Inside New York tax reform: Understanding the impact on asset management companies

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In brief

On March 31, 2014, New York Governor Andrew Cuomo signed into law NY S 6359, enacting significant changes to New York State's corporate tax regime, most of which take effect for the 2015 tax year. Some of the more important changes include: merging the bank franchise tax with the corporate franchise tax, establishing economic nexus provisions, replacing the state's existing combined reporting provisions with a unitary combined reporting system along with an effectively connected income approach, updating the single receipts factor apportionment formula to permit customer sourcing provisions for all taxpayers, and providing tax breaks to manufacturers. Coupled with these provisions, the corporate rate is reduced from 7.1% to 6.5%, effective January 1, 2016. As noted below, however, the MTA surcharge will greatly increase effective January 1, 2015.

While corporations are less common than pass-through entities in asset management structures, some advisors take the form of S corporations, and many offshore funds take the form of 'blocker corporations'; these entity types are subject to the newly-enacted corporate tax overhaul. In addition, the overhaul further widens the gulf between the corporate provisions and the existing New York State and City individual tax scheme and New York City Unincorporated Business Tax (UBT) scheme in terms of nexus and sourcing rules. Neither tax has been modernized to include economic nexus principles or customer sourcing for all taxpayers, and these taxes loom large in the tax profiles of asset management firms and their founders.

The features of the overhaul most salient to asset managers are economic nexus, customer based sourcing, and the treatment of investment income. The summary below highlights these changes. [NY S. 6359, A. 8559.]

In detail

Economic nexus

Under the legislation, taxable corporations include corporations that derive receipts, based on a $1 million threshold, from activity in New York. Physical presence in the state is no longer the sole requirement for New York to compel a corporate tax filing. For the typical blocker corporation receiving a K-1 from a portfolio company, it may be a reporting challenge to determine the corporation's share of the partnership's gross receipts (particularly for limited liability company blockers that don't receive the New York State corporate partner K-1). This has been a challenge in dealing with California's provisions of a similar nature. Many taxpayers have taken the approach that any amount of California source income is tantamount to economic nexus for the corporate partner.

Economic nexus within the MCTD district, surcharge rate increase

The same 'deriving receipts' standard will apply for the Metropolitan Transportation Authority (MTA) Surcharge, which will increase in three annual phases from 17% to 25.6% between January 2014 and January 2016. The ultimate effective rate will be 1.66%, based upon the 6.5% base income rate. While there is required disclosure of information needed to make the economic nexus determination on the New York State corporate partner K-1, it is not often fully completed by the partnership's tax preparer. Practitioners can expect the same challenges as described above in a corporate partner scenario regarding the state economic nexus provisions.

Corporate partner reporting of partnership activities

Corporate partners (such as blockers) have, until now, had the option to report partnership activity under either the 'entity' (separate accounting) or 'aggregate' (mixing bowl or unitary) method (*see* New York State Corporate Rules and Regulations Section 3-13), depending upon a number of factual elements. The typical blocker corporation meets the requirements to use the entity method, which is typically preferable from both a practical perspective as well as an economic perspective, to the extent the partnership interest is later divested of at a gain. The legislation adds a new subdivision 3 of section 210, which requires corporate partners to use the aggregate method.

Customer based sourcing, in general

While single-factor, receipts-only sourcing has been in effect since 2007, under the legislation, a complex series of customer based sourcing rules have been adopted. From a practical perspective, one of the most striking features of the new apportionment rules is that a broker-dealer license will no longer be required for a corporation to utilize customer based sourcing. It is questionable whether a management company subject to tax as an S corporation could take the position that its ultimate customers paying its management fees are its investors in its funds and source revenue accordingly. It should be noted that such position is not explicit in the language.

Under the former customer based sourcing rules available solely to licensed broker-dealers, the location of the customer was considered to be the customer's mailing address, regardless of whether the customer was an individual or a business entity. In contrast, under the new customer based sourcing provisions, which apply to all taxpayers, the determination of customer location differs depending upon whether a customer is an individual (the customer's mailing address is used) or a business entity (a hierarchy of rules is used, depending upon the customer's location of treasury function, seat of management and control, or finally its billing address).

Among the financial transaction sourcing provisions, the legislation provides an election for qualified financial instruments, defined as financial instruments marked-to-market under IRC Sections 475 or 1256 (excluding loans secured by real property). In determining New York receipts and net gains from qualified financial instruments, taxpayers may make an annual and irrevocable election to use a fixed percentage method. Under this method, 8% of all net income from qualified financial instruments is included in the apportionment factor numerator. If a taxpayer does not elect the fixed percentage method, receipts and net gains are sourced via a customer based sourcing method (using an individual's billing address or a business's commercial domicile).

Sourcing rules for financial instruments

Under the legislation, the definition of investment capital, discussed below, is significantly limited to include only equity securities held for six or more consecutive months, and the flexibility afforded by the cash election is eliminated. As such, many financial instruments previously treated as investment capital, as well as cash, are treated as business capital, with the associated income streams treated as business income. To greatly simplify the proposal, such income streams will be sourced using either an annual irrevocable election to use 8% as the New York factor for all income, or using actual customer based sourcing in accordance with specific rules for individual and entity customers as described above.

Asset managers are accustomed to utilizing the historical investment capital provisions and the cash election to effectuate a very low effective tax rate on interest, dividends, and capital gains from corporate securities (equity and debt) as well as cash and deemed cash, based upon the New York presence of the issuers of these securities. The typical asset manager calculates an IAP between 0% and 5%. The legislation will greatly alter this landscape; income from debt securities and cash will be sourced to New York either at 8% or based on the commercial domicile of the payor of the income stream. The challenge will be for the asset manager to decide between conceding the 8% versus doing the due diligence to determine whether its entity payors are commercially domiciled to a lesser extent in New York State.

Changes to 'investment capital/income'

As discussed above, under the legislation, the definition of investment capital (now a non-taxed asset/income category) will be significantly limited to include only equity securities held for six or more consecutive months, and the flexibility afforded by the cash election is eliminated. Accordingly, corporate-issued debt securities will no longer be afforded tax-advantaged treatment. While investment income is wholly exempt from tax, attribution of interest expense will apply, and the asset ratio used in this calculation will be net of liability attribution, which was not historically the case. To the extent that interest expenses attributable to investment income exceed investment income, the excess of expenses so attributed must still be added back to business income, which was also not historically the case. In lieu of calculating an actual interest expense attribution, investment income may be reduced by an arbitrary amount of forty percent.

Miscellaneous other provisions to note (list is non-inclusive)

- Increased fixed dollar minimum tax for corporations with New York State gross receipts greater than $50M. The maximum amount of this tax base is now $200K, up from $5,000, as shown in the following table:

New York Receipts	C Corp Fixed Dollar Minimum Tax
Not more than $100,000	$25
$100,001 - $250,000	$75
$250,001 - $500,000	$175
$500,001 - $1,000,000	$500
$1,000,001 - $5,000,000	$1,500
$5,000,001 - $25,000,000	$3,500
$25,000,001 - $50,000,000	$5,000
$50,000,001 - $100,000,000	$10,000
$100,000,001 - $250,000,000	$20,000
$250,000,001 - $500,000,000	$50,000
$500,000,001 - $1,000,000,000	$100,000
Over $1 billion	$200,000

- Elimination of subsidiary capital provisions (most subsidiary capital ends up being treated either as investment capital or as generating 'other exempt income', or being combined).
- Taxation of alien corporations on an effectively-connected income basis as opposed to the former worldwide-apportioned income basis.
- Numerous changes to NOL provisions.
- Combined reporting standards changed to a unitary business test with a greater than 50% stock ownership test.

Increasing the disconnect between Article 22 (New York State taxation of individuals) and New York City's UBT

New York State has not enacted a similar modernization of the nexus and apportionment provisions for partnerships or nonresident individuals under Article 22. Partnerships are not subject to economic nexus provisions and are subject to an evenly-weighted three-factor apportionment factor (where the use of separate books and records is not appropriate) with an archaic 'origin' rule for the sourcing of receipts from the performance of services. There is no provision for customer based sourcing under this tax article for providers of services to mutual funds or other entities, whereas such a rule has existed for corporations for many decades. The result is that an individual nonresident owner of a NY-based partnership is taxed differently than the out-of-state corporate owner of a NY-based partnership.

Nearly every New York-based asset manager pays the New York City UBT. New York City also imposes its General Corporate Tax (GCT) on both S corporations and C corporations; the GCT has been, up to the present time, similar, but not identical to, the New York State corporation tax. New York City has not enacted economic nexus, nor does it enable customer based sourcing for entities other than registered broker-dealers, and only for specific income streams. Its investment capital and income provisions for the UBT and GCT are similar to what New York State has greatly altered. While several years ago the State and City proposed to modernize their provisions in unison, such intent for unity is not seen or anticipated currently. This will leave asset managers subject to wildly disparate, highly complex tax schemes in this highest-tax jurisdiction in the country.

The takeaway

Corporate tax reform in New York may not have significant effects on standalone asset managers, other than on blocker corporations or S corporation management entities. The tax reform will, however, add complexity to the extant patchwork of individual and entity New York State and local tax provisions and compliance.

To read more on the New York State tax reform click here.

Let's talk

For more information on how New York's corporation tax reform will affect asset managers, please contact:

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