

NEW YORK CORPORATE TAX REFORM

Jeffrey S. Reed
Chair, State and Local Tax Department
Kilpatrick Townsend LLP
(212) 775-8792
jsreed@kilpatricktownsend.com

I. Overview

A. Goals

1. “Modernization.” In the words of the New York State Department of Taxation and Finance, the corporate tax reform implements “new rules” that “recognize the shift to a service and knowledge-based economy by adopting a comprehensive market state tax sourcing approach.”
2. “Treat Everyone Alike.” Corporate tax reform eliminates the Article 9-A and Article 32 distinction, so corporations and banking corporations are taxed under the same system, thereby eliminating some of the disconnects and game-playing resulting from having different income tax systems for corporations and banks.
3. “Make New York Competitive.” By making New York’s corporate tax system more in line with the systems in other states, New York has adopted rules that will be familiar to multi-state businesses already paying tax under a similar system in other states. An additional perceived advantage is that the combination of economic nexus and market-based sourcing is thought to export some of the tax burden to non-NY corporations, while at the same time incentivizing corporations to expand in New York or move operations to New York.
4. “Lower the Rates.” To help make the corporate tax reform more politically palatable, and reduce concerns that the complicated corporate tax reform changes will yield a tax increase, the corporate tax rates were lowered as part of the reform (particularly for small businesses and manufacturers). This way, it is harder for anyone to paint the corporate tax reform as a “tax increase.”

B. Timing for the Reform

1. Background. A skeletal outline of the corporate tax reform was circulated to tax practitioners years before the legislation was drafted.
2. Important Dates. New York corporate tax reform legislation was signed into law on March 31, 2014, and became effective, with only limited exceptions, on January 1, 2015.

II. Nexus

A. Economic Nexus (NY Tax Law § 209.1).

1. Basic threshold. A corporation is subject to tax if it derives more than \$1,000,000 in receipts from New York activity annually.
2. Aggregation rule. The receipts from all related, unitary corporations with over \$10,000 in receipts from New York activity must be added. If the sum is over \$1,000,000, then the group is subject to New York tax, even if no group member individually derives over \$1,000,000 from New York activity annually.
3. Corporate partners in partnerships/LLCs. If a partnership/LLC has over \$1,000,000 in receipts sourced to New York, then the Department's position is that any corporate partner in the partnership (or member in the LLC) also has nexus with New York (even if the corporate partner/member itself does not derive more than \$1,000,000 in receipts from New York sources). Draft regulations suggest that this rule will be limited to corporate general partners and will not apply to corporate limited partners.

B. Other Nexus Changes

1. Fulfillment services exception repeal. The fulfillment services exception existing under prior law was repealed under the reform. Under that exception, a corporation was not deemed to have nexus with New York if the corporation's only connection to New York was that it was using the services of a New York fulfillment service to store inventory and fulfill orders.
2. Alien (i.e., non-US) corporations. Alien corporations are not subject to tax if they have no effectively connected income. This rule is consistent with prior Article 32 law, but not prior Article 9-A law.

III. Combination Rules (Combined or Consolidated Filing)

A. Overview of Rules (NY Tax Law § 210-C)

1. Basic rule. Combination is required if corporations are: (1) more than 50% commonly owned based on voting power ("Ownership Test"); and (2) engaged in a unitary business ("Unitary Business Test").
2. Election. Corporations that meet the Ownership Test can elect to file combined for a seven-year period, regardless of whether they meet the Unitary Business Test.
3. Includable entities. The following entities may be included in a combined New York corporate income tax return: US corporations, alien corporations treated as domestic corporations under the IRC, alien corporations with ECI, captive REITs and RICS and captive insurance companies.

4. Excludable entities. The following entities may NOT be included in a combined New York corporate income tax return: certain utilities taxed under Article 9, insurance companies taxed under Article 33, non-captive REITs and RICs, S corporations.

B. Mechanics

1. Designation of agent. While the members of the combined group are treated as “one taxpayer,” and each group members is liable for the group’s whole tax, an agent must be assigned for administrative purposes to handle filings, assessments, payments, and waivers for the group.

2. Intercorporate transactions. Generally, intercorporate transactions are eliminated in the combined group and the federal intercorporate deferral rules apply.

3. Sharing of tax attributes. Generally, credits, prior PNOLs (NOLs), and capital losses can be used by the group, and are not limited to the corporation that generated the item.

C. The Unitary Business Test

1. Draft regulations. The draft regulations set forth criteria to apply in determining whether businesses are unitary.

2. Attributes of a Unitary Business. The draft regulations adopt the *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980) test for determining whether there is a unitary business: (1) functional integration; (2) centralized management; and (3) economies of scale.

3. Presumptions. The draft regulations contain several unitary presumptions, including that: (a) newly-formed corporations are presumably unitary with forming corporations; and (b) newly-acquired corporations are presumably unitary with the acquiring entity if there exists horizontal integration, vertical integration, or strong centralized management between the corporations. These presumptions are rebuttable.

IV. The Tax Base (Computing Business Income)

A. Overview.

1. Start with Federal Taxable Income (“FTI”) for domestic corporations and Effectively Connected Income (“ECI”) for non-US corporations.

2. Apply New York modifications (additions/subtractions from FTI/ECI) to arrive at entire net income (“ENI”).

3. Entire net income – investment income and other exempt income = “business income.” Taxpayers are taxed on their “business income.”

B. Investment Income (NY Tax Law §§ 208.5, 208.6)

1. Long-term stock holdings. The term “investment income” included “long-term stock holdings.” This category is defined to include any income from stocks of non-unitary corporations that are held for more than 6 months. A corporation is presumed to be non-unitary for this purpose if the taxpayer owns or controls less than 20% of its voting power. The 6 month holding period is measured across tax years.

2. Income that cannot constitutionally be included in the tax base. The other major category of investment income is “income that cannot constitutionally be included in the tax base.” This is a catch-all category. It is designed to include, for example, income from the sale of a non-unitary business.

C. Other Exempt Income (NY Tax Law § 208.6-a)

1. Exempt CFC income. Exempt income is not included in the tax base. Exempt income includes “exempt CFC income,” which is income received from a controlled foreign corporation that is not included in the combined group, such as Subpart F income and IRC § 956 dividends.

2. Exempt unitary dividends. Another category of exempt income is “exempt unitary dividends.” This category consists of: (1) dividends from a unitary corporation not included in the combined group, because for example the corporation is an insurance company or a utility taxed under another article; (2) dividends from an alien corporation with no ECI; and (3) dividends from a unitary corporation that does not meet the Ownership Test (and hence cannot be combined).

D. Expense Attribution (NY Tax Law §§ 208.6, 208.6-a, and 208.8)

1. Overview of concept. Since investment income and other exempt income are not subject to tax, taxpayers may not claim interest expense deductions for expenses related to that non-taxable income.

2. Example. If a taxpayer borrows money to purchase a minority stock interest in a corporation (the Ownership Test is not met), the taxpayer may not deduct interest expenses related to that borrowing.

3. Election. Rather than computing actual interest expenses related to investment income and other exempt income, a taxpayer can choose to reduce investment and other exempt income by 40%.

V. **PNOLs** (NY Tax Law § 210.1(a)(viii))

A. Overview

1. Policy. Rather than allow taxpayers to carry forward net operating losses generated during periods prior to the effective date of the corporate tax reform (i.e., pre-2015 NOLs), a policy decision was made to allow taxpayers to convert prior NOLs to PNOLs that could then be carried forward and used for 2015 and future periods.
2. Change in Treatment of NOLs. Under prior law, NOLs were computed on a pre-apportionment basis (i.e., before taking into account apportionment). Under the corporate tax reform, NOLs are computed on a post-apportionment basis.

B. Computation

1. Unabsorbed NOLs. Determine unabsorbed NOLs as of the end of 2014.
2. 2014 apportionment percentage. Determine 2014 BAP.
3. Error! Hyperlink reference not valid. Multiply: (1) unabsorbed NOLs as of the end of 2014; (2) 2014 BAP; and (3) 2014 tax rate. Take that product and then divide by 6.5% (5.7% for manufacturers). The result of these computations is the PNOL subtraction pool.

C. Applying PNOL Subtraction Pool

1. Default option. A taxpayer may use 1/10 of the PNOL subtraction pool in each year for the next twenty years.
2. Election. Alternatively, taxpayers may elect to use $\frac{1}{2}$ of the PNOL subtraction pool in 2015 and 2016 (if this option is taken, any unused NOLs from the PNOL subtraction pool cannot be used after 2016).

D. PNOLs in Groups

1. General rule – compute separately. If taxpayers or groups will file combined in 2015, but file separately in 2014, then each taxpayer and/or group must separately compute its PNOL using 2014 information.
2. Then add. Once the separate PNOLs have been computed for taxpayers and/or groups then add the PNOLs together and that becomes the group's 2015 PNOL.
3. Corporations leaving a group. If a taxpayer leaves a group after 2015, its proportionate amount of the group's PNOL subtraction is eliminated.

E. Applying PNOLs.

1. Post-apportionment. Since the PNOL is applied post-apportionment you first determine apportioned business income and then deduct the PNOL against apportioned business income.

VI. NOL Rules (NY Tax Law § 210.1(a)(ix))

A. Overview

1. Large conceptual change. Rather than base NY NOLs on federal NOLs, as under prior law, corporate tax reform places NY NOLs on a separate track from federal NOLs.
2. No IRC § 172 limitation. It is possible for a taxpayer to have more NY NOL than IRC § 172 NOL.

B. Rules.

1. Carry back. NOLs can be carried back 3 years (but not before 2015).
2. Carry forward. NOLs can be carried forward 20 years.
3. FIFO rule. Where there are two or more apportioned NOLs, carried back or carried forward to be deducted in one year, the earliest apportioned loss incurred must be applied first.

VII. Sourcing Rules

A. Overview (NY Tax Law § 210-A)

1. Adoption of market-based sourcing. The shift to a single factor receipts factor using market-based sourcing (also called “customer-based sourcing”) is a central pillar of the corporate tax reform. On audit, New York auditors had been attempting to apply market-based sourcing in some contexts for years, despite the prior location of performance sourcing rule for services.
2. Categories of Receipts. The statute and proposed regulations provide a variety of rules for different types of receipts. Accordingly, a key question is determining how to classify a type of receipt and which bucket it most logically fits into.
3. Distinction between humans and businesses. For many categories of receipts, the draft regulations distinguish between individual customers (human customers) and business customers. The general rule is that individual customers are deemed to receive the benefit based on billing address, whereas for business customers a taxpayer is supposed to use “books and records kept in the normal course of business” to determine where the customer receives the benefit of the service.

4. Due diligence. The draft regulations set forth a requirement that taxpayers “must annually exercise due diligence in attempting to apply the primary rule of where the benefit is received.” If after applying due diligence it cannot be determined where the benefit is received the default rule for business customers is to source receipts to “where the contract of sale is managed” or, that failing, to use billing address. As a practical matter, it may be difficult for a service provider with thousands of customers to exercise due diligence with respect to each customer.

B. Specific Categories

1. Qualified Financial Instruments (“QFI”). QFIs are instruments that are marked to market under IRC § 475 or IRC § 1256. This category includes commodities and securities, but not loans secured by real property. Taxpayers can elect to source 8% of the income from QFIs to New York. Alternatively, taxpayers can apply customer-based sourcing for each income stream that does not constitute tax exempt income. The 8% election must be made annually and must be made on a group-wide basis.

2. Non-QFIs. All financial instruments that do not meet the QFI definition are subject to other, specific sourcing rules. Many of those sourcing rules source to the “location of the [customer]” using this framework:

a) Human/Individual. A human is deemed to be in the state in which he/she has a billing address.

b) Business entities. A business entity is deemed to be in the state in which it is commercially domiciled. Commercial domicile is determined using this hierarchy: (1) location of the treasury function; (2) seat of management and control; (3) billing address.

c) 8%. In the case of many non-QFI financial instruments, 8% of the net income is sourced to New York.

3. Credit card receipts. Receipts from interest, fees, penalties, and services charges are sourced based on the mailing address of the card holder. Merchant discount is sourced to the location of the merchant (if the merchant has multiple addresses, only receipts from sales attributable to New York are sourced to New York). Receipts from credit card authorization processing, and clearing, and settlement processing is sourced to the location where the credit card processor’s customer accesses the credit card processor’s network.

4. Receipts from advertising. For newspapers and periodicals, apply a fraction with the numerator consistent of number of newspapers and periodicals delivered in New York and the denominator being the total number of newspapers and periodicals delivered. For sales of advertising on television or radio, apply an audience approach (in-state viewers or listeners / total viewers or listeners).

5. Digital products. Four-step hierarchy: (1) primary use location of the digital product; (2) location where received by customer; (3) apportionment fraction for the digital product determined from the prior taxable year; (4) apportionment fraction in the current taxable year for digital products that can be sourced using the hierarchy of sourcing methods in (1) and (2).

6. Receipts from other services and other business receipts. Catch-all category for receipts that cannot be fit into another category. Hierarchy of methods: (1) the benefit is received in the state; (2) delivery destination; (3) apportionment fraction for such receipts in the prior year; (4) apportionment fraction for such receipts in the current year, to the extent determinable under (1) and (2).

VIII. Qualified New York Manufacturer Incentive (NY Tax Law § 201.1(a)(vi))

A. Overview

1. Rate. “Qualified New York Manufacturers” are subject to a 0% rate for purposes of the business income base (they are also, at least until 2021, when the rate becomes zero, subject to a low rate on the capital base).

2. Requirements. To qualify as a “New York Manufacturer” a company must meet several tests, as noted below.

3. “Manufacturing.” A manufacturer is a taxpayer that is “principally engaged in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture...”

4. “Manufacturing is NOT.” Generation of electricity, distribution of electricity or natural gas, and the production of steam associated with the generation of electricity explicitly do not constitute manufacturing.

B. Tests

1. Property test. The company must have all its manufacturing property, or at least \$1,000,000 of its manufacturing property, in New York.

2. Receipts test. At least 50% of its receipts must be from manufacturing.

3. Meeting the tests. Ordinarily, a taxpayer must meet both tests to qualify as a “Qualified New York Manufacturer.” However, a taxpayer (or combined group) that fails the receipts tests may still qualify if it has at least 2,500 New York manufacturing employees and at least \$100,000,000 of manufacturing property in New York.

IX. New York City Corporate Tax Reform (NYC Administrative Code § 11-651 et seq.)

A. Overview

1. Generally. The NYC corporate tax code contains a new section that incorporates most of the New York State corporate tax reforms. A few of the key differences are highlighted below.
2. S corporations. The NYC corporate tax reform changes do not apply to S corporations.
3. Unincorporated business tax (“UBT”). The New York City corporate tax reforms do not impact the UBT. The UBT regime remains unchanged.

X. Impact on Pass-Through Entities

A. Overview

1. General. Limiting the corporate tax reform to entities organized in corporate form results in disparate treatment between entities. There can be different tax treatment depending on what form a business chooses. Accordingly, careful consideration to the impact of these disconnects should be given when organizing a new entity that will operate in New York.
2. C corporations. At the state and city level, C corporations are subject to the corporate tax reforms discussed above.
3. S corporations. At the state level, S corporations compute tax as if C corporations and accordingly many of the corporate tax reforms apply to S corporations; however, at the state level, S corporations pay a fixed dollar minimum based on New York receipts. At the city level, as discussed above, the corporate tax reforms do not apply and S corporations compute their tax under the prior (i.e., pre-corporate tax reform) system.
4. Partnerships. At the state level, partnerships are taxed under Article 22 (the article that applies to individuals) and accordingly the corporate tax reforms do not apply. At the city level, as discussed above, the UBT is not impacted by the corporate tax reform (so the same UBT rules remain in place).