Sweeping New York State Tax Reforms Enacted
April 1, 2014

Overview
On March 31, 2014, the Governor of New York State, Andrew Cuomo, signed the 2014-2015 Budget Act (S6359-D/A8559-D) into law. On April 1, 2014, the Governor presided over a ceremonial signing of the Budget Act; however, March 31, 2014 is the official date when the law was enacted.¹

As expected, the Budget Act substantially modifies and reforms various aspects of the New York Tax Law. In this Tax Alert we summarize the more salient New York State tax provisions contained in the Legislation. New York City corporate tax law is generally not impacted by the Budget Act. However, certain New York City tax credits, financial incentives and non-corporate taxes are impacted.

Corporate Tax Reforms
The Budget Act reduces the corporate franchise tax rate on entire net income from 7.1% to 6.5%, effective for taxable years beginning on or after January 1, 2016. In addition, the tax on entire net income is eliminated for “qualified New York manufacturers”² effective for taxable years beginning on or after January 1, 2014.

The Budget Act makes numerous changes to the corporate franchise tax. Highlighted below are the more significant corporate tax reforms. Unless otherwise noted, these changes generally will be effective for taxable years beginning on or after January 1, 2015:

- Merging the Banking Corporation Tax (Article 32) into the Corporate Franchise Tax (Article 9-A);
- Expanding the application of economic nexus so that corporations with sales of $1 million or more to New York customers during the taxable year will be subject to tax;³
- Retaining an apportionment formula based on a single receipts factor, but changing to customer (market) sourcing rules. Specific sourcing rules are provided for receipts from sales of digital property, services, intangible property, and certain principal transactions in various types of securities;
- Adopting full water's-edge unitary combined reporting with an ownership test of greater than 50%, and providing for an election to permit combined filing for certain commonly owned groups with a seven-year lock-in;
- Requiring that certain captive insurance companies (defined as overcapitalized captive insurance companies under prior law) be included in the combined report of a unitary group (with the definition of "premiums" now being referenced to federal tax law), and providing discretionary authority to the Department of Taxation and Finance (the “Department”) to re-allocate non-premium income from a captive to its shareholder;
- Limiting what constitutes investment capital and investment income (generally, dividends and gains from stock in non-unitary corporations held for more than six months, and income that New York is prohibited from apportioning as business income under U.S. Constitutional principles) and exempting investment capital and investment income from tax;

¹ See, http://assembly.state.ny.us/leg/?default_fld=&bn=S06359&term=&Summary=Y&Actions=Y. This Tax Alert is revised solely to provide the correct formal signing date of March 31, 2014.
² A “qualified New York manufacturer”, in general, is a taxpayer principally engaged in the production of goods by manufacturing (or through certain other activities) which has property in New York eligible for the investment tax credit meeting certain dollar value thresholds.
³ Lower thresholds exist for determining whether members of a combined return group satisfy the economic nexus standard, and therefore are considered “taxpayers” for purposes of New York’s “fixed dollar” minimum tax.
• Eliminating the additional tax on subsidiary capital, and eliminating most exclusions for income from subsidiaries, while retaining an exemption for dividends and "CFC income" (defined with reference to IRC section 951(a)) from unitary subsidiaries;
• Modifying existing expense attribution rules so that only interest expense attributable to non-taxable investment or exempt income is subject to disallowance (similar rules apply with respect to attributing debt to non-taxable investment capital), and by creating a safe harbor election whereby aggregate non-taxable investment and exempt income is reduced by a flat 40% amount in lieu of being subject to interest expense attribution;
• Reducing investment income by losses, deductions and expenses with respect to investment capital hedging transactions;
• Changing the NOL provisions from a pre-apportionment to a post-apportionment computation, ending the requirement that New York NOL usage be limited to the corresponding amount of federal NOL usage, and providing transition rules for converting NOL deductions arising in pre-tax reform taxable years for use in subsequent taxable years;
• Providing a three year carryback for NOLs incurred in post-reform taxable years, provided that no NOL can be carried back to a taxable year beginning before January 1, 2015 (the carryforward period remains at 20 years);
• Changing the starting point in calculating New York entire net income for non-US corporations with New York nexus from worldwide taxable income to federal "effectively connected income" ("ECI"), determined without regard to tax treaties. (Note: non-US corporations with ECI are included in the combined return if they otherwise satisfy the combined return requirements set out above.);
• Repealing the alternative tax on minimum taxable income;
• Increasing the maximum amount of alternative tax on business capital from $1 million to $5 million (for qualified New York manufacturers, the maximum tax is retained at $350,000), but scheduling a gradual phase-out of the business capital tax rate from 0.15% to zero between taxable years beginning on or after January 1, 2016, and taxable years beginning on or after January 1, 2021;
• Increasing the cap on the alternative "fixed dollar" minimum tax to $200,000 for taxpayer’s with New York gross receipts over $1 billion. (The fixed minimum tax is applied to each member of the New York combined group with New York gross receipts of $10,000 or more). For both the alternative tax on business capital and the "fixed-dollar" minimum tax, a credit is provided for such taxes paid to other states imposed on an identical tax base;
• Modifying the Metropolitan Transportation Authority ("MTA") Surcharge on New York franchise tax to provide an economic nexus standard so that sales of $1 million or more to customers in the Metropolitan Commuter Transportation District create an MTA Surcharge liability; basing the MTA surcharge on actual tax liability before credits, increasing the MTA Surcharge rate to 25.6% for taxable years beginning on or after January 1, 2015 and before January 1, 2016 (and thereafter providing an annual adjustment of the surcharge rate to be determined by the Tax Commissioner in accordance with the State’s financial projections), continuing three factor apportionment for determining business activities within the MTA Surcharge area (with the MTA receipts factor reflecting new customer (market) sourcing provisions), and modifying the MTA

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4 In general, usage of pre-tax reform NOLs is limited to 1/100 of entire prior pre-tax reform NOL conversion pool, plus any portion of the 1/100 pool not used in a preceding taxable year. However, taxpayers may elect to equally use one-half of the pool for its taxable years beginning in 2015 and in 2016. The election is made on the tax return for the taxable year beginning in 2015 filled by the extended due date of such return.
5 For qualified New York manufacturers and emerging technology companies, the maximum “fixed” minimum tax is $4,500 (at $25 million of New York receipts) for taxable years beginning before January 1, 2015. This amount is scheduled to gradually decline to a maximum of $3,750 for taxable years beginning on or after January 1, 2018.
6 The Metropolitan Commuter Transportation District encompasses the five boroughs (counties) of New York City and seven neighboring counties (Nassau, Suffolk, Dutchess, Orange, Putnam, Rockland and Westchester Counties).
7 The effective rate of the MTA surcharge in 2015 will be 1.8% (25.6% MTA rate multiplied by 7.1% Article 9-A rate), an increase of approximately 3% from 2014 when the effective rate of the MTA surcharge is 1.5% (17% MTA rate multiplied by 9% historical Article 9-A rate).
8 With respect to the MTA Surcharge property factor, property is valued at adjusted basis used for federal income tax purposes. However, taxpayers can make a revocable election on their first tax return due on or after January 1, 2015, to use fair market value in lieu of adjusted basis.
Surcharge so it is applicable to the amount of New York franchise tax before the use of tax credits.

Also, the Governor’s Budget Briefing Book, issued when the New York legislation was proposed, calls for the Department to streamline its corporate audit procedures. We understand that this may result in the Department developing a Compliance Assurance Process ("CAP") similar to that used by the Internal Revenue Service. Under this program, participating corporate taxpayers would work collaboratively with the Department’s audit division to identify and resolve potential tax issues before the tax return is filed.

As noted above, the New York State corporate tax reforms generally do not apply to New York City's corporate tax regime. However, the bill extends the Gramm-Leach-Bliley New York City bank tax transitional rules for two additional years.

**Tax Credits**

The Budget Act includes the following changes to New York State's tax credit regimes:

- Enacting a new real property tax credit for qualified New York manufacturers equal to 20% of qualifying real property taxes paid during the taxable year.\(^9\) The real property taxes upon which the credit is claimed cannot be deducted for New York income tax purposes (effective January 1, 2014);
- Extending the Empire State Commercial Production Tax Credit through taxable years beginning before December 31, 2017;
- Increasing the aggregate amount of Low Income Housing Tax Credit that the Commissioner of Housing and Community Renewal may allocate with respect to New York State’s 2014-15 and 2015-2016 fiscal years;
- Providing a refundable credit for telecommunications excise taxes paid by START-UP New York companies (effective January 1, 2014);
- Expanding the Youth Works Tax Credit with respect to employees who are enrolled in high school full-time and who work at least 10 hours per week, and providing an additional tax credit for employers who employ such youths for one additional year post-graduation (effective January 1, 2014);
- Creating a tax credit for musical and theatrical production companies equal to 25% of qualified production and transportation expenditures, not to exceed an aggregate of $4,000,000 per calendar year for all taxpayers (effective immediately);
- Creating a tax credit for qualified employers who employ persons with certain developmental disabilities equal to 10% - 15% of qualifying wages, up to a maximum of $2,500 per qualified part-time employee and $5,000 per qualified full-time employee (effective January 1, 2015).

The Budget Act includes the following changes to New York City's tax credit regimes:

- Extending the New York City Relocation and Employment Assistance Program ("REAP") and the Lower Manhattan REAP to June 30, 2015 (previously set to expire on June 30, 2013);
- Extending the Lower Manhattan Sales and Use Tax Exemption to September 1, 2017 (previously set to expire on September 1, 2015) for premises located at the World Trade Center site, World Financial Center, and Battery Park City; and to September 1, 2015 (previously set to expire on September 1, 2013) for other qualifying areas of lower Manhattan;
- Extending the Industrial & Commercial Abatement Program ("ICAP"), which provides real property tax abatements to approved projects, for applications submitted on or before March 1, 2017 (previously, March 1, 2015).

Certain significant credit regime proposals addressed in prior versions of the Budget Act, that were not enacted include:

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\(^9\) For taxpayers subject to the personal income tax under Article 22, if the credit allowed exceeds the taxpayer’s tax liability, the excess will be treated as an overpayment to be credited or refunded to the taxpayer.
- Repealing the investment tax credit for various industries and activities, including the financial services, film production, industrial waste treatment facilities, and air and water pollution control facilities;
- Requiring tax credit claims be claimed on an originally filed tax return.

Estate and Gift Tax Reform
The Budget Act codifies the rules determining the estate tax base, generally conforming New York’s estate tax to the federal estate tax law as of January 1, 2014. It increases the estate tax basic exemption-equivalent to $2,062,500 for decedents dying on or after April 1, 2014. This amount increases to $3,125,000 for decedents dying on or after April 1, 2015; to $4,187,500 for those dying on or after April 1, 2016; and to $5,250,000 for those dying on or after April 1, 2017 (and before January 1, 2019). Thereafter, the basic exemption-equivalent is indexed for inflation. The exemption-equivalent is provided in the form of a tax credit equal to the tax on the exemption-equivalent amount. This credit is phased out rapidly as the size of the taxable estate increase from 100% of 105% of the exemption-equivalent amount (seemingly producing effective tax rates exceeding 100% when taxable estate is in this range). The Budget Act also adds to the estate tax base gifts made by the decedent within 3 years of death if the decedent was a New York resident when the gift was made (effective for gifts made on or after April 1, 2014, and before January 1, 2019). While the Budget Act makes no changes to estate tax rates, the law only provides a rate schedule for decedents dying in the one year period beginning April 1, 2014. This appears to be a drafting error.

Trust Tax Reform
The Budget Act also makes several changes to the rules regarding income taxation of trusts. A “throwback” rule is adopted whereby accumulation distributions of income not previously subject to New York tax from a trust to a New York resident beneficiary earned when the beneficiary was a New York resident will be added back in computing income subject to the beneficiary's personal income tax. Credit is provided for tax paid to another state. The Budget Act adds return filing requirements for trusts making accumulation distributions to New York residents. This change will be effective for 2014 with respect to income earned by the trust on or after January 1, 2014; however, distributions prior to June 1, 2014, are exempt. Also, trusts will be treated as grantor trusts if they are structured to avoid federal gift tax on contributions of property to the trust (so called “incomplete gift non-grantor trusts”). This provision is effective with respect to income earned on or after June 1, 2014, and does not apply to trusts liquidated prior to that date. These provisions also apply to the New York City personal income tax.

Property Tax Relief
For years beginning on or after January 1, 2014, the Budget Act includes a two-year property tax freeze to homeowners which will be provided in the form of a rebate. In year one of the freeze, New York will provide tax rebates to homeowners who live in a jurisdiction that does not impose a property tax increase greater than 2%. In year two, rebates will be provided to homeowners who live in a jurisdiction that does not impose a property tax increase greater than 2% and agree to implement a shared services or administrative consolidation plan. This rebate does not apply to New York City homeowners.

The Budget Act also includes a property tax circuit breaker credit under the personal income tax for New York City residents, effective for 2014-15.

Other Tax Simplifications and Reforms
The Budget Act implements a series of actions to simplify the New York tax code, including the following:
- Repealing the “add-on” minimum tax currently applicable to individual taxpayers;
- Repealing the corporate organization and license taxes and the maintenance fees;
- Aligning the filing of MTA mobility tax and personal income tax returns for self-employed individuals;
- Modifying the signature requirement for e-filed personal income tax returns prepared by tax professionals;
- Repealing corporate franchise tax on agricultural co-ops; and
- Repealing the generation-skipping tax.
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