Inside New York tax reform: Understanding the new unitary combination provisions

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In brief

On March 31, 2014, New York Governor Andrew Cuomo signed into law S.B. 6359-D, A 8559-D, (Chapter 59), enacting significant changes to New York State's corporate tax regime, most of which take effect for the 2015 tax year. One of the more notable changes is the state's adoption of mandatory unitary combined reporting, which replaces required combination based on the existence of substantial intercorporate transactions. The substantial intercorporate transaction provisions were effective starting in 2007 and replaced the state's previous rules that required or permitted combination by commonly owned corporations only when the corporations engaged in a unitary business and combined filing was necessary to prevent distortion. This Insight highlights changes made to the state's combined reporting system.

The tax reform legislation also provides other important changes, which include: merging the bank franchise tax with the corporate franchise tax, establishing economic nexus, updating the single receipts factor apportionment formula to permit customer sourcing provisions for all taxpayers, and instituting tax benefits for manufacturers. (Click here for more on New York tax reform).

In detail

Pre-reform combination requirements

The pre-2007 rules

Historically, New York State law and regulations granted the Department of Taxation and Finance authority to require or permit combined filing by commonly owned (i.e., 80% or more) corporations only when the corporations engaged in a unitary business and combined filing was necessary to prevent distortion. Regulations set forth a rebuttable presumption of distortion when there were 'substantial intercorporate transactions' between or among group members. Distortion could be rebutted by a showing that intercorporate transactions occurred at arm's length and that separate reporting resulted in proper reflection of income. The regulatory presumption of distortion led to frequent litigation as to whether the Department properly exercised its discretionary authority regarding combined filing.

Combination effective in 2007

Statutory amendments effective in 2007 require that taxpayers satisfying a control test must file a combined franchise tax report where there are substantial intercorporate transactions, regardless of the transfer price for such transactions. The 2007 change significantly reduces the Department's discretion once the control and substantial intercompany transaction criteria are met. However, the Department may require or permit combination when necessary to properly reflect a taxpayer's liability because of intercompany transactions or some other agreement, understanding, arrangement, or transaction.

These changes took effect for tax years beginning on or after January 1, 2007. New York City conformed to these changes in 2009.

According to a New York Division of Budget Memorandum of Support, by eliminating transfer pricing as a component of a combined report determination, the law change eliminated the need for corporations or the Department "to hire expensive experts to endlessly litigate the arm's length pricing issue."

In addition, the law required controlled real estate investment trusts (REITs) and regulated investment companies (RICs) to file on a combined basis with their parent. These provisions were amended one year later to provide that a controlled REIT or RIC must file a combined report with the corporation that directly owns or controls more than 50% of its voting stock if that corporation is subject to the franchise tax under Article 9-A or is required to be included in a combined corporation franchise tax report**.**

In March 2008, the state issued TSB-M-08(2)C, Combined Reporting for General Business Corporations and Insurance Companies, detailing the changes to combined reporting. In 2012, regulations were issued (view summary). Since these changes were enacted, the Department, on audit, frequently decombined entities that failed to meet the substantial intercorporate transaction standard.

Tax reform - mandatory unitary combined reporting

General requirements

Applicable to tax years beginning on or after January 1, 2015, New York replaces its existing substantial intercorporate transactions combined reporting regime with unitary combined reporting. Under the tax reform 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 <u>*and*</u>
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) is 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.

The combined reporting requirements do not apply to: corporations subject to the franchise tax under Article 9 or Article 33 (the insurance franchise tax), non-captive REITs or RICs, New York S corporations, and alien corporations that under the IRC are not treated as domestic corporations under IRC § 7701 and have no effectively connected income.

The new combined reporting requirements do not prohibit trucking and aviation companies from inclusion in a combined group. Prior to the new law, corporations with different allocation methodologies (e.g., aviation, railroad, and trucking companies) could not file as members of the same combined group.

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 requires every combined group to have a designated agent that must be a New York taxpayer in its own right. If the parent corporation is a New York corporation, the parent will be the agent; if there is no parent corporation or the parent is not a New York taxpayer, another group member may be appointed as the designated agent.

Combined tax base

The combined business income base is the group's combined business income apportioned to the state, reduced by any net operating loss deduction for the combined group. The legislation requires elimination of all intercompany dividends. The combined capital base is determined in a similar manner to business income (absent the NOL reduction). In addition, all other intercompany transactions must be deferred in a manner similar to US Treasury Regulations relating to intercompany transactions under IRC § 1502. The legislation also provides for the elimination of all intercorporate stockholdings, intercorporate bills, intercorporate notes and accounts, receivable and payable, and other intercorporate indebtedness when computing combined capital.

The legislation allows an NOL deduction in computing the combined business income base. The deduction may reduce the tax on the combined business income base to the higher of the tax on the combined capital base or the fixed dollar minimum amount that is attributable to the designated agent of the combined group. A combined NOL deduction is equal to the amount of combined NOL or losses from one or more taxable year that are carried forward to a particular income year. A combined NOL is the combined business loss incurred in a particular taxable year multiplied by the combined apportionment factor for that year.

When a corporation files a combined report either in the year the NOL is incurred or in the year in which a deduction is claimed on account of the loss, the combined NOL deduction is determined as if the group is a single corporation and is subject to the same limitations that would apply federally as if the corporation filed a consolidated federal income tax return for the year with the same corporations included in the combined report. The legislation also provides that if a corporation files a combined report, regardless of what return is filed federally, the NOL and NOL deduction for the combined group must be computed as if the corporation had filed a federal consolidated return for the same corporations.

NOL carryovers from a year that a combined report was filed must be based on the combined NOL of the filing group. The portion attributable to a group member that files a separate return for a later year will be based on that member's portion of the combined NOL.

The legislation provides that the NOL conversion subtraction (designed to account for pre-tax reform NOLs, click here for additional information) is allowed in computing the combined business income base. The subtraction may reduce the tax on the combined business income base to the higher of the tax on the combined capital base or the fixed dollar minimum amount that is attributable to the designated agent of the group.

The election to reduce total investment income, CFC income, or exempt unitary corporate dividends by 40%, in lieu of claiming interest deductions, would apply to all members of the group.

Combined captive REITs or captive RICs must compute entire net income in the manner provided for REITs and RICs under Tax Law §§ 209(5) and (7), respectively. Consistent with pre-reform law, the legislation disallows any deduction for dividends paid by the captive REIT or RIC to any member of the affiliated group.

Apportionment

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…" Intercorporate receipts, income, and gains are eliminated.

An election made to use a fixed percentage method to apportion qualified financial instruments, defined as financial instruments marked to market under IRC §§ 475 or 1256 (excluding loans secured by real property), applies to all members of the combined group.

Credits

Credits are not determined on a combined group basis but separately for each member of the group. However, credits will be applied against the combined tax of the group.

Additional reading

- New York tax reform enacted (April 2, 2014)
- Inside New York tax reform: Understanding the impact on asset management companies (April 10, 2014)
- Inside New York tax reform: Understanding the impact on state tax credits (April 14, 2014)
- Inside New York tax reform: Understanding the impact on manufacturers (May 7, 2014)

The takeaway

This change marks the third combined reporting system in New York over a 10-year period. Both the pre-2007 distortion regime and the substantial intercorporate transaction requirements generated significant audit activity, assessments, appeals, and litigation. If activity in other unitary combined reporting states is any indication, audits, assessments, appeals and litigation will continue to be a feature of New York combination.

The tax reform legislation did not provide a definition of a unitary group or unitary business and the Department has yet to issue guidance. It can be expected that many questions will arise regarding whether an affiliated group of companies is a unitary business. For guidance, taxpayers and the Department may look to cases and guidance under the pre-2007 law to determine whether unity exists. Under that older law, combination was required or permitted only where the corporations engaged in a unitary business and combined filing was necessary to prevent distortion.

Taxpayers should note that New York City has yet to conform to these changes, meaning that for many, there will be two separate reporting systems in New York.

Let's talk

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