Proposed New York Tax Reform: Setting the Stage for New Legislation

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Addressing what is perceived to be a negative tax environment for business, the New York State Tax Reform and Fairness Commission has proposed revenue-neutral tax reforms to modernize New York's corporate tax law. In this article, Russell W. Banigan, Kenneth Jewell and Mary Jo Brady, of Deloitte Tax LLP, discuss how certain of the Commission's proposals compare with current New York State corporate franchise tax law and how they stack up against a competing report issued by the New York State Senate Republican Conference.

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Introduction

On Nov. 11, 2013, the New York State Tax Reform and Fairness Commission (the ''Commission'') issued its Final Report to Gov. Andrew Cuomo (D).[1] The Commission's charge from Gov. Cuomo was to undertake a broad review of New York State's tax code to develop recommendations regarding how to make the tax law more simple and fair and to help reduce the tax burden faced by New York residents and businesses. Following that charge, the Commission drafted a full range of proposed reforms to the corporate franchise, sales and use, real property, individual income and estate and gift taxes. The discussion below will focus on some of the significant corporate franchise tax proposals that would impact corporations currently subject to corporation franchise taxes under either Article 9-A (General Business Corporation Franchise Tax) or Article 32 (Banking Corporation Franchise Tax) of Chapter 60 of the New York tax law. Specifically, we will discuss the Commission's proposals concerning: merging Article 32 into Article 9-A, revising the types and compositions of the various franchise tax bases, adopting an economic nexus standard, modifying the income and capital apportionment provisions, changing how combined return groups are determined, modifying the calculation of net operating loss carryover deductions and tax credits.

Shortly after the issuance of the Commission Final Report, the New York State Senate Republican Conference issued its own preliminary report with respect to

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[1] New York State Tax Reform and Fairness Commission, *Final Report*, Nov. 2013, at 3, *available at http://www.governor.ny.gov/assets/documents/greenislandandreportandappendicies.pdf*. [hereinafter *Commission Final Report*].

proposed New York tax reforms.[2] In this article, we will compare and contrast the Senate Republican Conference Report with that of the Commission, where relevant.

By way of observation, we note that the Commission focused on reforming and modernizing the corporate franchise taxes, but it is our understanding that the Commission's proposals are intended to be revenue neutral in the totality of their effects. In contrast, the Senate Republican Conference has proposed working toward eliminating the corporate franchise tax. In that regard, the Senate Republican Conference has proposed adopting a triggering event whereby every $500 million of new revenue results in a specific reduction to the corporate franchise tax rates.[3] Thus, there is less discussion of reforming particular aspects of the corporate franchise tax in the Senate Report than is found in the Commission Final Report.

Articles 9-A and 32 to Be Merged

Summary of Current Law

New York taxes general business corporations and many types of financial services corporations under Article 9-A. Banking corporations and most bank holding companies are taxed under Article 32.

Article 9-A. Under Article 9-A, corporations are taxed on the highest of four alternative tax bases: a tax at the rate of 7.1 percent on the amount of entire net income apportioned to New York; a tax at the rate of 0.15 percent on business and investment capital that has been apportioned to New York (up to a maximum capital tax of $1 million); a tax at the rate of 1.5 percent on minimum taxable income; or a ''fixed'' minimum income tax ranging from $25 to $5,000 based on the amount of the taxpayer's New York gross receipts.[4] In addition, there is added to the highest tax base a tax on the value of subsidiary capital allocated to New York at the rate of 0.09 percent.[5] Certain manufacturers are eligible for reduced tax rates (as low as 3.25 percent on entire net income, $350,000 maximum tax on investment and business capital tax, 0.75 percent on minimum taxable income and a ''fixed'' minimum tax that is one half of that imposed on other taxpayers).[6]

Under Article 9-A, income, expenses, gains, losses and capital are classified as being derived from subsidiary, investment or business capital.[7] Income, expenses, gains and losses from subsidiary capital are excluded from the computation of entire net income, while subsidiary capital is subject to the add-on tax, as noted above.[8] Income, expenses, gains and losses from investment capital are included in entire net income, and investment capital is included in the alternative tax on investment and business capital, but the amounts of investment income and capital are apportioned to New York based on how much capital the corporations and governmental units invested in by the taxpayer have been employed in New York (see ''Apportionment Reforms,'' below).[9] Business income and capital are apportioned to New York based on the portion of the taxpayer's New York sourced gross business receipts over its total gross business receipts.[10] Receipts are sourced in a hybrid fashion, where receipts from the sale of tangible personal property are sourced to the location of the buyer, while services generally are sourced to the location of where they are performed. Receipts from the sale or rental of real property are sourced to the location of the property, while receipts generated from intangible property, such as patents, copyrights and trademarks tend to be sourced to where the intangible property is being used.[11]

Article 32. Under Article 32, banking corporations are taxed on the highest of four alternative bases: a 7.1 percent tax on the amount of entire net income apportioned to New York; a tax ranging from 0.002 percent to 0.01 percent on taxable assets; a 3 percent tax on alternative entire net income; and a fixed minimum tax of $250.[12] There is no subsidiary capital tax under Article 32; nor is there an investment capital concept.

In contrast to Article 9-A, Article 32 provides only partial exclusions from entire net income for items of income from subsidiary capital (60 percent for dividends and gains, and 17 percent for interest income, in contrast to full exclusions for those items under Article 9-A).[13] But, Article 32 taxpayers can exclude from entire net income 22.5 percent of interest income from Federal and New York obligations held for investment.[14] As another Article 32 benefit (in contrast to Article 9-A) there is no attribution of interest and other expenses against subsidiary capital or against the 22.5 percent interest exclusion.[15]

Another significant difference between Articles 9-A and 32 is that under the former, a foreign corporation that is doing business in New York is required to apportion worldwide net income and capital to New York, while a banking corporation is only required to apportion to New York its U.S. effectively connected income and total assets related to such effectively connected income.[16] Furthermore, Article 32 taxpayers with depos-

[2] *The New York State Senate Tax Policy Review and Reform Initiative Republican Conference Preliminary Report,* Nov. 2013 [hereinafter *Senate Report*], *available at http://www.nysenate.gov/files/pdfs/2013%20Preliminary%20Tax%20Report%20FINAL.pdf*.

[3] *See Senate Report* at 6.

[4] N.Y. Tax Law §210.1(a)-(d).

[5] N.Y. Tax Law §210.1(e).

[6] N.Y. Tax Law §210.1(a)-(d).

[7] *See* Banigan, 2200-2nd T.M., *New York State and City Corporation Income Taxes*, §2200.01.A.4.

[8] N.Y. Tax Law §§208.9(a)(1) and (b)(6) and 210.1(e)(1).

[9] N.Y. Tax Law §§208.9, 210.3(b) and (c) and 210.5. For a more complete discussion of what constitutes investment income and capital and how those items are apportioned, *see* Banigan, 2200-2nd T.M., *New York State and City Corporation Income Taxes*, §2200.08.

[10] N.Y. Tax Law §§210.3(a) and 210.4.

[11] N.Y. Tax Law §210.3(a). For a more complete discussion of how New York apportions net business income and capital, *see* Banigan, 2200-2nd T.M., *New York State and City Corporation Income Taxes*, §2200.09.

[12] N.Y. Tax Law §1455(a) and (b).

[13] Compare N.Y. Tax Law §208.9(a)(1) with §1453(e)(11).

[14] N.Y. Tax Law §1453(e)(12).

[15] *See* N.Y. Tax Law §§208.9(b)(6) and 1453(b), N.Y. Dept. of Taxn. and Fin., TSB-M-88(5)C and TSB-M-95(2)C.

[16] With respect to Article 9-A, See N.Y. Tax Law §§208.9(c) and 210.1(b)(1). *See also Bass Ratcliff Gretton Ltd.*, 266 U.S. 271 (1924) and *Reuters Ltd.*, 603 N.Y.S.2d 795 (1993). With respect to Article 32, *see* §§1453(b)(1) and 1455(b)(1)(v)(A).

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its from and loans to foreign persons can treat a portion of their receipts and expenses as attributed to an international business facility ("IBF"). The IBF is treated as a foreign branch of a taxpayer and therefore its net income (or net loss) is excluded from the Article 32 taxpayer's entire net income. The net income or loss of the IBF is determined under either a separate accounting approach or through certain adjustments to the numerators of the taxpayer's business apportionment ratios.[17]

Entire net income and taxable assets are apportioned under Article 32 based on the average of the following factors – New York receipts to total receipts, New York payroll to total payroll and New York deposits to total deposits.[18] The receipts and deposit factors are double weighted for the entire net income and taxable asset bases, but given only single weighting for the tax on alternative entire net income.[19]

There are also differences between Article 9-A and 32 regarding how and when related entities are permitted or required to file combined returns (see the combined return discussion, below).[20] Differences also exist on how net operating losses are determined[21] and what credits are available.[22]

The differing approaches were developed decades ago due to federal restrictions on the activities and taxation of national banks.[23] However, with the enactment of the Federal Gramm-Leach-Bliley Act in 1999 ("GLBA"), most of the previous restrictions barring cross ownership of banks and securities firms were repealed.[24] Thus, banks, securities firms and other financial services providers were placed more directly into competition with each other than ever before.

Since, to a large extent, the classification as an Article 32 taxpayer was based on the federal definition of permissible bank and bank holding company activities, New York enacted provisions ("GLBA transition provisions") to temporarily freeze the Article 9-A and Article 32 classifications of the various financial services corporations until comprehensive corporation franchise tax reforms could be enacted.[25] While the GLBA transition provisions were originally enacted for only two years, those provisions have been repeatedly extended over a period of nearly fifteen years so that they are still in effect at the present time.[26]

[17] N.Y. Tax Law §§1453(f) and 1454(b)(2).

[18] N.Y. Tax Law §1454.

[19] N.Y. Tax Law §1454(b)-(d).

[20] Compare N.Y. Tax Law §211.4(a) and 20 NYCRR §§6-2.1 to 6-2.8 with N.Y. Tax Law §1462(f) and 20 NYCRR §§21-2.1 to 21-2.7.

[21] *Compare* N.Y. Tax Law §208.9(f) with §1453(k-1).

[22] For example, Article 9-A taxpayers that are licensed brokers and/or dealers of securities may claim an Employment Incentive Credit of up to 2.5 percent on property for which investment tax credit was claimed, while Article 32 taxpayers that are licensed brokers and/or dealers of securities cannot. *See* N.Y. Tax Law §210.12-D(a)(i) and N.Y. Dept. of Taxn. and Fin., TSB-M-98(8)C.

[23] For a brief history on the taxation of banks and other financial services corporations, *see* BNA State Portfolio 1800-1st: *State Taxation of Banks and Financial Institutions (CA, IL, NY, TN)*, Worksheet 3, *Welcome to the Brave New World of Financial Services: Unexpected State Tax Ramifications of Gramm-Leach-Bliley*, by Russell W. Banigan.

[24] *Id.*

[25] N.Y. Tax Law §§1452(h)-(m).

[26] *Id.*

In the view of the Commission, the extended GLBA transition provisions have perpetuated New York's disparate franchise tax treatment of banks and other financial services corporations, so that taxpayers performing similar activities remain subject to significantly different tax treatment. In addition, the Commission noted that dissimilarities between Article 9-A and Article 32 have continued to provide room for tax planning opportunities for certain taxpayers.[27]

Reforms

Unification of Article 9-A and Article 32. The Commission recommended that Article 32 be merged into Article 9-A, meaning that both existing Article 9-A taxpayers and existing Article 32 taxpayers would be subject to tax under a reformed Article 9-A.[28] The Commission believes that this would "modernize the corporate tax structure to reflect today's financial services sector, simplify compliance for taxpayers and reduce tax avoidance opportunities that are available in the current structure."[29] The merger of Article 32 into Article 9-A is also recommended in the Senate Republican Conference Report.[30]

Banking corporations would no longer be subject to an alternative tax on total assets, as is currently applied under Article 32, as such tax does not exist under Article 9-A. Instead, banking corporations would be subject to a tax on capital (net worth) in the same manner as currently applicable to nonbanking securities firms. Both the tax on minimum taxable income under the current version of Article 9-A and the Article 32 alternative tax on entire net income would be eliminated.[31]

As proposed, the Article 9-A tax bases would be 7.1 percent on New York apportioned entire net income, 0.15 percent on apportioned business capital, with the maximum tax on this base set at $10 million for nonmanufacturers (up from its current maximum of $1 million) and a "fixed" minimum tax that ranges from $25 to $200,000, depending upon the amount of taxpayer's New York receipts.[32] It appears that the current reduced tax rates on entire net income and business capital for manufacturers will remain at current rates.[33]

The Commission has also proposed the creation of a tax credit for taxes paid to other states to be applied against the alternative tax bases.[34] This is to mitigate the risks of any Constitutional challenges; particularly since the maximum tax amounts under the alternative bases are to be substantially higher than under the current Article 9-A provisions.

The merger of Article 32 into Article 9-A would also provide uniformity regarding how income and capital of

[27] *Commission Final Report, supra* note 1 at 6.

[28] *Commission Final Report, supra* note 1, at 24; *See also*, *Senate Report*, at 25 (agreeing with this recommendation, adding that the Alternative Minimum Tax should be eliminated and the modifications to Federal tax base should be repealed).

[29] *See Commission Final Report, supra* note 1, at 24.

[30] Senate Report, at 25-26.

[31] New York State Tax Reform and Fairness Commission, *Corporate Tax Reform Proposals, supplemental memo from the Commission Staff*, Nov. 14, 2013, at 8. [hereinafter *Commission Staff Memo*].

[32] *Commission Staff Memo*, at 3 and 8.

[33] *Commission Staff Memo*, at 8.

[34] *Commission Final Report*, at 24.

financial services firms are sourced within and without New York State, as further discussed below.[35]

Entire Net Income. The starting point for entire net income would continue to be based on federal taxable income and would take into account most of the current Article 9-A modifications.[36] In contrast to current law where a foreign corporation (alien corporation in New York parlance) conducting business in New York is required to use its worldwide net income to determine its New York entire net income, the proposed reforms require the foreign corporation to include only its U.S. effectively connected income and related expenses in determining New York entire net income. ''Effectively connected income'' would be defined pursuant to the U.S. Internal Revenue Code (I.R.C.), without regard to the provisions of any tax treaties.[37] Thus, the starting point for the reformed Article 9-A would more resemble the current starting point for Article 32 than for current Article 9-A.

The special modifications in determining entire net income, such as the 22.5 percent exclusion for interest from certain government securities and the IBF provisions would be eliminated under the proposed reforms.[38] Certain thrift institutions and community banks, however, would be able to retain the current Article 32 modification for bad debts or elect an alternative benefit with respect to their New York small business loans and residential mortgages (the details of this benefit have not been elaborated upon at the time of this article's publication).[39]

The current Articles 9-A and 32 exemptions for income from subsidiary capital would be eliminated. Instead, net investment income and net other exempt income, as defined, would be exempt from tax. Net investment income would consist of dividends,[40] gains and losses from stock held for longer than six months[41] if the corporation which issued the stock in question is not unitary with the taxpayer. It would also include income that cannot be apportioned to New York under the U.S. Constitution. Dividends from stock of unitary subsidiaries not included in the combined group (such as alien corporations with no effectively connected income) would be classified as other exempt income.[42] So, in effect, part of the current Article 9-A subsidiary capital concept would survive as part of the new investment capital concept. All other dividends, gains and losses would be business income. Interest income, and gains and losses from debt instruments generally would be business income.

Solely for determining whether income should be classified as investment income or business income, corporations less than 20 percent directly or indirectly owned would be presumed to be non-unitary. Only stock that entitles the holders to vote for the election of directors or trustees would be considered in determining whether a corporation is 20 percent directly or indirectly owned by another corporation. For corporations meeting the 20 percent ownership threshold, a determination of the unitary/non-unitary relationship would take into account the facts and circumstances, and no presumption would be made.

Aside from investment income and other tax exempt income, all other income is business income. This includes interest income and gains and losses from debt instruments, gains and losses from the sale of stock of a unitary corporation, dividends and gains and losses from stock held in a non-unitary corporation for six months or less and income from ''cash'' (essentially working capital).[43]

Merging Articles 9-A and 32 would impose modifications to the net income tax base.

Deductions for interest expenses attributable to investment income and other exempt income would be disallowed (as interest attributable to subsidiary capital is currently disallowed). The computation of the amount of interest expense attributed to investment and other exempt income received by a combined return group would be done on a ''one company'' basis. There would still be the indirect attribution of interest expense against tax exempt income based on the ratio of value of the assets producing tax-exempt income over total assets, as is currently done.[44] However, there also would be an expanded use of direct tracing of interest expense and, where that occurs, the numerators and denominators of the indirect attribution ratio are to be decreased by the amount of the average liabilities for which interest expense was directly traced.[45] This adjusting of the attribution ratios reflects the method by which interest expense attribution was calculated prior to the issuance of the New York State Department of Taxation and Finance's (the ''Department's'') current policy on interest expense attribution in 1988.[46]

One situation where direct tracing would be allowed is where a unitary business includes a financing company that deals mainly with unrelated third parties. Under that circumstance, the interest expense of the fi-

[35] *Id.*

[36] *Senate Report, supra* note 2, at 26 (calling for a repeal of 38 modifications to the Federal income tax base.

[37] *Commission Final Report,* at 24 and Commission Staff Memo, at 2.

[38] *Commission Staff Memo*, at 3.

[39] *Commission Staff Memo*, at 4.

[40] Dividends, in these proposals, include Subpart F income. *Commission Staff Memo*, at 2.

[41] The six-month holding period for stocks would be measured across tax years. In instances where the holding period is split across tax years, a taxpayer would be allowed to classify income from stock as investment income in the first year if it intends to hold the stock for more than six months. If the stock is not held for more than six months, the dividends and gains and losses from the stock generated in year one and year two would be required to be included in the year two return as business income. *Commission Staff Memo*, at 2.

[42] These dividends would be exempt from tax, and deductions for interest expenses attributable to the income would be disallowed. If actual expense attribution exceeds income, the excess would still be disallowed. *Commission Staff Memo*, at 3.

[43] *Commission Staff Memo*, at 3.

[44] *Commission Staff Memo*, at 2 and 3 and N.Y. Dept. of Taxn. and Fin., TSB-M-88(5)C.

[45] *Commission Final Report*, at 24 and *Commission Staff Memo* at 2 and 3.

[46] *See* N.Y. Dept. of Taxn. and Fin., TSB-M-88(5)C and Banigan, 2200-2nd T.M., *New York State and City Corporation Income Taxes*, §2200.05.H.2.a.

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nance company would be directly attributed to its business income (thereby removing it from the pool of interest expense subject to indirect attribution).[47]

It also appears that there would be no attribution of non-interest expenses against tax-exempt income under the proposed reforms.[48]

Lastly, there is a proposed provision whereby the Tax Commission would be granted discretionary powers to make a deemed distribution of non-premium income from overcapitalized Article 33 corporations (insurance corporations) to affiliated Article 9-A corporations to ''properly reflect the activities of the unitary business.'' This is an interesting provision, particularly considering that mandatory combination of all captive insurance companies is among the Commission's proposed Article 9-A reforms (see ''Combined Reporting,'' below). This would seem to be a backstop to those combined return provisions or be aimed at the shared captive insurance company situation. However, it is not entirely clear from Commission's Final Report or related Commission Staff memorandum whether such provisions would reach beyond a captive insurance company situation.[49]

Senate Republican Conference Proposes Reforms

The Senate Republican Conference recommended a reduction in the corporate franchise tax rate with a proportional reduction in tax credits (for example, a 25 percent tax rate reduction— from 7.1 percent to 5.3 percent — together with a 25 percent reduction of all credits under Article 9-A) and the elimination of the corporation franchise tax for manufacturers. This would be an interim step toward the complete elimination of the corporation franchise tax. The Senate Republican Conference also has recommended eliminating the tax on minimum taxable income and combining Articles 9-A and 32; both of these recommendations are consistent with those of the Commission.[50]

Further still, the Senate Republican Conference recommends fully recoupling New York to the federal depreciation rules (thereby allowing federal bonus depreciation for New York tax purposes) and permitting the Qualified Production Activities (I.R.C. §199) deduction (which currently is not allowed by New York State). Lastly, the Senate Republican Conference recommends exploring whether New York could use an allocated amount of a corporate taxpayer's federal tax liability as its New York tax obligation.[51]

Nexus

Summary of Current Law

Under current law, New York generally applies a physical nexus standard, rather than an economic nexus standard. The one exception is a statutory provision, enacted in 2008, under Article 32, that subjects out-of-state banking corporations that issue credit cards to New York residents or have merchant customer contracts with New York merchants to Article 32 taxation, without such banks having a physical presence in New York.[52]

Reforms

The Commission Final Report recommends New York's adopting an economic nexus standard. Under this standard, were a corporation to derive more than a certain amount of its receipts from New York sources, that corporation would be subject to the Article 9-A franchise tax. While the Report did not set a specific threshold of receipts from New York sources for triggering this bright-line nexus standard, it is worth noting that proposed legislation drafted in 2010 set the threshold amount at one million dollars. Foreign corporations that meet the economic nexus standard but do not have federal taxable income (effectively connected income without regard to the provisions of tax treaties) would not be subject to tax and would be excluded from any New York unitary combined return group (see discussion below).

Apportioning Business Income and Capital

Summary of Current Law

Under Article 9-A, as discussed above, the net assets of a corporation are classified as being either subsidiary, investment or business capital. Interest, dividends, gains and losses from subsidiary or investment capital are respectively classified as income from subsidiary capital or investment capital. Income not falling within those categories is treated as income from business capital. Interest and other expenses are attributed among the three classes of capital in accordance with certain New York administrative pronouncements.[53]

Net income from subsidiary capital is excluded from New York State entire net income. Income from investment and business capital is included in entire net income, but investment income is apportioned within and without New York based upon the taxpayer's investment allocation percentage, while net business income is apportioned based upon the New York sourced business receipts of the taxpayer over its total business receipts (receipts factor).[54] The taxpayer's investment allocation percentage is essentially the ratio of the amount of capital employed in New York by the corporations in which the taxpayer holds minority equity positions or debt instruments issued by such corporations over the total amount of investment capital held by the taxpayer.[55]

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[47] *Commission Staff Memo*, at 3.

[48] *Commission Final Report*, at 24 and *Commission Staff Memo*, at 2 and 3.

[49] *Commission Staff Memo*, at 8.

[50] *Senate Report*, at 24 and 25.

[51] *Senate Report*, at 26.

[52] N.Y. Tax Law §1451(c).

[53] N.Y. Dept. of Taxn. and Fin., TSB-M-88(5)C and TSB-M-95(2)C.

[54] N.Y. Tax Law §210(3).

[55] Certain short-term corporate and government-issued debt instruments constitute ''cash,'' which generally may be classified as investment capital or business capital at the election of the taxpayer. Where the taxpayer elects to classify ''cash'' as investment capital, such ''cash'' is not used in determining the taxpayer's investment allocation percentage.

With respect to capital taxes, each item of subsidiary capital is apportioned to New York based upon that subsidiary's issuer's allocation percentage (essentially the ratio of capital employed in New York by that subsidiary over that subsidiary's total capital). The sum of New York subsidiary capital is subject to a tax of 0.09 percent that is added to any other tax imposed under Article 9-A. Investment and business capital are respectively apportioned in the same manner as investment and business income.

In determining the receipts factor, receipts from selling tangible personal property are sourced to where the tangible personal property was delivered.[56] Receipts from services are generally sourced to where the services are performed, though in recent years New York has been asserting that services delivered in some automated fashion should be sourced to the location of the customer.[57] Receipts from the rental of tangible property[58] and the sale of real property[59] are sourced to where the property is located. Royalties from patents and copyrights are sourced to where such intangible property is used.[60] All ''other business receipts'' are sourced to where they are ''earned.''[61] Receipts from the sale of capital assets are excluded from the determination of the receipts factor, though such receipts typically are included in apportionable income.[62] Income from subsidiary capital and investment capital are also excluded from the receipts factor.[63]

Apportionment Reforms

Under the tax reforms drafted by the Commission, the investment capital concept in its current form would be eliminated—and with it, the investment allocation percentage.[64] Similarly, the subsidiary capital provisions (which include the current rules for apportioning subsidiary capital) would be eliminated.

All income of the taxpayer would be classified as ''business income,'' except for investment income and ''other exempt income,'' both of which would be excluded from entire net income.[65] As noted above, dividends, gains and losses from stock that currently constitutes subsidiary capital would be classified as investment income under the tax reform proposals, if the subsidiary is not in a unitary business relationship with the taxpayer, and the subsidiary's stock is held for more than six consecutive months.

Dividends from unitary subsidiaries would be classified as ''other exempt income'' where such subsidiaries are not included in the taxpayer's New York unitary combined return group because such subsidiaries are:

- Corporations taxable under another article of the New York tax law (Articles 9 and 33 for telecommunications and insurance corporations, respectively);
- Alien corporations (corporations organized under the laws of a country other than the United States) with no effectively connected income; or
- Corporations not more than 50 percent directly or indirectly owned by the taxpayer.[66]

Business income and capital would continue to be allocated based on a single receipts apportionment formula.[67] However, in contrast to the current provisions, income generally would be sourced by customer location.

The tax reform proposals include certain provisions for the sourcing of income from financial services income as arising from ''qualified financial instruments'' (''QFIs'') or nonqualified financial instruments. A QFI is defined as an instrument marked to market under either I.R.C. §§475 or 1256. This includes commodities as well as securities. However, it does not include loans secured by real property.[68]

Customer-based Sourcing for QFIs. A taxpayer that has income from QFIs would be required to use customer-based sourcing for each income stream that does not constitute exempt income or may elect to use a ''fixed percentage'' method. Under the fixed percentage method, the taxpayer must treat all income from QFIs as taxable business income and 8 percent of the net income (dividend income, interest income and net gains), not less than zero, from QFIs is included in the numerator of the receipts factor, with all net income, not less than zero, from QFIs being included in the denominator. The fixed percentage method election, which would be irrevocable, must be made on an annual basis and would apply to all members of a combined return group that have QFI income. The eight percent would be fixed by statute and not subject to periodic revision. Eight percent was selected because it represents New York's current contribution to the U.S. gross domestic product.[69]

Customer-based sourcing would be required for income from nonqualified financial instruments (which is any financial instrument not included in the term ''QFI''). Such income would not be covered by the fixed percentage method. Additionally, receipts constituting the primary spread or selling concessions from underwritten securities would no longer be sourced using production credits. Rather, the receipts would be sourced to the customer.[70]

Certain receipts are to be sourced to the location of the customer's commercial domicile. Under the proposed reforms, commercial domicile would be determined using the following hierarchy:

1) location of the treasury function,

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[56] 20 NYCRR §4-4.2

[57] N.Y. Tax Law §210.3(a)(2)(B) and 20 NYCRR, Sec. 4-4.3(a). *See also* the following Advisory Opinions: N.Y. Dept. of Taxn. and Fin., TSB-M-00(15)C; TSB-A-09(5)C; TSB-A-09(8)C; TSB-A-11(1)C; TSB-A-11(8)C.

[58] 20 NYCRR §4-4.4(a).

[59] 20 NYCRR §4-4.6(a).

[60] 20 NYCRR §4-4.4(c).

[61] N.Y. Tax Law §210.3(a)(2)(C) and 20 NYCRR §4-4.4(c).

[62] 20 NYCRR §4-4.6(e).

[63] 20 NYCRR §4-4.1(a).

[64] *Commission Staff Memo,* at 2.

[65] *Commission Staff Memo,*at 2-3.

[66] *Commission Staff Memo*, at 2-3. The Commission Staff Memo described the third bullet as corporations less than 50 percent directly or indirectly owned by the taxpayer. This, however, appears inconsistent with the combined return ownership criteria in *Commission Final Report*, at 24 and *Commission Staff Memo*, at 6.

[67] *Commission Staff Memo*, at 5. *See also* Proposed Tax Law §210-a.1, as contained in the Department's proposed reforms, dated June 17, 2010.

[68] *Commission Staff Memo*, at 5. *See also* Proposed Tax Law §210-a.5(a), as contained in the Department's proposed reforms, dated June 17, 2010.

[69] *See Commission Staff Memo*, at 5.

[70] *Commission Staff Memo*, at 5-6.

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2) seat of management and control, or

3) billing address.[71]

The Commission Staff Memo also contains provisions for sourcing receipts from digital products, originally put forth as the Governor's Budget Proposals for 2009/2010 (Part CC of S.60/A.160), but they were not adopted at that time.

Under the 2009/2010 proposals, the term ''digital products'' would mean any property or services or combination of property and services delivered to a purchaser through the use of wire, cable, fiber-optic, laser, microwave, radio wave, satellite or similar successor media, or any combination thereof. Digital products would include items such as information services, video games, books and other literary works, the storage of digital products and computer software.[72] Generally, receipts from the sale of digital products would be sourced to New York if the product or service is used in New York, as determined under the following hierarchy:

1) The location from which the customer accessed the digital product (demonstrated by using the customer's IP address (or similar or successor indicator), the location of equipment used by the customer to access the digital product or delivery address indicated on a bill of lading or purchase invoice;

2) The billing address of the customer;

3) The zip code or other geographic indicator of the purchaser's location; or

4) The percentage of the taxpayer's receipts sourced to New York in the preceding taxable year (but if the taxpayer was not subject to New York taxation in the preceding year, the percentage of its receipts sourced to New York in the current taxable year.)[73]

Receipts That Would Retain Current Law Sourcing. Receipts from the following items would be sourced as they are under current law:

- interest, fees, penalties, service charges, merchant discounts and fees from credit cards;
- broker/dealer activities, except as describes earlier;
- services provided to a regulated investment company (mutual fund);
- sales of tangible personal property;
- railroad and trucking activity;
- air freight forwarding activity;
- rentals of real and tangible personal property;
- royalties from the use of patents, copyrights and other intangibles;
- transportation of gas through pipes;
- aviation services (other than air freight forwarders); and
- advertising in newspapers, periodicals, television and radio (however, receipts from Internet advertising would be sourced to New York if the potential customers are located in the state). [74]

[71] *Id*.

[72] N.Y. State 2009-2010 Executive Budget, S.60/A.160, Part CC, §1.

[73] N.Y. State 2009-2010 Executive Budget, S.60/A.160, Part CC, §5.

[74] *Commission Staff Memo*, at 6.

Senate Republican Report makes no explicit modification to apportionment.

However, in contrast to current tax law, receipts from services would generally be sourced to New York if the customer is located in the state.[75]

There were no specific modifications to the current New York State apportionment provisions in the Senate Republican Conference's proposed tax reforms. That set of proposals recommends combining Articles 9-A and 32 in a manner that results in no tax increases to any taxpayer. This would seem to result in modifications to how income and capital is apportioned to New York for at least some taxpayers. However, not enough information is provided to project how that is to be accomplished.

Combined Reporting

Summary of Current Law

Under the General Corporation Franchise Tax (Article 9-A), New York may permit or require a related group of corporations to file a combined report if certain conditions are met. Specifically, those conditions are the satisfaction of an ownership standard, the existence of unitary business among the entities to be combined and the existence of ''substantial intercorporate transactions'' among the related entities, as that concept is described below. Alternatively, where the ownership and unitary business conditions are met, but there are no substantial intercorporate transactions between or among the related corporations, a combined return may still be permitted or required where the activities, business, income or capital would otherwise be misstated in the absence of a combined return.

Ownership Standard. The stock ownership requirement is met if any taxpayer:

1) Directly or indirectly owns or controls substantially all the capital stock of one or more other corporations;

2) Has substantially all the capital stock owned or controlled, directly or indirectly, by one or more other corporations; or

3) The taxpayer and one or more other corporations are owned or controlled by the same interests.[76]

For decades, the ownership standard was defined as ownership or control of 80 percent of the voting stock of a corporation.[77] Since the current version of the New York State combined return provisions were enacted effective for taxable years beginning in 2007, ownership or control has been defined as controlling 80 percent or more of the stock that entitles the holder to vote for the directors of another corporation and the right to receive dividends.[78] For tax years beginning on or after Jan. 1,

[75] *Commission Staff Memo*, at 6.

[76] N.Y. Tax Law §211.4.

[77] Former 20 NYCRR §6-2.2(a)(2).

[78] N.Y. Dept. of Taxn. and Fin., TSB-M-08(2)C.

2013, the term was modified to mean 80 percent or more of the voting power of all classes of stock of the given entity (as well as the right to receive dividends).[79]

Existence of Unitary Business. The unitary business requirement has been defined by New York based upon the ''flow of value'' concept as delineated by the U.S. Supreme Court.[80] New York case law has determined this ''flow of value'' to exist in cases where there is centralized management, functional integration and economies of scale resulting from coordinated business operations.[81]

Substantial Intercorporate Transactions. Where the ownership and unitary business requirements have been met, New York requires that there exist ''substantial intercorporate transactions'' between or among two or more related corporations before permitting or requiring the filing of a combined return.[82] For this purpose, the term ''substantial intercorporate transactions'' is defined as:

1) 50 percent or more of a corporation's receipts are from a related corporation or a combinable group of related corporations;

2) 50 percent or more of a corporation's expenditures are to a related corporation or a combinable group of related corporations;

3) 50 percent or more of a corporation's expenditures directly or indirectly benefit a related corporation or a combinable group of related corporations; or

4) there is a substantial intercorporate asset transfer to a related corporation (usually the movement of certain intangible assets or the incorporation of a business unit, where the transferred assets or business unit produces 20 percent or more of the gross receipts of the transferee related corporation).[83]

Alternatively, where the ownership and unitary requirements have been met, but substantial intercorporate transactions are lacking, a combined report may be permitted or required where there exist intercorporate transactions or some agreement, understanding, arrangement, or transaction that results in the subject corporation's New York Article 9-A tax liability being improperly reflected unless a combined return is filed.[84]

With respect to corporations subject to the Franchise Tax on Banking Corporations (Article 32), a bank and bank holding company that is a New York taxpayer and either owns 80 percent or more of the voting stock of another corporation that is also subject to Article 32 taxation, or has 80 percent of its voting stock owned or controlled directly or indirectly by another corporation subject to Article 32, is required to file an Article 32 combined return with that other corporation. In addition, Article 32 combined returns are permitted or required where an Article 32 taxpayer:

1) owns 65 percent or more of the voting stock of another banking corporation or bank holding company;

2) has 65 percent or more of its voting stock owned or controlled by another banking corporation or bank holding company; or

3) has 65 percent or more of its voting stock owned or controlled by the same interests that own or control 65 percent or more of the voting stock of one or more other corporations that are the types of entities that are subject to, or would be subject to, Article 32 taxation had such entities been New York taxpayers.[85]

To permit or require the filing of combined returns under the 65 percent ownership standard, there must be a unitary business among the banks and bank holding companies that are to be combined. Also, the filing of separate returns by the related banks would have to result in an improper reflection of New York tax liabilities, due to intercorporate transactions or some agreement, understanding, arrangement, or transaction among the banks. If the Article 32 tax liabilities of the related banks are not properly reflected on a separate return basis, they must file a combined return.[86]

New York does not permit corporations that are or would be subject to tax under Article 9-A to be combined with corporations that are or would be subject to tax under Article 32.[87] In addition, within Article 9-A certain entities using special apportionment provisions (aviation, railroad and trucking corporations) are not permitted to be combined with Article 9-A taxpayers that do not use the same special apportionment provisions.[88]

Provisions under both Articles 9-A and 32 require that captive REITs, captive RICs and overcapitalized captive insurance companies[89] be subject to combination with a related group of corporations.[90] However, an affiliated group of banking corporations with no more than $8 billion in assets is not subject to the captive REIT/RIC combination provisions.[91]

Combined Reporting Reforms

The Commission Final Report contains a proposal to significantly revise the current combined reporting requirements, bringing them more in line with the requirements used by other states. Specifically, the proposed changes would require combined reporting for related corporations based on satisfaction of a more than 50 percent ownership or control standard (instead of the current 80 percent or more ownership or control) and would also require the existence of a unitary business among those related corporations.[92] Substantial intercorporate transactions or ''distortion'' would not

[79] N.Y. Tax Law §211.4.

[80] *See generally*, *Container Corp. of America v. California Franch. Tax Bd.*, 463 U.S. 159 (1983); *Allied Signal Corp. v. New Jersey Dir., Div. of Taxn.*, 504 U.S. 768 (1992).

[81] *British Land (Maryland) Inc. v. New York Tax App. Trib.*, 85 N.Y.2d 139 (1995); *Heidelberg Eastern Inc.*, N.Y. Tax App. Trib., Nos. 806890 and 807829 (May 5, 1994); *Sears, Roebuck and Co.*, N.Y. Tax App. Trib., No. 801732 (April 28, 1994).

[82] N.Y. Tax Law §211.4(a)(4) and 20 NYCRR §6-2.1(a).

[83] 20 NYCRR §6-2.3(b).

[84] N.Y. Tax Law §211.4(a)(4).

[85] N.Y. Tax Law §§1462(f)(2)(ii) and (iii) and 20 NYCRR §§21-2.3(a)(1) and (2).

[86] N.Y. Tax Law §1462(f)(ii) and (iii) and 20 NYCRR §21-2.3(b)(2).

[87] 20 NYCRR §6-2.5(b) and 21-2.6(b).

[88] N.Y. Tax Law §211.4(a)(2) and (3).

[89] An overcapitalized insurance company is essentially a closely held insurance company that covers the risks of related corporations and generates 50 percent or less of its gross receipts from insurance premiums. N.Y. Tax Law §2.11. *See also* TSB-M-09(10)C and TSB-M-09(10)C.

[90] N.Y. Tax Law §§211.4(a)(6) and (7) and 1462(f)(2)(v) and (vi).

[91] N.Y. Tax Law §1462(f)(2)(v)(G).

[92] *Commission Final Report*, *supra* note 1, at 24.

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be a prerequisite for either permitting or requiring combined returns.[93] This would put New York's combined return rules more in line with other states imposing mandatory unitary combination.

The new proposed combined return standard would be effected on a ''water's-edge basis.'' Such a grouping would consist of all domestic corporations, foreign corporations deemed domestic corporations under the I.R.C. (such as certain corporations in contiguous countries, stapled corporations and inverted corporations) and foreign corporations to the extent they have effectively connected income.[94] Since Article 32 is to be merged into Article 9-A, there would no longer be any barrier to combining banking corporations and bank holding companies with related general business corporations.[95] In addition, the prohibition on combining aviation, railroad and trucking corporations with corporations not engaged in such activities would be eliminated.[96]

Significant in the proposed reforms for combined reporting is the election to treat all commonly owned corporations as part of one unitary business group. Under this election, a commonly owned group of corporations would be effectively treated as a single unitary combined return group, and all of its net income (other than such items that are classified as investment income or other tax exempt income, as discussed above) would be subject to formula apportionment, regardless of whether that income is from a corporation or set of activities that is not part of the unitary business being conducted in New York. This is essentially a ''full apportionment election.'' The election would be binding for seven years and would be automatically renewed at the end of that seven-year period unless the electing group affirmatively notifies the Department that the group no longer intends to continue with the election.[97]

The advantage to making this full apportionment election is that it provides certainty as to the composition of the New York combined return group. The potential disadvantage, of course, is that income (and capital) and apportionment inputs from activities not part of the New York unitary business would become part of the New York combined return group's tax base and apportionment calculation. Accordingly, careful consideration should be given by taxpayers before they enter into this election.

New York would continue to require the inclusion of captive REITs and RICs in its combined return groupings. However, the $8 billion total assets exception, as discussed above, would be eliminated.[98] In addition, New York would require the inclusion of all captive insurance companies in the new Article 9-A unitary combined return group, not just overcapitalized captive insurance companies as is the case under current law.[99]

[93] *Commission Final Report, supra* note 1, at 24-25. *See also Commission Staff Memo,* at 6.
[94] *Commission Staff Memo,* page 6.
[95] *Commission Final Report, supra* note 1, at 24-25. *See also Commission Staff Memo*, at 6.
[96] *See Commission Staff Memo,* at 7. It is not clear how the special allocation formulas applicable to such industries would be taken into account for this purpose.
[97] *Commission Final Report, supra* note 1, at 25. *See also Commission Staff Memo,* at 6-7.
[98] *See Commission Staff Memo,* at 7.
[99] *Commission Final Report, supra* note 1, at 24. *See also Commission Staff Memo,* at 7.

In terms of tax computations for the combined return, a unitary business is to be treated as if it were a single entity. Thus, nexus would be determined on a ''Finnigan'' (as is the case under current law), rather than a ''Joyce'' approach.[100] Each taxpayer member of the group would be liable for the tax of the entire group, which is consistent with New York's current provisions.[101] A combined return group would designate one taxpayer member to serve as the agent of the group for administrative purposes, such as for making tax filings, receiving assessments, making payments and executing waivers of the statute of limitations.[102]

The combined return group's tax would be the highest of the tax on the apportioned entire net income of the group, the apportioned business capital of the group or the ''fixed'' minimum tax of the designated agent. In addition, there would be a ''fixed'' minimum tax imposed on each taxpayer member of the combined return group (other than the designated agent).[103] This mirrors how New York currently determines the tax obligation of an Article 9-A combined return group.[104]

Combined net income would generally be determined by using the federal intercorporate deferral rules.[105] Again, this essentially mirrors current practice.[106] NOLs, capital losses and credits would be used by the combined return group, not just the corporation incurring the item.[107] This is the current practice with respect to NOLs and capital losses; however, this is not necessarily the current practice with regard to tax credits.[108]

Net Operating Losses

Summary of Current Law

New York permits general business corporations (subject to taxation under New York Tax Law Article 9-A) and banking corporations (subject to Article 32 taxation) to take net operating loss (''NOL'') deductions. I.R.C. §172, with certain modifications, is used to determine New York NOL deductions.[109] Therefore,

[100] *Disney Enterprises Inc. v. New York Tax App. Trib.*, 10 N.Y.3d 392 (2008). ''Finnigan'' and ''Joyce'' represent shorthand terminology of state tax practitioners regarding whether a state treats a unitary combined return grouping as a single taxpayer for purposes of applying 15 U.S.C. §381-384 (Pub. L. No. 86-272) safe-harbor nexus standards or whether each member of the group is separately tested under the Pub. L. No. 86-272 standards.
[101] *See Commission Staff Memo,* at 7. *See also* 20 NYCRR §§8-1.3(a) and 21-2.7(r).
[102] *See Commission Staff Memo,* at 7.
[103] *See Commission Staff Memo*, at 7.
[104] N.Y. Tax Law §211.4(b)(1) and 20 NYCRR §3-5.3(a).
[105] *See Commission Staff Memo*, at 7.
[106] *See* 20 NYCRR §3-2.10(b).
[107] *See Commission Staff Memo*, at 7.
[108] *See* 20 NYCRR §3-2.10(b) and 3-8.7. *See also H&S Holdings Ltd*, N.Y. Tax App. Trib., No. 813573 (Sept. 11, 1997).
[109] N.Y. Tax Law §208.9(f); 20 NYCRR §3-8.2(a). A corporation that reports as part of a consolidated group for federal income tax purposes but on a separate basis for purposes of Article 9-A computes its NOL and its NOL deduction as if it were filing on a separate basis for federal income tax purposes. N.Y. Regs. §3-8.1(a). For a more complete discussion of the Article 9-A NOL provisions, *see* Banigan, 2200-2nd T.M., *New York State and City Corporation Income Taxes*, §2200.07.

New York provides for 2-year carryback and 20-year carryforward periods. One of the New York modifications of I.R.C. §172, though, limits the amount of NOL carrybacks to only the first $10,000 of an NOL incurred in any taxable year. The excess over $10,000 is to be carried forward and used in the 20-year period subsequent to when the NOL was incurred.

In addition to restricting the amount of an NOL carryback, New York provides three limitations to the NOL permitted under I.R.C. §172.[110] First, no NOL deduction is allowed for a loss sustained during any year in which the corporation was not subject to the corporation franchise tax under article 9-A or Article 32.[111] With respect to Article 32, an NOL incurred prior to a taxable year beginning on or after Jan. 1, 2001, cannot be carried to another taxable year.[112] The second limitation is that the NOL is adjusted to reflect the New York modifications used in converting federal taxable income to New York entire net income.[113]

The third limitation is that the New York NOL deduction may not exceed the deduction allowable for federal income tax purposes.[114] The amount of the taxpayer's federal NOL for purposes of this limitation is not necessarily the actual amount of the NOL that the taxpayer used for federal tax purposes, but rather the amount of federal NOL that the taxpayer would have used had the taxpayer's federal filing status mirrored its New York filing status (such as if a separate return was filed for New York purposes, then the federal NOL is determined as if a separate federal return had been filed by the taxpayer). This pro forma federal NOL is also determined as if only the first $10,000 of the federal NOL could be carried back.[115] Lastly, the limitation of NOL to the federal NOL also has been interpreted by the Department as requiring the New York loss to originate from the same loss years as when the pro forma federal NOLs were suffered.[116]

For Article 32 taxpayers, the amount of federal NOL used in the third limitation is increased by the excess of the New York addition to the allowance for bad debt over the amount of bad debts allowed for federal income tax purposes for NOLs incurred in taxable years beginning prior to Jan. 1, 2010.[117]

The New York NOL is determined on a pre-apportionment basis, so the year the NOL is utilized determines how much of the NOL is effectively apportioned to New York. If an Article 9-A taxpayer has income from investment capital, then in the year of utilization, the NOL is required to be divided between the taxpayer's net investment and business income.[118] So where a general corporate taxpayer has an investment allocation percentage that is considerably less than its business apportionment percentage, this division of the NOL effectively results in the loss of a good portion of the benefit of the NOL carryforward deduction.

Since New York adopts I.R.C. §172 as the starting point for determining the New York NOL deduction, it has followed the provisions of I.R.C. §381 with respect to corporations succeeding to tax attributes of another corporation in certain corporate reorganization situations. In addition, the limitations of I.R.C. §382 would apply for New York tax purposes—as a result of New York's reference to I.R.C. §172, as well as its requirement that the NOL deduction cannot exceed the corresponding federal NOL deduction, as discussed above. For taxpayers that file New York combined returns, the New York NOL is determined by reference to the applicable federal consolidated return provisions.[119] As a result, federal provisions such as the separate return limitation year (SRLY) and the §382/SRLY overlap provisions apply to New York combined return situations.[120]

Net Operating Loss Reforms

There were no specific NOL proposals in the Commission Report, but details were provided in the Commission Staff Memo, which are discussed below. There were no modifications to the New York NOL provisions in the New York Senate's tax reform proposals.

Under the reform proposals, New York NOL carrybacks would not be permitted. The New York NOL carryforward period would continue to conform to that provided for federal tax purposes. The New York NOL would be determined on a post-apportionment basis (that is the business apportionment percentage would be multiplied by the NOL in the year in which the loss was incurred to determine the NOL carryforward amount).[121] This would put the New York NOL methodology in line with the vast majority of states that permit NOL carryovers. The requirement that the New York NOL not exceed the corresponding amount of pro forma federal NOL would be eliminated. Eliminating this requirement would greatly simplify the New York NOL computation, since the New York NOL would no longer potentially be lost as a result of differing federal/New York treatment for items such as depreciation, foreign dividend income and state/local taxes.

New York would still require that an NOL be incurred in a year that the corporation in question was subject to New York taxation and that no NOL may be carried forward from a pre-tax reform year to a year in which the corporate franchise tax was reformed. However, as discussed below, NOLs predating the tax reform are converted into tax credits that can be utilized under the reformed corporate franchise tax.[122]

The amount of NOL used would be the amount necessary to reduce the tax on entire net income down to the higher of the tax measured by capital or the fixed minimum tax. The remaining unused NOL would be carried forward to future taxable years. In contrast, the current law requires using enough NOL to reduce New York entire net income to zero.[123]

[110] 20 NYCRR §3-8.2(a).
[111] N.Y. Tax Law §§208.9(f)(2) and 1453(k-1)(2); 20 NYCRR §3-8.2(b).
[112] N.Y. Tax Law §1453(k-1)(2).
[113] N.Y. Tax Law §§208.9(f)(1) and 1453(k-1)(1); N.Y. Regs. §3-8.2(c).
[114] N.Y. Tax Law §§208.9(f)(3) and 1453(k-1); N.Y. Regs. §3-8.2(d).
[115] N.Y. Tax Law §208.9(f)(5).
[116] *Re Lehigh Valley Industries Inc.*, N.Y. Tax App. Trib., No. 801617 (May 5, 1988).
[117] N.Y. Tax Law §1453(k-1)(3) and N.Y. Dept. of Taxn. and Fin., TSB-M-10(4)C.
[118] 20 NYCRR §3-8.8.
[119] 20 NYCRR §3-8.7.
[120] N.Y. Dept. of Taxn. and Fin.,TSB-A-07(2)C.
[121] *See Commission Staff Memo*, at 4.
[122] *Id*.
[123] *Id*.

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The reform proposals state that New York's current use of SRLY rules would continue under the new NOL regime.[124] Those proposals do not provide any specific guidance on whether New York would continue to follow I.R.C. §381 for determining whether a transferee corporation can succeed to a transferor corporation's New York NOL, nor whether I.R.C. §382 or the I.R.C. §382/SRLY overlap provisions will continue to apply for New York tax purposes.

Transition Rules

The tax reform proposals provide transition rules with respect to NOLs incurred in pre-tax reform years. Under those transition rules, NOLs incurred before the first year the corporate franchise tax reforms take effect would be converted into a credit. The stated purpose for this credit is to stabilize the value of deferred tax assets established for financial reporting purposes for such pre-reform NOLs.

The amount of the credit would be determined by multiplying the amount of the corporate taxpayer's New York carryover available in the taxable year immediately preceding the taxable year when the tax reforms take effect by both the tax rate and the taxpayer's business apportionment percentage in that taxable year. This credit can only be applied against the taxpayer's tax measured by entire net income and is limited to reducing that tax so that it is no higher than the tax on capital or the fixed minimum tax. No more than 1/10th of the NOL tax credit can be used in any taxable year and the credit may be carried forward for 20 years. If less than a tenth of the NOL credit is used in any taxable year, the difference between 1/10th of the credit and the fraction of that credit that was utilized can be carried forward to a subsequent year and used to increase the 1/10th limitation of such subsequent year. Qualifying small business taxpayers would not be subject to the 1/10th limitation.[125]

Where two or more taxpayers and/or combined return groups existed in the taxable year immediately before that in which the tax reform first takes effect and constitute one combined return group in the year in which such reform first applies, each taxpayer and/or group would separately compute its NOL credit for the pre-reform year. For the years in which the reform applies, the group's total NOL credit would be the sum of the credits of each of its constituent taxpayers and/or combined return groups.[126]

Tax Credits

The Commission's recommendations for reforming various New York tax credits offered an interesting contrast to the proposals put forth by the Senate's Republican Conference.

Investment Tax Credits

Under current law, taxpayers may claim investment tax credits ("ITC") for tangible property that is principally used in a "qualified activity." Property is so used if the property is:

- Principally used by the taxpayer in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture or commercial fishing;
- An industrial waste treatment facility or air pollution control facility used in the taxpayer's trade or business;
- Research and development property;
- Principally used by the taxpayer engaged in certain financial services, for example, as a registered broker/dealer of securities or commodities; or
- Principally used as a qualified film production facility.[127]

Qualifying property may be new or used, so long as the property is acquired by "purchase," as that term is defined under I.R.C. §179(d) and certain other criteria are satisfied.[128]

The Commission has recommended that the ITC provisions be narrowed, limiting eligibility to "manufacturers of goods." In the Commission's view, too many nonmanufacturers satisfy the current eligibility provisions, thereby providing tax incentives where none were originally intended when the ITC was adopted.[129] In addition, the Commission recommended eliminating the ITC for purchases of used property. This would eliminate ITC for purchases of existing businesses.[130] Lastly, the Commission has recommended repealing the ITC for the financial services industry.[131]

With respect to carryovers of existing ITC, which under current law can be carried over for up to 15 years,[132] the Commission Staff Memo provides that amounts of credit carryforwards that existed in prereform years would continue to be carried forward in post-reform years, with the exception of the alternative minimum tax credit.[133]

In contrast to the Commission's recommendations, the Senate Republican Conference has recommended making permanent the ITC for the financial services industry.[134] In addition, the Senate Republican Conference has proposed eliminating the imposition of the franchise tax on manufacturers, which presumably would make the ITC moot for such manufacturers.[135] There was no mention of otherwise restricting the ITC, so presumably the types or groups of taxpayers "unintendedly" benefiting from the ITC under current law would continue to receive such benefits, if they do not qualify for the manufacturer's proposed exemption from the corporate franchise tax.

Brownfield Tax Credits

Under New York's Brownfield Cleanup Program, a number of credits are offered for cleaning up and rede-

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[124] *Id.*
[125] *See Commission Staff Memo*, at 5.
[126] *Id.*

[127] N.Y. Tax Law §210.12(b)(ii).
[128] N.Y. Tax Law §210.12(b)(i) and 20 NYCRR §5-2.2.
[129] *Commission Final Report, supra* note 1, at 24-25.
[130] *Commission Final Report, supra* note 1, at 24-25.
[131] *Commission Final Report, supra* note 1, at 24-25. Note that the ITC for the financial services industry is currently scheduled to "sunset" for property purchased on or after Oct. 1, 2015. *See also* 1998 N.Y. Laws, Ch. 56, §124(2)(c), as amended by 2008 N.Y. Laws, Ch. 57, Part YY-1, §1 and further amended by 2011 Laws, Ch. 61, Part E, §1.
[132] N.Y. Tax Law §210.12(e)(1).
[133] *See Commission Staff Memo*, at 4.
[134] *Senate Report*, at 34.
[135] *Senate Report*, at 25, 33.

veloping Brownfield sites, as defined under Title 14, Article 27 of the New York Environmental Conservation Law (Brownfield credits). The Brownfield credits were the subject of various recommendations by the Commission.

As currently constituted, the tangible property credit component of the Brownfield credits can equal as much as 24 percent of the cost of tangible property placed in service at a Brownfield site. This credit is limited to the lesser of $35 million or three times the eligible costs of site preparation and ground-water remediation. The Commission has recommended that the following additional restrictions be added:

- The site has been abandoned for 10 years;
- Redevelopment of the site would be unlikely without New York State assistance, as determined by the Empire State Development Corporation (the New York State agency responsible for encouraging economic development); or
- The cost of the cleanup of the site is greater than its value after cleanup.[136]

The Commission also recommended scaling back or eliminating the costs currently allowed under the site preparation component of the Brownfield credit that exceed those associated with the actual cost of remediation.[137]

Lastly, the Commission suggested allowing the Brownfield credit program, as currently structured, to sunset as scheduled in 2015.[138]

In contrast, the Senate Republican Conference has recommended that the Brownfield Credits be made permanent. The Senate Republican Conference also recommended providing an advanced approval process to be administered by the Department to determine eligibility for the Brownfield Credits. No other reforms to the Brownfield credits were recommended in the Senate Republican Conference's Preliminary Report.[139]

Reduce the Film Production Tax Credit Allocation

The Commission has recommended reducing the annual allocation for the film production credit. Currently, film production credits can equal 30 percent of the ''below the line'' production costs, with total cumulative credits granted to all such producers limited to $420 million per year (the annual allocation). While the Commission acknowledged that this credit has been instrumental in increasing employment in New York with respect to the film industry, it is concerned that the credit is not ''self-funding'' in its current format. As a result, the Commission has recommended that the annual allocation be reduced by $50 million.[140]

The Senate Republican Conference report also makes a general statement about reducing the film production credits. However, that report also contains a proposal for extending the film production credit to those making capital investments in film production studios. The credit would equal 30 percent of qualified costs of constructing buildings that house studios and the equipment permanently housed in such buildings.[141]

It should be noted that under current law, tangible property principally used as a qualified film production facility is eligible for New York's five percent investment tax credit where the taxpayer provides certain services to a qualified film production company using the facility in question.[142] This, in turn, makes the taxpayer eligible for the employment incentive credit, which effectively doubles the New York ITC credit in the two years subsequent to when eligible property is placed in service, if certain increased employment levels are achieved.[143] So if adopted, the expansion of the film production credit, as proposed by the Senate Republican Report, would appear to at least triple the tax incentives available under current law for investments in film production facilities.

Commission's General Observations on Other Credits

The Commission noted the number of New York business tax credits has increased from nine credits, costing New York $200 million in 1994, to 50 credits (37 of which are refundable), costing New York $1.7 billion in 2013. As a result, the Commission recommended a general re-evaluation of the effectiveness of New York's various tax credits. In addition, the Commission recommended adding transparency to the credit programs, so that information will be available to identify the beneficiaries of the various credits.

Senate Republican Conference Recommendations on Other Credits

In its report, the Senate Republican Conference has recommended expanding some existing tax credits and creating others. In particular, it recommends creating an ''Angel Investment Tax Credit'' to enable small businesses to leverage tax credits to create private investment pools.[144] The Senate Republican Conference also noted that it received the following suggestions during the course of public hearings held throughout New York State:

1) Make the Low Income Housing Tax Credit refundable;

2) Permit the bifurcation of the Low Income Housing Tax Credit so that developers would be able to market the credits separately, and in the last instance, use the credits themselves;

3) Move up the date of implementation of the refundability of the Historic Tax Credit to property placed in service on or after Jan. 1, 2014;

4) Provide a tax credit for asbestos abatement;

5) Enact legislation to correct the retroactive changes to the Qualified Enterprise Tax Credits, as well as clarify and extend these credits; and

6) Provide refundable R&D credits.[145]

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136 *Commission Final Report, supra* note 1, at 25.
137 *Commission Final Report, supra* note 1, at 24 and 25.
138 *Commission Final Report, supra* note 1, at 25.
139 *Senate Report, supra* note 2, at 26, 34.
140 *Commission Final Report, supra* note 1, at 24, 26.
141 *Senate Report, supra* note 2, at 27 and 34.
142 N.Y. Tax Law §210.12(b)(i)(G).
143 N.Y. Tax Law §210.12-D(a)(i).
144 *Senate Report, supra*, at 27, 34.
145 *Senate Report, supra*, at 34.

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MTA Surcharge

Summary of Current Provisions

To assist in funding the Metropolitan Transportation Authority (''MTA''), New York State currently imposes a 17 percent surcharge (''MTA Surcharge'') on Article 9-A and Article 32 taxpayers, based on the amount of their respective franchise taxes apportioned to the Metropolitan Commuter Transportation District (''MCTD'').[146] The MCTD encompasses New York City and seven neighboring counties. The MTA Surcharge is imposed on the highest of the Article 9-A tax on the entire net income, investment and business capital, minimum taxable income or the fixed minimum tax. Once the highest base is determined, that tax base is recomputed using the following tax rates:

- 9 percent on entire net income apportioned to New York;
- 0.178 percent on investment and business capital that is apportioned to New York (with a maximum tax of $350,000);
- 3.5 percent on minimum taxable income; or
- The fixed minimum tax at its current rate.[147]

After the tax base is redetermined, it is apportioned to the MCTD based on the average of the ratios that respectively consist of property, payroll and receipts in the MCTD over property, payroll and receipts in New York State.[148] The 17 percent MTA Surcharge is then applied the result.[149]

For Article 32 taxpayers, if the entire net income base is the highest, then it is recomputed as if the tax rate was 9 percent.[150] Article 32 franchise tax is apportioned to the MCTD based on the ratio of the Article 32 taxpayer's gross income within the MCTD to gross income within New York State.[151]

Proposed Reforms

The Commission Staff Memo has proposed revising the MTA Surcharge tax base and apportionment rules to conform to the proposed New York State tax base and apportionment reforms. However, the Commission proposed making those changes in a manner that does not result in the loss of revenue to the MTA. No details were offered by the Commission or the Commission's Staff as to how this will be accomplished.[152]

Effective Date for Proposed Reforms

If adopted into law, the Commission's proposed tax reforms would appear to become effective no earlier than for taxable years beginning on or after Jan. 1, 2015. However, it appears that making the reforms effective for taxable years beginning on or after Jan. 1, 2016 is the Commission's preference to allow more time for both the taxpayers and the Department to make the necessary preparations.[153]

Tax Relief Commission Final Report

Recently, the New York State Tax Relief Commission (the ''Tax Relief Commission''), which was formed this past October by Gov. Andrew Cuomo, released its report. In that report, the Tax Relief Commission recommended deviating from the goal of revenue neutrality in developing the corporation franchise tax reforms and setting the corporate franchise tax rate at 6.5 percent. In addition, other recommendations of the Tax Relief Commission include merging Article 32 into Article 9-A, using single (receipts) factor apportionment for determining the corporate tax liabilities and sourcing receipts from services based on customer locations. The Tax Relief Commission recommends making its reforms effective for tax year 2015, with full implementation in the 2016-2017 New York State fiscal year.[154]

New York City Conformity

The Commission has recommended that New York City adopt the proposed New York State corporation franchise tax reforms for purposes of the City's banking corporation and general corporation taxes.[155] It is not certain at the time of the publication of this article whether New York City will conform to the New York State proposed reforms.

Conclusion

The corporate franchise tax reform proposals put forth by the Commission would, if enacted into law as proposed, eliminate or modify substantially specific aspects of the current franchise tax law that are unique to New York, such as the subsidiary capital and combined reporting rules. In other respects, the reform proposals would follow existing trends in state taxation, such as economic nexus and apportionment of receipts based on customer (market) sourcing rules.

It is expected that Governor Cuomo will highlight certain of the Commission's reform proposals in his State-of-the-State address to be delivered in January of 2014. While it is not possible to predict the likelihood of which, if any, of the Commission's corporate franchise tax proposals may ultimately be enacted into law, mention of a specific proposal in the Governor's address may indicate some degree of priority—at least as far as Gov. Cuomo (a Democrat) and the New York State Assembly are concerned.[156] Finally, as noted above, the Republican Conference of the New York State Senate[157] has put forth its own package of tax reform proposals. While there is some overlap in the proposals put forth by the Commission and the Senate, such as merging Article 32 into Article 9A and eliminating the corpo-

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[146] N.Y. Tax Law §209-B.1 and .6; §1455-B.1 and .5.

[147] N.Y. Tax Law §209-B.1.

[148] N.Y. Tax Law §209-B.2. Special MCTD formulas are applied to corporations engaged in aviation, railroads or trucking. N.Y. Tax Law §§209-B.2-a to 2-b.

[149] N.Y. Tax Law §209-B.1.

[150] N.Y. Tax Law §1455-B.1.

[151] N.Y. Tax Law §1455-B.2 and 20 NYCRR §23-1.3.

[152] *Commission Final Report*, p 24 and *Commission Staff Memo*, p 8.

[153] *Commission Staff Memo*, at 9.

[154] Tax Relief Commission Final Report, December 2013, pages 4, 5, 8-10.

[155] Commission Final Report, at 27.

[156] Democrats are currently the majority party in the State Assembly.

[157] Republicans are currently the majority party in the State Senate.

rate minimum tax credit,[158] there are many areas of divergence in the two overall approaches. Accordingly, the ultimate path of the reform proposals contained in the Commission's Report must inevitably be influenced by the political process.

[158] The amount of minimum tax credit generated in a tax year is the amount of excess of the minimum tax on entire net income over the next highest tax (taking into account certain other adjustments). *See* N.Y. Tax Law §210.13.

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