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## ***New York tax reform enacted***

*April 2, 2014*

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### ***In brief***

On March 31, 2014, New York Governor Andrew Cuomo signed the state's FY14-15 executive budget legislation. The legislation overhauls the state's corporate tax regime as well as makes other significant tax changes. Important changes include: eliminating the bank franchise tax and subjecting all corporations to a revised corporate franchise tax, reducing the tax rate from the existing 7.1% to 6.5% effective for tax years beginning on or after January 1, 2016, establishing economic nexus, replacing the state's existing combined reporting provisions with a unitary combined reporting system, providing an effectively connected starting point for foreign corporations, revising net operating loss provisions, establishing a single receipts factor apportionment formula with customer sourcing provisions, and providing tax breaks to manufacturers. [[S.B. 6359-D, A 8559-D](#), (Chapter 59), enacted 3/31/2014]

Some notable provisions in the final bill that differ from the proposal originally issued in January include: eliminating the income tax on all qualified New York manufacturers, not just qualified upstate manufacturers; phasing out of the capital tax; adding where the benefit is received to the sourcing hierarchy for other business receipts and services; excluding captive insurance companies from combination where more than 50% of company's gross receipts consist of premiums from arrangements that constitute insurance for federal income tax purposes; and expanding the investment tax credit by removing language limiting the credit to qualified manufacturers, and applying it to a broader range of property including property used by broker dealers and investment advisors and in film production.

Although the impact on financial institutions might seem to be the most significant, all existing New York taxpayers, their affiliates, and businesses that sell into the state need to examine the legislation for potential benefits and detriments these changes pose.

Except where noted, the legislation takes effect on January 1, 2015 and applies to taxable years commencing on or after that date. Notably, New York City has yet to conform to these changes.

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### ***In detail***

#### ***Bank tax elimination and corporate tax reform***

The legislation repeals the bank franchise tax (Article 32) and subjects all taxpayers to a revised corporate franchise tax (Article 9-A) for tax years beginning on or after January 1, 2015.

#### ***Economic nexus***

Under the legislation, taxable corporations include corporations that derive receipts, based on a \$1 million threshold, from activity in New York. This new standard will also apply to taxability under the metropolitan business tax surcharge.

For purposes of the state's combined reporting provisions (see below section related to combined reporting), a corporation that is part of a combined group and that has less than \$ 1 million, but more than \$10,000, of New York receipts is deemed to satisfy

the receipts threshold if the in-state receipts of all members of the group that separately exceed \$10,000 meet the \$1 million threshold in the aggregate.

The Article 32 nexus thresholds for credit card companies based on customers in the state are transferred over to Article 9-A. The legislation repeals the nexus rule for fulfillment services.

### **Rates**

The legislation reduces the tax rate from the existing 7.1% to 6.5% effective for tax years beginning on or after January 1, 2016, and increases the rate of the MTA surcharge to 25.6% effective for tax years beginning on or after January 1, 2015 and before January 1, 2016. The rate of the MTA surcharge for later years will be determined by the commissioner at a rate necessary to meet state financial projections.

Effective for tax years beginning on or after January 1, 2014, the tax rate imposed on a 'qualified New York manufacturer' will be 0%. The definition of a qualified New York manufacturer is addressed below.

The capital base tax rate will be gradually phased to 0% by 2021, with qualified New York manufacturers paying a lower rate than other taxpayers during the phase out period. The cap for manufacturers is retained at \$350,000 and increased to \$5 million from \$1 million for other taxpayers.

### **Apportionment**

The state's apportionment rules are revised so that business income and capital are apportioned using a single receipts factor. A complex series of customer based sourcing rules are adopted with provisions for tangible personal property and electricity, rentals and royalties, digital products,

a variety of financial transactions, railroad and trucking businesses, aviation services, advertising, gas transmission and transportation, and other business services and receipts.

Among the financial transaction sourcing provisions, the legislation provides an election for qualified financial instruments, defined as financial instruments marked to market under IRC §§ 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 the commercial domicile of a business).

Under the new sourcing rules, a patent, copyright, trademark, or similar intangible property is used in the state to the extent the activities related to such items are carried on in the state. Also, sourcing rules for asset backed securities apply to securities issued by a government agency.

For receipts not specifically addressed, the legislation provides a category for receipts from other services and other business receipts. Such receipts are sourced to New York based on customer location, with a hierarchy of methods used to determine location, starting with where the benefit is received.

### **Combined reporting**

Applicable to tax years beginning on or after January 1, 2015, the state replaces its existing combination

provisions, which require combination based on the existence of substantial intercorporate transactions, with unitary combined reporting provisions. Under the legislation, a combined report must be filed by any taxpayer:

1. that owns or controls, directly or indirectly, more than 50% of the capital stock of one or more other corporations or
2. more than 50% of the capital stock of which is owned or controlled either directly or indirectly by one or more other corporations or
3. more than 50% of the capital stock of which, and the capital stock of one or more other corporations, is owned or controlled, directly or indirectly, by the same interests *and*
4. that is engaged in a unitary business with those corporations.

Combined returns include:

1. a captive REIT or a captive RIC that is not required to be included in a combined insurance tax report under Article 33.
2. a combinable captive insurance company. A combinable captive insurance company is an entity that is treated as a corporation under the IRC and that: (1) more than 50% of the voting stock of which is owned or controlled, directly or indirectly, by a corporation subject to the federal income tax; (2) licensed as a captive insurance company under the laws of New York or another jurisdiction; (3) whose business includes providing,

directly and indirectly, insurance or reinsurance covering the risks of its parent and/or members of its affiliated group; and (4) 50% or less of its gross receipts consist of premiums from arrangements that constitute insurance for federal income tax purposes.

3. an alien corporation that satisfies the state ownership and unitary thresholds and that is treated as a domestic corporation under IRC Sec. 7701 or has effectively connected income for the taxable year.

Corporations may elect to be combined with their non-unitary affiliates provided the ownership thresholds are met. The election would be irrevocable and binding for the taxable year and the next six years and then is automatically renewed for an additional seven years unless it is affirmatively revoked.

The legislation details how a combined group claims NOLs, credits, and apports its tax base. For apportionment purposes, the legislation adopts a *Finnigan* approach by providing for the inclusion of the ‘receipts, net income, net gains and other items of all members of the combined group, whether or not they are a taxpayer...’

### **Net operating loss**

The legislation revises the state’s existing net operating loss provisions and creates a new ‘prior net operating loss (PNOL) conversion subtraction.’ In computing business income, taxpayers are allowed both this PNOL and a net operating loss deduction (NOLD).

The PNOL will be applied against the business income base before the NOLD.

The PNOL is calculated in the following manner:

1. The taxpayer must calculate the tax value of its unabsorbed NOL for the base year. The value is equal to the product of (1) the amount of the taxpayer’s unabsorbed NOL, (2) the taxpayer’s base year business allocation percentage (BAP), and (3) the taxpayer’s base year tax rate.
2. The product determined under 1 (above) is divided by 6.5% (or in the case of a qualified New York manufacturer, 5.7%). This result will equal the taxpayer’s prior net operating loss conversion subtraction pool.
3. The taxpayer’s PNOL for the taxable year will equal 10% of its NOL conversion subtraction pool plus any amount of unused PNOL conversion subtraction from preceding taxable years. The PNOL of a small business corporation will not be subject to the 10% limitation.

In lieu of the amount of the PNOL subtraction determined above, taxpayers may elect their PNOL conversion subtraction for tax years beginning on or after January 1, 2015 and before January 1, 2017 to equal in each year up to 50% of its NOL conversion subtraction pool. The taxpayer must make this election on its return for the tax year beginning during 2015. The legislation also provides a method for determining the PNOL for taxpayers that are members of a combined group.

For purposes of the PNOL, the following definitions apply:

- Base year - the last taxable year beginning on or after January 1, 2014, and before January 1, 2015.

- Unabsorbed net operating loss - the unabsorbed portion of NOL as calculated under prior law (either Art. 9-A or Art. 32) as was in effect on December 31, 2014, that was not deductible in previous taxable years and was eligible for carryover on the last day of the base year, including any NOL sustained by the taxpayer during the base year.
- Base year BAP – the taxpayer’s business allocation percentage as calculated for corporate franchise tax purposes for the base year, or the taxpayer’s allocation percentage as calculated for bank franchise tax purposes as such sections were in effect on December 31, 2014.
- Base year tax rate – the taxpayer’s tax rate for the base year as calculated under Article 9-A or Article 32, as such provisions were in effect on December 31, 2014.

The PNOL conversion subtraction may be used to reduce the taxpayer’s tax on allocated business income to the higher of the tax on the capital base or the fixed dollar minimum. Any amount of unused subtraction will be carried forward to the subsequent tax year or years until tax years beginning on or after January 1, 2036, and will not be subject to the 10% limitation in subsequent tax years. However, if the taxpayer makes the PNOL conversion subtraction election (50% of the pool), carryforwards for any amount of the subtraction beyond its tax year beginning on or after January 1, 2016 and before January 1, 2017 will be disallowed.

For purposes of the NOLD, the legislation provides that: the deduction is not limited to the amount allowed under IRC §172 or the amount that would have been allowed had the taxpayer not made an election under subchapter S of the IRC; the

deduction does not include any NOL incurred during any tax year beginning before January 1, 2015, or any year the taxpayer was not subject to the corporate franchise tax; the deduction is post-apportionment; NOLs can be carried forward for 20 years; NOLs can be carried back for three years, but not prior to a year beginning on or after January 1, 2015; and that a taxpayer that is a member of a federal consolidated group but that files a separate New York return must compute its NOLD as if it filed a separate federal income tax return.

### **Tax base and addback provisions**

Under the legislation, the entire net income base is replaced with a tax based on business income, defined as entire net income minus investment income and other exempt income. In addition, provisions related to subsidiary capital are repealed.

The legislation redefines investment income to mean income, including capital gains in excess of capital losses, from investment capital (as redefined), to the extent included in computing entire net income, less (1) in the discretion of the commissioner, any interest deductions allowable in computing entire net income that are directly or indirectly attributable to investment capital or investment income, and (2) the taxpayer's loss, deduction and/or expense attributable to any transaction, or series of transactions, entered into to manage the risk of price changes or currency fluctuations with respect to any item of investment capital that is held by the taxpayer, or the aggregate investment capital that is held by the taxpayer, if all (or a de minimis amount) of the risk is with respect to investment capital. Investment income cannot exceed entire net income. If the amount subtracted under (1) or (2) exceeds investment income, the excess of such amount over investment income must be added back to entire net income. In

lieu of subtracting from investment income the amount of those interest deductions, the legislation allows a taxpayer to elect to reduce its total investment income by 40%. Investment income does not include any amount treated as dividends under IRC §78.

Under the legislation, an addback is required when a taxpayer attributes interest deductions to other exempt income and the amount subtracted exceeds other exempt income. 'Other exempt income' is the sum of 'exempt CFC income' (as defined in the legislation) and 'exempt unitary corporation dividends (as defined in the legislation). Other exempt income does not include any amount treated as dividends under IRC §78.

The legislation also provides addbacks for: the amount of any federal deduction for the excise tax on telecommunication services to the extent such taxes are used as the basis of the calculation of the tax-free New York area excise tax on telecommunication services credit; and the amount of any federal deduction for real property taxes to the extent such taxes are used as the basis of the calculation of the real property tax credit for manufacturers. The legislation eliminates the addback for taxes measured by income or profits paid to a foreign country.

It should be noted that elimination of the treaty exception to royalty addbacks is *not* included in the final legislation.

### **Business credits**

The legislation reforms the state's credit provisions. Specifically, it provides for a new Investment Tax Credit (ITC) with respect to qualified depreciable property that is located in the state and is: (a) principally used by the taxpayer in the production of goods (by manufacturing and other means); (b) an industrial waste

treatment or pollution control facility; (c) research and development property; (d) used in the ordinary course of the taxpayer's trade or business as a broker-dealer in connection with the purchase or sale of stocks, bonds or other securities, or of commodities; (e) used in the ordinary course of the taxpayer's trade or business as providing investment advisory services for a regulated investment company, or lending, loan arrangement, or loan origination services to customers in connection with the purchase or sale of securities; (f) originally used in the ordinary course of the taxpayers business a registered national securities exchange; or (g) principally used as a qualified film production facility.

The legislation also provides for an employment incentive credit, empire zone investment tax credit, empire zone employment incentive credit, QEZE credit for real property taxes, QEZE tax reduction credit, qualified emerging technology company employment credit, qualified emerging technology company capital tax credit, credit for the special additional mortgage recording tax, credit for servicing certain mortgages, an agricultural property tax credit, credits for film production, and film post-production, credits for commercial production, credits for environmental remediation, and a series of other credits.

### **Foreign corporations**

An alien corporation is not deemed to be doing business, employing capital, owning or leasing property, or maintaining an office in this state if its in-state activities in this state are limited solely to (a) investing or trading in stocks and securities for its own account (b) investing or trading in commodities for its own account or (c) any combination of these activities. In addition, the legislation provides that an alien corporation with no effectively connected income for the

taxable year would not be subject to the corporate franchise tax for that year.

The legislation adopts 'effectively connected' income as the starting point for the corporate tax base calculation for non-US corporations (subject to adjustments). For foreign corporations, the legislation disallows exclusions, deductions or credits for (1) income from dividends or interest in stock, securities, or indebtedness but only if such income is treated as effectively connected with the conduct of a US trade or business (IRC §864); (2) any income exempt from federal taxable income under any treaty, but only if such income is treated as effectively connected in absence of such exemption, provided that the treaty does not prohibit the state's taxation of such income; and (3) any income that would be treated as effectively connected if such income were not otherwise excluded from gross income under IRC §103.

#### **Small banks**

The legislation allows a deduction for a thrift institution or community bank that maintains a qualified residential loan portfolio. The deduction would be for the amount by which 32% of the taxpayer's entire net income exceeds the amounts it deducts under IRC §§166 and 585 (bad debts), less any amounts included in federal taxable income as a result of a recovery of a loan. Additionally, the legislation would allow qualified community banks (banks with under \$8 billion of assets), a subtraction modification equal to 50% of gross interest income from qualifying loans divided by gross interest income from all loans.

#### **Manufacturers**

The legislation creates a tax credit (under both the corporate franchise and personal income tax) for qualified New York manufacturers equal to 20% of real property tax paid on property used for manufacturing

during the taxable year. A qualified New York manufacturer is a manufacturer (as defined) having property in New York that is eligible for the investment tax credit and either (1) the fair market value of that property has an adjusted basis for federal income tax purposes of at least \$1 million at the close of the taxable year or (2) all of the manufacturer's real and personal property is located in New York.

A taxpayer or combined group that does not satisfy the manufacturer requirement may be deemed a qualified New York manufacturer if the taxpayer or combined group employs during the tax year at least 2500 people in manufacturing in the state and the taxpayer or combined group has property in the state used for manufacturing, the adjusted basis of which for federal income taxes is at least \$100 million at the close of the taxable year.

These changes would take effect for tax years beginning on or after January 1, 2014.

#### **Corporate partners**

The legislation requires corporate partners to compute tax under the aggregate method as determined by regulation, unless such regulation provides or allows for another method of computation. Under the aggregate method (1) a corporate partner is deemed to have an undivided interest in the partnership's assets, liabilities, and items of receipts, income, gain, loss and deduction, and (2), the corporate partner is treated as participating in the partnership's transactions and activities.

The legislation also provides that if a partnership has nexus with New York, a corporate partner of the partnership will likewise have nexus. Specifically, if a partnership is doing business, employing capital, owing or leasing property in the state, or deriving

receipts from activity in the state, any corporation that is a partner in the partnership is subject to tax.

#### **Other changes**

The legislation also provides for:

- an 'enhanced' real property tax circuit breaker credit for individuals
- amendments to the estate tax, applicable to decedents dying on or after April 1, 2014
- a real property tax freeze credit
- an extension, for another two years, of the transitional provisions relating to the enactment and implementation of the federal Gramm-Leach-Bliley Act, for New York City purposes.

#### **The takeaway**

The bill was signed on March 31, 2014, and therefore, is a first quarter financial statement event for calendar year taxpayers.

This bill marks a years-long effort to reform the state's tax system, which several commissions described as being overly complex and harmful to the state's economic competitiveness.

Most of the changes take effect in 2015, which gives businesses time to digest these changes. Although, taxpayers presently subject to the bank franchise tax under Article 32 probably have the greatest adjustment. The changes enacted in New York are significant. The new customer based sourcing provisions and the new NOL provisions are rather complex. In addition, the composition of many New York combined groups may change. Taxpayers should weigh the benefits of the numerous elections provided for in the legislation, such as the alternative PNOL conversion subtraction, the apportionment election for qualified financial

instruments, the 40% safe harbor election for interest expenses related to investment income and the election to combine with non-unitary affiliates.

The final bill has several differences from the version that was introduced in January, including phasing out the

capital tax, extending investment tax credit eligibility to manufacturers and broadening the credit to encompass financial investments.

Importantly, New York City has yet to conform to these changes. Differences between city and state tax treatment

will undoubtedly create an administrative burden for taxpayers that have to determine their overall state and city liability under two very different tax regimes.

## ***Let's talk***

For a deeper discussion of how this issue might affect your business, please contact:

### ***State and Local Tax Services***

Peter Michalowski  
Principal, *New York*  
+1 (646) 471-5259  
[peter.michalowski@us.pwc.com](mailto:peter.michalowski@us.pwc.com)

Jack Kramer  
Principal, *New York*  
+1 (646) 471-2640  
[jack.kramer@us.pwc.com](mailto:jack.kramer@us.pwc.com)

Brian Rebhun  
Principal, *New York*  
+1 (646) 471-4024  
[brian.rebhun@us.pwc.com](mailto:brian.rebhun@us.pwc.com)

Virginia Gates  
Partner, *New York*  
+1 (646) 471-9144  
[virginia.gates@us.pwc.com](mailto:virginia.gates@us.pwc.com)

Tov Haueisen  
Principal, *New York*  
+1 (646) 471-0848  
[tov.haueisen@us.pwc.com](mailto:tov.haueisen@us.pwc.com)

Caleb Gauen  
Principal, *New York*  
+1 (646) 471-7684  
[caleb.gauen@us.pwc.com](mailto:caleb.gauen@us.pwc.com)

Sean Kanousis  
Principal, *New York*  
+1 (646) 471-4858  
[sean.richman.kanousis@us.pwc.com](mailto:sean.richman.kanousis@us.pwc.com)

Greg Lee  
Managing Director, *New York*  
+1 (646) 471-2654  
[gregory.a.lee@us.pwc.com](mailto:gregory.a.lee@us.pwc.com)

John Verde  
Managing Director, *New York*  
+1 (646) 471-1804  
[john.a.verde@us.pwc.com](mailto:john.a.verde@us.pwc.com)

Carolyn Makuen  
Managing Director, *New York*  
+1 (646) 471 7942  
[carolyn.makuen@us.pwc.com](mailto:carolyn.makuen@us.pwc.com)