New York budget proposes corporate tax overhaul

January 22, 2014

In brief

On January 21, 2014, New York Governor Andrew Cuomo released his FY14-15 executive budget. The proposed legislation would overhaul the state's corporate tax regime as well as make other significant tax changes. Some of the more important changes include the merging of the bank franchise tax with the corporate franchise tax, establishing economic nexus, replacing the state's existing combined reporting provisions with a unitary combined reporting system along with an effectively connected income approach, adopting a single receipts factor apportionment formula with customer sourcing provisions, and providing tax breaks to manufacturers. Based on a series of proposals suggested by several commissions over the years, the release of the budget is a signal that tax reform in New York is likely imminent.

Although the impact on financial institutions might seem to be the most pronounced, all existing New York taxpayers and businesses that sell into the state should monitor the proposals as they are considered by the legislature and understand the potential benefits and detriments these changes pose.

The summary below highlights only some of significant corporate tax proposed changes. [2014 New York State Executive Budget, Revenue Article VII Legislation, issued 1/21/14]

In detail

Bank tax elimination and corporate tax reform (Part A)

The legislation would repeal the bank franchise tax (Article 32) and subject 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 would include corporations that derive receipts, based on a $1 million threshold, from activity in New York. The Article 32 nexus thresholds for credit card companies based on customers in the state would be transferred over to Article 9-A. The legislation would repeal the nexus rule for fulfillment services. The deriving receipts standard would also apply to taxability under the metropolitan business tax surcharge.

Apportionment

The state's apportionment rules would be revised so that business income and capital would be apportioned using a single receipts factor. A complex series of customer based sourcing rules would be 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 Secs. 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).

Combined reporting

The state would replace its existing 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 would 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 would be defined as an entity that is treated as 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 taxable corporation; (2) licensed as a captive insurance company under the laws of New York or another jurisdiction; and (3) whose business includes providing, directly and indirectly, insurance or reinsurance covering the risks of its parent and/or members of its affiliated group.
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 would be allowed to 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 revoked.

Other changes

The legislation would:

- replace the entire net income base with a business income (meaning entire net income minus investment income) base
- reduce the tax rate from the existing 7.1% to 6.5% effective for tax years beginning on or after January 1, 2016
- reform the Investment Tax Credit (ITC) by instituting a manufacturing enterprise qualification
- repeal provisions related to subsidiary capital
- adopt 'effectively connected' income as the starting point for the corporate tax base calculation for non-US corporations (subject to adjustments)
- exempt investment and disallow deductions for interest expenses attributable to investment income
- eliminate the treaty exception to royalty addback provisions
- increase the rate of the MTA surcharge to 24.5%
- disallow NOL carrybacks
- revise the state's net operating loss provisions. NOLs incurred during any pre-tax reform year would be disallowed. However, unabsorbed NOLs will be converted into a tax credit. This credit, called the NOL conversion credit, would be the product of: (1) any unabsorbed portion of the NOL that was not deductible in previous taxable years and was eligible for carryover on the last day of the base year (the last taxable year beginning on or after January 1, 2013, and before January 1, 2014), including any NOL sustained by the taxpayer during the base year; (2) the taxpayer's business allocation percentage for the base year; and (3) the taxpayer's tax rate for the base year. For other than small

businesses, the annual NOL conversion credit would be equal to 10% of the amount calculated above.

For foreign corporations, the legislation would disallow 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 Sec. 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 Sec. 103.

The legislation would allow 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 its entire net income exceeds the amounts deducted by the taxpayer under IRC Secs. 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 40% of gross interest income from qualifying loans divided by gross interest income from all loans.

Except where noted, these changes would apply to tax years beginning or after January 1, 2015.

Manufacturers (Part R)

The legislation would create a refundable tax credit for qualified New York manufacturers equal to 20% of the real property tax paid on property used for manufacturing during the taxable year. A qualified New York manufacturer is a manufacturer having property in New York that is used for manufacturing and either (1) the fair market value of that property is at least $10 million at the close of the taxable year or (2) all of the manufacturer's real and personal property is located in New York.

For qualified upstate New York manufacturers (manufacturers with a zero apportionment percentage in the metropolitan commuter transportation district), the tax on entire net income would be eliminated.

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

The takeaway

Corporate tax reform in New York is finally here. As stated above, there are many changes including the group composition, sourcing method, and nexus standards. This proposal should prompt all companies to consider their New York tax filing posture now, examine the proposals for benefits and detriments, and follow developments in Albany as they occur. Amendments to the proposal will undoubtedly be considered.

As he stated yesterday, Governor Cuomo is aiming for another on-time budget, so developments could occur quickly. One unanswered question at this point is what will New York City do – will it conform to all, some, or none of these changes? It should be noted that New York City Mayor Bill de Blasio's proposal to increase personal income taxes on residents earning over $500,000 is not part of the proposal. Since changes to the city income tax have to be approved by the full state legislature, any such proposal will either have to be added once the budget measure is formally introduced as a bill or as a separate bill.

Let's talk

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

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