporate franchise tax under Article 9-A
- Tax computed on three bases:
  - Business income
  - Capital
  - Fixed dollar minimum
- Separate tax on subsidiary capital eliminated

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Classification of Income and Expenses

- Three categories of income: (i) Business Income (ii) Investment Income and (iii) Other Exempt Income
- Only business income is subject to tax
- Business income = ENI minus (i) Net Investment Income and (ii) Net Other Exempt Income
- Repeals the exclusion for 100% of income, gains and losses from subsidiary capital

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Entire Net Income

- The starting point for ENI is a corporation's federal taxable income
- For a taxable alien (non-U.S.) corporation, the starting point for ENI is effectively connected income
  - ENI is determined without regard to any Tax Treaty protections/benefits

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Investment Income

The new law narrows the definition of "investment capital" to investments in stocks of non-unitary corporations held by the taxpayer for more than six consecutive months and not held for sale to customers

- Presumption that a taxpayer is not unitary with a corporation in which it owns (directly or indirectly) less than 20% of the voting stock

Corporate equity instruments, government debt instruments and qualifying corporate debt instruments constitute business capital, not investment capital

- The election to treat "cash" as investment capital is eliminated
- Income or gain from debt obligations or other securities that "cannot be apportioned to the state" under the U.S. Constitution is classified as exempt investment income

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Other Exempt Income

The sum of (i) exempt CFC income and (ii) exempt unitary corporation dividends

- Exempt CFC income is income included in federal taxable income under IRC § 951(a), received from a corporation conducting a unitary business with the taxpayer, but that is not included in the Article 9-A unitary combined return
- Exempt unitary corporation dividends are dividends from stock of a unitary corporation that is not included in the Article 9-A unitary combined return

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Changes to Expense Attribution

- Under the new law, investment income and "other exempt income" must be reduced by *interest* expenses directly or indirectly attributable to those items of income
- Attribution is no longer required for non-interest expenses
- If the interest expense attribution amount exceeds investment income and other exempt income, the excess interest expense must be added back to ENI

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The 40% Election

In lieu of computing the actual amount of interest expenses attributable to investment income or other exempt income, a corporation may instead elect to reduce its investment and other exempt income by 40%

- This will increase business income by the dollar amount of the 40% reduction
- The election reduces the uncertainties resulting from audits; once the election is made, no further interest expense attribution is required
- The 40% election must be applied to both investment income and other exempt income

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Apportionment

- The new law retains the receipts-only apportionment scheme under Article 9-A
- The new law generally applies a market-based sourcing methodology to all receipts
- The new law expands the categories of receipts for which specific sourcing rules are enumerated
- Numerous new rules for sourcing specific financial service receipts/gains
- Fixed percentage method election for receipts/gains from "Qualified Financial Instruments"

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Apportionment

Digital Products and Receipts from "Other Services and Other Business Receipts"

- Hierarchies determine where to assign particular receipts
- A taxpayer is required to exercise due diligence under each method before rejecting it and moving to the next method in the hierarchy

Alternative Apportionment

- Commissioner has discretion to apply alternative methods "to effect a fair and proper apportionment of the business income and capital reasonably attributed to the state" when the standard statutory scheme "does not result in a proper reflection of the taxpayer's business income or capital within the state"
- The party seeking alternative apportionment bears the burden of proof

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Combined Reporting

- Combined report required if corporations:
  - Are engaged in a unitary business; and
  - More-than-50% common ownership test is met (measured by voting power of capital stock)
- Substantial intercorporate transactions or distortion are no longer requirements for combined reporting
- Affiliated Group Election
  - Corporations that meet the more-than-50% common ownership test may elect to be treated as a combined group, regardless of whether those corporations are conducting a unitary business
  - The election must be made on an original timely filed return, and is irrevocable for seven taxable years
  - Any corporation entering the commonly owned group while the election is in effect is automatically included in the combined group
  - Election is automatically renewed for another seven taxable years unless affirmatively revoked
  - Once revoked, a new election is not permitted for any of the three immediately following taxable years

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Combined Reporting

Corporations that must be included in a combined report:

- General domestic corporations
- Certain alien corporations
- Combinable captive insurance companies
  - Captive insurance companies that have 50% or less of their gross receipts for the tax year from arrangements that constitute "insurance" for federal income tax purposes
- Captive real estate investment trusts (REITs), and
- Captive regulated investment companies (RICs)

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Combined Reporting

Corporations that cannot be included in a combined report:

- Corporations taxable (or that would be taxable if subject to tax) under Article 9 (certain utilities) or Article 33 (insurance corporations)
- A REIT or RIC that is not a captive REIT or a captive RIC
- A New York S corporation, and
- An alien corporation that is not treated as a domestic corporation under the Internal Revenue Code and that has no effectively connected income for the taxable year

If a corporation is subject to tax solely as a result of its ownership of a limited partnership interest in a limited partnership that meets the new (or old) nexus standards and none of its related corporations are subject to tax under Article 9-A, the corporation is not required to file a combined return with those related corporations

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Combined Reporting

Tax on a combined report will be the highest of the:

- Tax on the combined business income base
- Tax on the combined capital base, or
- Fixed dollar minimum tax for the designated agent of the combined group
- Plus, fixed dollar minimum tax for each member of the combined group (other than the designated agent) that is a New York taxpayer

In computing the tax bases, the combined group is generally treated as a single corporation

All New York taxpayers will be jointly and severally liable for the tax due on the combined report

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Combined Reporting

The capital base is the portion of the combined capital of the combined group that is apportioned to New York

- In computing combined capital, all intercorporate stockholdings, intercorporate bills, intercorporate notes receivable and payable, intercorporate accounts receivable and payable, and other intercorporate indebtedness are eliminated

The business income base is the portion of the combined business income of the combined group that is apportioned to New York, reduced by any net operating loss (NOL) deductions for the group

- All intercorporate dividends must be eliminated and all other intercorporate transactions are deferred in a manner similar to § 1502 of the Internal Revenue Code

The new law continues the "Finnigan" approach by including any New York receipts, net income, net gains and other items of all combined group members in the numerator of the combined apportionment calculation, regardless of whether the individual members are New York taxpayers

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Combined Reporting

Net Operating Losses

- The prior NOL conversion subtraction and NOL deduction are allowed in computing the combined business income base and reduces the tax on that base to the higher of:
  - The tax on the combined capital base, or
  - The fixed dollar minimum tax that is attributable to the designated agent of the combined group

Credits

- Qualification for credits, including any limitations thereon, are generally determined separately for each member of a combined group
- Credits will be applied against the group's combined tax
- To the extent a credit is applied against the fixed dollar minimum tax, the credit is applied to only the fixed dollar minimum tax attributable to the designated agent

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Net Operating Losses

- The new law makes significant changes to the treatment of net operating losses.
- Corporations are permitted two types of NOLs:
  1. a net operating loss deduction (for post-2014 NOLs), and
  2. a “prior NOL conversion subtraction” (for pre-2015 NOLs)

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Changes to the NOL Deduction

- Under the new law, the NOL is the amount of a corporation's *business loss* for the tax year multiplied by its apportionment factor for that year
- Does not include NOLs from tax years beginning before January 1, 2015 (replaced with the "prior NOL conversion subtraction")
- Removes the existing limitation on NOL deductions based on the "amount allowed for federal income tax purposes"
- Eliminates the requirement that the NOL deduction originate in the same source year as the federal NOL deduction for that year
- Conforms the NOL carryforward period to the 20-year federal carryforward period, and permits a three-year carryback (but not to tax years beginning before January 1, 2015)

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Prior NOL Conversion Subtraction

- Unabsorbed NOLs generated in tax years beginning before January 1, 2015 cannot be carried forward
- Instead, unabsorbed NOL carryforward amounts existing on the last day of the taxpayer's base year are converted into a "prior NOL conversion subtraction"
- The prior NOL conversion subtraction may be claimed in future tax years (i) in amounts equal to 1/10 of the conversion subtraction amount over a 20-year period, or (ii) the taxpayer may elect to utilize up to 50% in 2015 and 50% in 2016 (but unused subtraction amounts cannot be carried forward)
  - The conversion subtraction must be applied before claiming the regular NOL deduction for the tax year

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Tax Credits

- Nearly all of the existing tax credits under Article 9-A and Article 32 remain in effect under the new law
- Effective in 2014, the new law introduces a *real property tax credit* for "qualified New York manufacturers" equal to 20% of the real property taxes paid on New York real property that is principally used in manufacturing
- No repeal of the ITC for the financial services industry
- No requirement that tax credits be claimed only on the taxpayer's originally filed return

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Update on New York City

- On January 12, 2015, New York City Mayor Bill de Blasio proposed a major reform of the New York City corporate tax structure.
- *If* enacted, the proposed reforms would bring the New York City General Corporation Tax into substantial conformity with the New York State corporate franchise tax reforms enacted into law in 2014.
- The New York City proposals do not contain an income tax rate reduction for all corporate taxpayers and do not call for the reduction and ultimate elimination of the alternative tax base on capital.
- The proposals do not modify New York City's unincorporated business tax and do not appear to apply to federal subchapter S corporations or subchapter S subsidiaries, which would continue to be taxed in accordance with the currently-applicable, pre-reform provisions.
- The reforms, as contained in the proposed draft legislation, are intended to be revenue neutral and, if enacted, are expected to be retroactive to January 1, 2015.

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