New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200 • http://www.nysba.org

NYSBA

Tax Section

Comments Regarding Corporate Income Tax Reform

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S. 6359-B, Part A		By:	BUDGET
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		Senate Committee:	Finance
		Assembly Committee:	Ways and Means

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NEW YORK STATE BAR ASSOCIATION
TAX SECTION
REPORT ON THE CORPORATE INCOME TAX REFORM PROVISIONS OF THE NEW YORK STATE 2014-2015 EXECUTIVE BUDGET[1]

Introduction

This report on the corporate income tax reform proposals in the New York State 2014-2015 Executive Budget (the "Budget Bill") was prepared by the Tax Section of the New York State Bar Association. It focuses on certain technical, administrative and conceptual issues raised by the Budget Bill and identifies aspects we think should be clarified or reconsidered prior to adoption by the Legislature.

Executive Summary

Governor Cuomo, the New York State Department of Taxation and Finance ("the Department"), and the state and local tax community have been actively working to create a comprehensive corporate tax reform proposal that would better serve the realities of businesses in New York, the State's administrative and financial needs, and the overall climate of tax jurisprudence. The Budget Bill, as it relates to corporate tax reform, is largely a result of such discussions.

This report covers the following areas: nexus; tax bases and rates; classification of income and expenses, apportionment, combined reporting, tax attributes, the Metropolitan Transportation Business Tax Surcharge, and miscellaneous provisions of the Budget Bill. The Tax Section's comments regarding each of these areas are summarized as follows:

Nexus. The Tax Section acknowledges and reaffirms its prior support for the adoption of a national economic nexus standard for business activity taxes. However, we note that the proposed economic nexus standard will likely be subject to constitutional challenges.

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[1] The principal drafters of this report were: Jack Trachtenberg, Paul R. Comeau, Christopher Doyle, Maria Eberle, Joshua E. Gewolb, Jennifer Goldstein, Lindsay LaCava, Dennis Rimkunas, Elizabeth Pascal, Arthur R. Rosen, Lance E. Rothenberg, Irwin M. Slomka, and Gordon Yu. Helpful comments were received from Kimberly Blanchard, Michael Schler and David Schnabel. This report reflects solely the views of the Tax Section and not those of the NYSBA Executive Committee or the House of Delegates.

Tax Bases and Rates. We note the proposed merger of the Article 32 bank tax into Article 9-A of the Tax Law and assume that the goal of the proposed merger generally is to provide for a more predictable and simplified tax structure. In addition, we suggest some technical corrections and raise some concerns regarding the constitutionality of the preferential tax rate for "qualified New York manufacturers."

Classification of Income and Expenses. As a general proposition, we commend the Budget Bill's success at simplifying the income base tax scheme. We note, however, that clarification is needed in certain areas, particularly with respect to the definition of "stock" for purposes of calculating investment capital. The Tax Section also notes our understanding of how the 40% election (in lieu of attributing expense) should be applied in determining business income, investment income, and other exempt income, and note that clarification would be beneficial if our interpretation is incorrect.

Apportionment. The Tax Section applauds the inclusion of updated and well-defined apportionment rules as applied to distinct types of receipts. We note, however, the need for regulations or other clarification as to the definition of certain types of receipts and the application of certain apportionment principles. With respect to the Budget Bill's provision for alternative apportionment, we recommend clarifying the proposal to make it clear that the burden of proof should rest with the party seeking to apply an apportionment method that differs from those set forth in the Budget Bill.

Apportionment (Digital Goods). The Tax Section recommends that consideration be given to conforming the concepts and terminology in the proposed hierarchy for sourcing receipts from sales of digital products to the hierarchies adopted by other states in both the apportionment context and the sales and use tax context. We also suggest a number of clarifications to alleviate confusion or a misapplication of the sourcing rules.

Combined Reporting. The Tax Section notes that the proposed elimination of the substantial intercorporate transaction and distortion requirements is likely to significnatly reduce existing controversies surrounding composition of the combined group, We also raise a variety of other concerns in the combined reporting context regarding apportionment issues, computation issues, and who can be included in the combined return.

Tax Attributes. The Tax Section raises concerns that there is ambiguity regarding the calculation of the "net operating loss subtraction" pool amount. Further, we question the need for imposing a new limitation on the ability of taxpayers to claim tax credits on an amended report (and raise other issues in this context worthy of clarification). We also recommend that the Budget Bill include provisions to safeguard taxpayers that detrimentally relied on the availability of the investment tax credit prior to the release of the Budget Bill on January 21, 2014.

Metropolitan Transportation Business Tax Surcharge. The Tax Section supports conforming the rules associated with the metropolitan transportation business tax surcharge to those under Article 9-A.

Other Provisions. The Tax Section supports the repeal of various miscellaneous taxes in order to simplify and ease administrative and compliance burdens.

Discussion

I. Corporations Subject to Tax - Nexus

The Budget Bill proposes to increase the universe of corporations subject to the Article 9-A franchise tax in a number of different ways. It would shift banking corporations from taxation under New York Tax Law (the "Tax Law"), Chapter 60, Article 32 ("Article 32") to taxation under Tax Law, Chapter 60, Article 9-A ("Article 9-A"). It would mandate waters' edge unitary combined reports. It would adopt a "bright line" economic nexus threshold for corporations not otherwise doing business in New York. Lastly, the Budget Bill proposes to eliminate the Article 9-A nexus exception for out-of-state businesses that purchase fulfillment services from non-affiliated in-state fulfillment services providers. This portion of the Report focuses only on the last two areas for expansion.

A. Current Law

New York's Article 9-A franchise tax is currently imposed on all domestic and foreign corporations for the privilege of exercising their corporate franchise in New York; doing business in New York; employing capital in New York; owning or leasing property in New York in a corporate or organized capacity; and maintaining an office in New York.[2]

Under the Commerce Clause of the U.S. Constitution, as interpreted by the U.S. Supreme Court, a foreign corporation must have "substantial nexus" with the State before a foreign corporation may be

[2] Tax Law § 209.1.

subject to taxation.[3] Consistent with the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), "substantial nexus" has historically been interpreted in New York as requiring an in-state physical presence.[4] Unlike some other jurisdictions that have changed their nexus standards over the past several years, New York has historically viewed the physical presence standard as applying to gross receipts and corporate income-type taxes.[5] Indeed, in the past when New York imposed an economic nexus standard upon out-of-State credit card issuers, it was done through an act of the Legislature.[6]

Further, under the current physical presence standard, the Tax Regulations make it clear that the scope of nexus-creating activities does not go beyond that permitted under Pub. L. 86-272. The Tax Regulations provide a list of activities viewed as ancillary to protected solicitation that will also not trigger nexus.

Specifically with respect to fulfillment services, Tax Law §209.2(f) provides that a foreign corporation shall not be deemed to be engaged in nexus-generating activities by reason of "the use of fulfillment services of a person other than an affiliated person and the ownership of property stored on the premises of such person in conjunction with such services." In other words, a foreign corporation that engages a non-affiliated New York entity to provide fulfillment services on its behalf will not, as a result, have nexus with New York for corporate income tax purposes. For purposes of that section, persons are affiliated persons with respect to each other where one of such persons has an ownership interest of more than five percent, whether direct or indirect, in the other, or where an ownership interest of more than five percent, whether direct or indirect, is held in each of such persons by another person or by a group of other persons which are affiliated persons with respect to each other.

The term "fulfilment services" is defined in Tax Law § 208.19. It provides that "fulfillment services" shall mean any of the following services performed by an entity on its premises on behalf of a purchaser: (a) the acceptance of orders electronically or by mail, telephone, telefax or internet; (b)

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[3] *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977).

[4] *See, e.g., Orvis Co. v. Tax App. Trib.*, 86 N..Y.2d 165 (1995).

[5] *See, e.g., Matter of Wascana Enery Marketing, Inc.*, Admin. Law Judge (Aug. 8, 2002); *Matter of Hamilton Manufacturing Corp.*, TSB-A-04(15)C.

[6] *See* Tax Law § 1451.

responses to consumer correspondence or inquiries electronically or by mail, telephone, telefax or internet; (c) billing and collection activities; or (d) the shipment of orders from an inventory of products offered for sale by the purchaser.

B. Proposed Changes

The Budget Bill would create franchise tax nexus for those corporations that are "deriving receipts from activity in this state." A corporation would be "deriving receipts from activity" in New York if it has receipts within New York of $1,000,000 or more in the taxable year. "Receipts within this state" means the receipts a corporation would include in the New York numerator of its apportionment factor under the apportionment rules proposed in the Budget Bill. A corporation that has less than $1,000,000, but more than $10,000, of New York receipts and is part of a combined reporting group (the standards for combined reporting are also be amended by the proposed Budget Bill) would be "deriving receipts from activity" in New York if the sum of the New York receipts of the members of the *combined reporting group* (only those members that have at least $10,000 in NY receipts) total more than $1,000,000 in the aggregate during the taxable year under the proposed apportionment rules.

Under the current franchise tax on banking corporations, as referenced above, New York applies an economic nexus standard over certain credit card corporations. The Budget Bill would substantially incorporate the credit card corporation economic nexus provisions. In addition to the standard nexus-generating provisions, credit card corporations that have the following activity in New York would be subject to the franchise tax:

- The corporation has issued credit cards to 1,000 or more customers who have a mailing address within New York as of the last day of its taxable year;
- The corporation has merchant customer contracts with 1,000 or more merchant-locations in New York to whom the corporation remitted payments for credit card transactions during the taxable year;
- The sum of the number of New York customers who were issued credit cards and the number of New York merchant contracts whom the corporation remitted payment to for credit card transactions equals 1,000 or more.

Aggregate combined reporting economic nexus thresholds would also apply to credit card banks. These aggregate threshold provisions would create nexus for a corporation that has at least ten customers, or merchant customer locations, or a combination of both, in New York and is a member of a combined reporting group. So long as the aggregate number of customers or merchant locations in New York is 1,000 or more, the corporation will be deemed to be doing business in New York.

In addition, Part A, section 5 of the Budget Bill would repeal subsection (f) of Tax Law § 209.2 (relating to the use of fulfillment services). Accordingly, the use of fulfillment services by a non-New York corporation would now be sufficient to establish nexus with New York for purposes of Article 9-A.

C. Comments

The proposal has a number of issues worthy of comment.

First, it is not clear that having $1 million or more of New York receipts, without any additional in-State connection, satisfies the Commerce Clause's "substantial nexus" requirement, or Due Process Clause, which generally requires that the tax be rationally related to in-State activities. This concern will be heightened as New York is poised to adopt a customer-based sourcing apportionment regime. One can envision many corporations having no physical presence nor conducting any activities in the state but having more than $1 million of receipts sourced here under the customer-based approach. One obvious example would involve an online retailer whose sales are solicited exclusively through Internet and email marketing campaigns. Such companies typically have traditional "nexus" in only one state (or foreign country), and have a business model that allows for delivery of products or certain services into the State via common carrier or electronic means. Under the proposed economic nexus standard, even though this company would neither conduct any activities in New York nor have any physical presence in New York, it would be deemed to be exercising its franchise in New York.

In a report issued in January 2008, the Tax Section supported the adoption of a national economic nexus standard for business activity taxes.[7] That report, which recommended Congressional action to adopt a clear and uniform nexus standard based on a taxpayer's economic presence, recognized that such an

[7] Letter from Patrick C. Gallagher, Chair, Tax Section of the New York State Bar Association, to Max S. Baucus, Chairman, Senate Committee on Finance et. al. (Jan. 25, 2008), *available at* http://old.nysba.org/AM/Template.cfm?Section=Tax_Section_Reports_2008&ContentID=28851&template=/CM/ContentDisplay.cfm.

approach would present certain challenges to administer. Moreover, the report was not without controversy. For example, the Tax Section's recommendation was criticized by at least one prominent academic.[8] Moreover, since the time of our report, the courts and administrative tribunals have been divided on the issue of whether an economic presence nexus standard violates the requirements of the Due Process clause.[9]

While the Tax Section expresses no opinion here as to the policy underlying nexus issues, we believe that the adoption of an economic nexus standard would undoubtedly be subject to constitutional challenges (as such standards have faced in other states), which would likely result in years of litigation. While we know that under the standard established in *Quill,* [10] the Commerce Clause requires physical presence for a state to impose a sales tax collection responsibility on a vendor, the Supreme Court has not ruled as to whether this applies in the franchise tax context. Without the benefit of clear guidance on this issue from the Supreme Court, state courts have differed in their treatment of economic nexus.

In *J.C. Penney National Bank v. Johnson,*[11] the taxpayer, a national banking association with its commercial domicile in Delaware, engaged in credit card lending through the issuance of credit cards to residents of Tennessee. Except for sending solicitations through the mail to Tennessee residents, the bank did not engage in any other activities in the state. The Tennessee Court of Appeals extended the Supreme Court's physical presence requirement to business activity taxes and held that J.C. Penney could not be subject to the Tennessee franchise and excise taxes because it lacked physical presence with the state.

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[8] *See* Marjorie B. Gell, "Broken Silence: Congressional Inaction, Judicial Reaction, and the Need for a Federally Mandated Physical Presence Standard for State Business Activity Taxes," 6 Pitt. Tax Rev. 99 (2009).

[9] *Scioto Ins. Co. v. Oklahoma Tax Com'n*, 279 P.3d 782 (Okla., 2012), rehearing denied Jun 11, 2012; *Griffith v. ConAgra Brands, Inc.*, 728 S.E.2d 74 (W.Va., 2012); *In re Washington Mut., Inc.*, 485 B.R. 510, (Bkrtcy. D. Del. 2012); *but see Geoffrey, Inc. v. South Carolina Tax Com'n*, 437 S.E.2d 13 (S.C., 1993); *Lamtec Corp. v. Department of Revenue*, 246 P.3d 788 (Wash., 2011).

[10] *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).

[11] 19 S.W.3rd 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000).

In a case with similar facts, however, the West Virginia Court of Appeals held in *Tax Commissioner v. MBNA America Bank,*[12] that MBNA, a foreign banking corporation, had substantial nexus in West Virginia for corporate net income and franchise taxes even though it lacked a physical presence. The court concluded that MBNA had substantial nexus with West Virginia because it continuously and systemically engaged in direct-mail and telephone solicitation and promotion in West Virginia related to its credit cards, generating almost $19 million in gross receipts from West Virginia customers over a two-year period.

The courts are similarly divided as to what nexus standard should apply to an out-of-State intangibles holding or investment company—i.e., out-of-state subsidiaries designed to hold intangible assets and handle an in-state parent corporation's investment activities. In *Geoffrey, Inc. v. South Carolina Tax Commission,*[13] Toys R Us, a retailer with a physical presence in South Carolina, created a subsidiary, Geoffrey Inc., and transferred trademarks and trade names to it. Geoffrey then licensed the intangibles back to Toys R Us in exchange for royalty payments. Geoffrey did not have employees or physical property in South Carolina, but the South Carolina Supreme Court held that Geoffrey had nexus as a result of the use of the intangible property within the state.

Conversely, and more recently, in *Scioto Insurance Company v. Oklahoma Tax Commission,*[14] the Oklahoma Supreme Court refused to apply the holding in *Geoffrey.* The court held that Scioto, an out-of-state insurance subsidiary that also licensed trademarks and other intellectual property to its parent, Wendy's International Inc., did not have sufficient nexus under the Due Process clause to enable the state to tax its royalty income. The court based its decision on due process grounds, finding that Oklahoma could not tax an out-of-state corporation with no contact with the state other than receiving payments from an Oklahoma taxpayer.

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[12] *Tax Commissioner of the State of West Virginia v. MBNA America Bank,* 220 W. Va. 163 (2006), *cert. denied,* 551 U.S. 1141 (2007).

[13] 313 S.C. 15 (1993), *cert. denied,* 510 U.S. 992 (1993).

[14] 279 P.3rd 782 (Okl. 2012).

The various state cases give no clear indication as to whether New York's proposed economic nexus standard would withstand constitutional scrutiny under either the Due Process or Commerce clauses, but it will undoubtedly result in considerable litigation.[15]

In addition to the constitutional concerns raised above, there are several specific items worthy of comment.

First, it is not clear why it is necessary to have the $10,000 to $1 million rule for corporations that are part of a "combined reporting group." But assuming the rule is needed to combat avoidance of nexus by breaking a larger corporation into many small affiliates, the term "combined reporting group" should be defined in the law for clarity.

Second, the proposed legislation creates questions about corporations or combined groups that might meet the economic nexus thresholds in one year, but not the next. There are numerous situations in which this could occur: changes in the corporation's customer base; an unusual surge or decline in receipts; or changes to the combined group. This could create administrative and compliance complications that should be addressed in regulations.

II. Tax Bases and Rates

A. Article 32

1. Current Law

Under the current tax regime banks and financial institutions are subject to tax under Article 32 of the Tax Law.[16] Corporations subject to tax under Article 32 are required to calculate tax on three different bases, and pay the highest of the alternative amounts.[17] The three alternative amounts are: (1) net income base tax; (2) taxable asset

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[15] Moreover, the economic nexus threshold should not trump Pub. L. 86-272's sphere of protected activity, and it is assumed that the proposal is not an attempt to do so. However, an explicit statement to this effect should be added to the proposal to promote clarity.

[16] Tax Law §§ 209(4), 1451.

[17] *Id.* at § 1455.

base tax; and (3) alternative entire net income.[18] However, taxpayers may not pay less than $250.[19]

Generally, for tax years beginning on or after January 1, 2007, the tax rate on the entire net income base is 7.1%.[20] The tax rate on the taxable asset base varies based on the taxpayer's net worth ratio.[21] The rate is generally 1/10 of a mill, but for taxpayers whose assets consist of at least 33% mortgages, it may fall to 1/25 of a mill for taxpayers with net worth less than 5% but more than or equal to 4%, and 1/50 of a mill for net worth less than 4%.[22] The tax rate for the alternative entire net income base is 3%.[23]

2. Proposed Changes

Part A of the Budget Bill would repeal Article 32 in its entirety. Therefore, the Article 32 alternative entire net income base, the Article 32 taxable asset base, and the Article 32 fixed dollar minimum tax would be eliminated. Taxpayers historically taxed under Article 32 would be taxed under Article 9-A.

3. Comments

The existing differing approaches to taxation under Articles 9-A and 32 were the result of federal restrictions on the activities and taxation of national banks, most of which were repealed with the passage of the Federal Gramm-Leach-Bliley Act ("GLBA") in 1999. Following the enactment of the GLBA, New York adopted

[18] Tax Law § 1455.

[19] *Id.*

[20] *Id.* at § 1455(a).

[21] *Id.* at § 1455(b)(1).

[22] *Id.* at § 1455(b)(1).

[23] *Id.* at § 1455(b)(2).

transitional provisions to freeze the Article 9-A and Article 32 classifications of various financial service corporations (because the Article 32 classifications were largely based on pre-GLBA federal definitions). The GLBA transitional provisions have been repeatedly extended and are still currently in effect. The result is a perception by some that there is a disparate tax treatment of banks and other financial service companies, despite their performance of similar activity.

The Tax Section presumes that one of the goals of the proposed merger of Article 32 into Article 9-A is to remedy this perceived disparate tax treatment and provide for a more predictable and simplified tax structure, which would serve to ameliorate the administrability and compliance burdens associated with having a distinct tax scheme for banks and financial institutions. We also presume that the proposal is designed to remove any uncertainty that may exist for some taxpayers in determining whether they should be taxed as banks or general business corporations. Additionally, the merger of Article 9-A and Article 32 would remove the significant differences between the two taxing regimes with regard to the scope of their respective income exclusions and the apportionment schemes.

B. Article 9-A

1. Current Law

Generally, corporations subject to tax under Article 9-A are required to calculate tax on four alternative bases and pay the highest of the alternative amounts.[24] The four alternative bases are: (a) entire net income base; (b) capital base; (c) minimum taxable

[24] Tax Law § 210.

income base; and (d) fixed dollar minimum base.[25] S-corporations are subject to tax on the fixed dollar minimum base only. The tax rates on each of the bases are as follows:

- Entire Net Income Base - For tax years beginning on or after January 1, 2007, the tax rate is 7.1%.[26]
- Capital Base - For tax years beginning on or after January 1, 2008, the tax rate is 0.15%.[27] For tax years beginning on or after January 1, 2011, the tax is capped at $1 million for all taxpayers other than qualified New York manufacturers.[28]
- Minimum Taxable Income Base - For tax years beginning on or after January 1, 2007, the tax rate is 1.5%.[29]
- Fixed Dollar Minimum Tax – For tax years beginning on or after January 1, 2008, the tax range for C-corporations is $25 to $5,000 for C-corporations and $25 to $4,500 for S-corporations, based on New York receipts.[30] The highest tier applies to taxpayers with more than $25 billion in New York receipts.

In addition to the tax computed on the four alternative bases, the Tax Law imposes a tax on subsidiary capital, at a rate of 0.09%.[31]

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[25] *Id.*

[26] *Id.* at § 210(1)(a).

[27] Tax Law § 210(1)(b).

[28] *Id.*

[29] *Id.* at § 210(1)(c).

[30] *Id.* at § 210(4)

[31] *Id.* at § 210(1)(e).

Further, the Taw Law gives preferential treatment to "qualified New York manufacturers." A "qualified New York manufacturer" is defined as a corporation for which all of the following are true: (1) the corporation is principally engaged in the production of goods by, among other things, manufacturing, processing assembling or refining; (2) the corporation has property located in New York (of the type described under section 210.12(b)(i)(A) for investment tax credit purposes); and (3) either (i) the fair market value of the corporation's qualifying property at the close of the taxable year is at least $1 million or (ii) all of its real and personal property is located in New York.[32] A "qualified New York manufacturer" also means a taxpayer which is defined as a qualified emerging technology company (QETC) under Public Authorities Law section 3102-e(1)(c), regardless of the requirement that they must limit annual product sales to ten million dollars or less to qualify as a QETC .[33]

For tax years beginning on or after January 1, 2008, the capital base tax for qualified New York manufacturers is capped at $350,000.[34] For tax years beginning on or after January 1, 2012 and before January 1, 2015, the tax rate for the minimum taxable income base for an eligible qualified New York manufacturer is 0.75%.[35] For tax years beginning on or after January 1, 2012 and before January 1, 2015, the fixed dollar minimum tax for qualified New York manufacturers is half that of all other C-corporations.[36]

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[32] Bill Part A § 4; Tax Law § 208.15.

[33] Tax Law § 210(1)(b)(2).

[34] *Id.*

[35] *Id.*

[36] *Id.* at § 210(5)

2. Proposed Changes

Part A of the Budget Bill would repeal the minimum taxable income base. Therefore, corporations with nexus in New York would be required to calculate tax on three different bases, and pay the highest of the alternative amounts. The three alternative amounts would be: (a) business income base tax; (b) capital base tax; and (c) fixed dollar minimum tax (attributed to each member of the combined group).[37] The capital and fixed dollar minimum bases would include a credit for taxes paid to other states on identical bases.[38] In addition, the separate tax on subsidiary capital would be repealed.

As discussed below, the Budget Bill also proposes to reduce the tax liability (in all tax bases) for qualified New York manufacturers and upstate qualified New York manufacturers. A "qualified New York manufacturer" is defined in the same manner as under existing law, with the exception that to qualify, the fair market value of the corporation's property at the close of the taxable year must be *at least ten million dollars* (unless all of its real and personal property is located in New York).[39] In addition, under the proposal, a corporation may also be classified as a qualified New York manufacturer if it (or its combined group) employs during the taxable year at least 2,500 employees in manufacturing in New York and has property in New York used in manufacturing, the adjusted basis of which for federal income tax purposes at the close of the taxable year is at least one hundred million dollars.[40]

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[37] *Id.*

[38] Bill Part A § 17; Tax Law § 210-B.42.

[39] Bill Part A § 4; Tax Law § 208.15.

[40] *Id.*

An "upstate qualified New York manufacturer" would be defined as a qualified New York manufacturer that has no property or payroll for the taxable year attributable to the Metropolitan Commuter Transportation District ("MCTD") for purposes of the metropolitan transportation business tax surcharge.[41]

Small businesses would also be subject to a preferential business income base tax rate for tax years beginning on or after January 1, 2015.

With each of these definitions in mind, the follow charts and descriptions summarize the tax rates under each tax base:

a) *Business Income Base*[42]

Business Income Base Rates				
Type of Business	**TYBOA 1/1/2015**	**TYBOA 1/1/2016**	**TYBOA 1/1/2017**	**TYBOA 1/1/2018**
Qualified New York Manufacturers	5.70%	5.50%	5.50%	4.875%

[41] *Id.*

[42] Bill Part A § 12, Tax Law § 210.1(a).

Upstate New York Manufacturers	0.00%	0.00%	0.00%	0.00%
Small Businesses	6.50%	6.50%	6.50%	6.50%
Remaining Taxpayers	7.10%	6.50%	6.50%	6.50%
TYBOA – Tax year beginning on or after				

b) *Capital Base*[43]

Business Capital Base Rates				
Type of Business	**TYBOA 1/1/2015**	**TYBOA 1/1/2016**	**TYBOA 1/1/2017**	**TYBOA 1/1/2018**
Qualified New York Manufacturers	0.132%	0.127%	0.127%	0.1125%
Cooperative Housing Corporation	0.04%	0.04%	0.04%	0.04%
Remaining Taxpayers	0.15%	0.15%	0.15%	0.15%

The tax on the capital base would continue to be capped at $350,000 for qualified New York manufacturers. The tax would be capped at $5 million for all other taxpayers – an increase for existing Article 9-A taxpayers and a decrease for existing Article 32 taxpayers currently subject to the alternative gross asset tax which has no cap on

[43] Bill Part A § 12; Tax Law § 210.1(b).

liability.[44] Further, small business taxpayers would continue to be exempt from the capital base tax for the first two tax years.[45]

c) Fixed Dollar Minimum

The fixed dollar minimum tax for C-corporations with $25 million or less of New York receipts would remain the same as under existing law. Taxpayers with more than $25 million in New York receipts would be subject to tax as follows:

Amount for Remaining C-corporations	
New York Receipts	**TY 2015 forward**
$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

Qualified New York manufacturers would be subject to the following fixed dollar minimum amounts:

Amounts for Qualified New York Manufacturers				
New York Receipts	TYBOA 1/1/2015	TYBOA 1/1/2016	TYBOA 1/1/2017	TYBOA 1/1/2018
Not more than $100,000	$22	$21	$21	$19
$100,001 - $250,000	$66	$63	$63	$56
$250,001 - $500,000	$153	$148	$148	$131
$500,001 - $1,000,000	$439	$423	$423	$375
$1,000,001 - $5,000,000	$1,316	$1,269	$1,269	$1,125
$5,000,001 - $25,000,000	$3,070	$2,961	$2,961	$2,625
Over $25 million	$4,385	$4,230	$4,230	$3,750

[44] Bill Part A § 12; Tax Law § 210.1(b).

[45] Bill Part A §13; Tax Law §210.1-c.

TYBOA - Tax year beginning on or after

3. Comments

Small Business Tax Computation. As noted in the chart above, the general tax rate on business income for small business taxpayers is 6.5%. However, for tax years beginning on or after January 1, 2015 and before January 1, 2016 (when the tax rate for taxpayers other than certain manufacturers is 7.1%), the Budget Bill proposes to increase the effective rate for small businesses once the business income base exceeds $290,000. Specifically, the proposal would require such small businesses to pay tax on business income as follows: the sum of $18,850, plus 7.1% of the amount business income between $290,000 though $390,000, plus 4.35% of the amount of business income between $350,000 and $390,000. Given the overlap in the ranges stated for the additional tax, the Tax Section is concerned that a drafting error has occurred. Specifically, we question whether the intent was for the 7.1% to apply to business income between $290,000 thought $350,000. We believe that our correction would meet the intent of the Budget Bill given that the current small business tax rate is computed using a similar computation.

Fixed Dollar Minimum Tax. There is a slight drafting error in proposed Section 210.1(d) (4). In the final table for fixed dollar minimums, a dollar sign was omitted from the front of the tax amount "50,000."

Preferential Treatment of New York Manufacturers. Under the Budget Bill, the ability of a manufacturer to qualify for a lower tax rate depends on whether it has certain property located in New York State, or on whether all of its real and tangible personal property is located in the state. As discussed in NYSBA Report No. 1128, the Tax Section continues to have concerns that conditioning the lower tax rate for certain New

York manufacturers on whether a corporation maintains a sufficient level of its property in New York will be susceptible to constitutional challenges as discriminating against interstate commerce. As we noted in our prior report, this is particularly true as to smaller manufacturers who can qualify for a lower rate of tax only if all of their property is in New York. Under the proposal, this concern is heightened given that the qualifying threshold for manufacturers that do not have all of their property in the state has been raised from one million to ten million dollars. As such, a broader range of business taxpayers will be affected by the threshold requirement, potentially increasing its susceptibility to constitutional challenge.

III. Classification of Income and Expenses

New York's franchise tax is unique. Harking back to 1944, Article 9-A divides a corporation's capital and income into three categories: subsidiary capital and income, investment capital and income, and business capital and income. Each of these categories is subject to a specific treatment under the Tax Law in determining the corporation's overall tax liability.

This trifurcated tax regime was enacted to continue the historic tax treatment by New York of business corporations, holding companies, and investment trusts. To attract corporate headquarters and investment companies to New York, the pre-1944 franchise tax had provided for a special tax treatment of such entities, and taxed them under three different tax regimes. The franchise tax in place since 1944 recognizes, however, that a modern corporation can simultaneously function as any of these three types of entities. Therefore, beginning in 1944, the special treatment previously granted to holding companies and investment trusts was incorporated into the franchise tax under the concepts of subsidiary capital and investment capital.

A. Current Law

The portion of the New York franchise tax imposed on income is based on a taxpayer's "entire net income" allocable to New York. "Entire net income" is defined as "total net income from all sources, which shall be presumably the same as the entire taxable income" the taxpayer is required to report for federal income tax purposes, subject to statutory adjustments.[46] New York entire net income includes all income of a corporation, regardless of whether the income is earned within or without the United States.[47] For U.S. corporations this occurs automatically

[46] Tax Law § 208.9.

[47] *Id.* at § 208.9(c); NYCRR § 3-2.3(a)(9).

because worldwide income is included in federal taxable income. Alien corporations, however, that for federal income tax purposes may only be reporting income effectively connected with a U.S. trade or business, are required to modify federal taxable income by including income and deductions from its non–U.S. activities.[48]

Entire net income "excludes income, gains and losses from subsidiary capital."[49] Subsidiary capital is defined as "investments in the stock of subsidiaries and any indebtedness from subsidiaries ... provided, however, that, in the discretion of the commissioner, there shall be deducted from subsidiary capital any liabilities which are directly or indirectly attributable to subsidiary capital."[50]

Entire net income is composed of "investment income" and "business income." Business income is defined as "entire net income minus investment income."[51]
Investment income is defined as "income . . . from investment capital, to the extent included in computing entire net income, less, (a) in the discretion of the commissioner, any deductions allowable in computing entire net income which are directly or indirectly attributable to investment capital or investment income . . . ."[52] Investment capital, in turn, is defined as "investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business, exclusive of subsidiary capital and stock issued by the taxpayer, provided, however, that, in the discretion of the commissioner, there shall be deducted from investment capital any liabilities which are directly or indirectly attributable to investment capital . . . ."[53]

B. <u>Proposed Changes</u>

The overarching purpose of the proposed legislation is to incorporate the provisions of Article 32 (bank franchise tax) into Article 9-A. These modifications, however, result in significant changes that would impact corporations historically taxed under Article 9-A.

1. *Entire Net Income*

It should be noted at the outset that under the proposal, the portion of the New York franchise tax imposed on income would be based on a taxpayer's "business income" and not on "entire net income." Therefore, only items that are includible within business capital and business income would be taxable. Categories such as "investment income" and the newly created "other exempt income" would not be subject to the franchise tax.

Nevertheless, "entire net income" remains the starting point of the tax calculation. Although the definition of "entire net income" would generally remain the same, for alien

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[48] *See Reuters Ltd. v. Tax Appeals Tribunal,* 603 N.Y.S.2d 795 (1993).

[49] Tax Law § 208.9(a).

[50] *Id.* at § 208.4.

[51] *Id.* at § 208.8.

[52] Tax Law § 208.6.

[53] *Id.* at § 208.5.

corporations, the starting point would now be effectively connected income as determined for federal income tax purposes.[54] The effectively connected income to be reported by the alien corporation to New York, however, may not be reduced by any applicable U.S. tax treaty exemptions.[55]

2. *Subsidiary Capital*

In one of the more significant departures from Article 9-A's trifurcated tax regime, the Budget Bill would completely eliminate the "subsidiary capital" category.[56] The proposed legislation would also eliminate the exemption for fifty percent of dividends from non-subsidiaries.[57] However, to offset the elimination of the fifty percent dividend deduction, proposal would eliminate the requirement that a dividend received deduction must be added back to federal taxable income for purposes of calculating the entire net income.[58]

3. *Business Income*

Although entire net income would continue to be composed of "investment income" and "business income," business income would now be defined as "entire net income minus investment income *and other exempt income*."[59] The new category of "other exempt income" is discussed in more detail below.

4. *Investment Capital*

The category of "investment capital" would also be significantly curtailed, with investment capital now being limited to only "investments in stocks [of non-unitary corporations] that are held by the taxpayer for more than six consecutive months."[60] "Stock" would be defined as "a direct interest in a corporation that is treated as equity for federal income tax purposes."[61] For purposes of the definition of investment capital, corporations less than 20 percent directly or indirectly owned by a taxpayer would be presumed non-unitary.[62] If the six-month holding period is split across tax years, a taxpayer would be allowed to classify income from stock as investment income in the first year if it intends to hold the stock for more than six months.[63] If stock is not held for six months, the business capital in the following year must be increased by the amount of investment capital attributable to that stock in the prior year.

[54] Proposed Tax Law § 208.9(iv).

[55] Proposed Tax Law § 208.9(b)(1).

[56] Tax Law § 208.9(a)(1).

[57] *Id.* at § 208.9(a)(2).

[58] Proposed Tax Law § 208.9(b)(2).

[59] *Id.* at § 208.8 (Emphasis added).

[60] *Id.* at § 208.5.

[61] *Id.* at § 208.4.

[62] Proposed Tax Law § 208.5.

[63] *Id.*

Investment income would also include income or gain from debt obligations or other security that cannot be included in apportionable business income under the U.S. Constitution.

Thus, under the proposed legislation, items such as "corporate equity instruments," "debt instruments issued by [any governmental instrumentality]," and "qualifying corporate debt instruments"[64] would now be includible in business capital, the income from which would constitute business income. Also, the election to treat cash and certain short-term securities as investment capital[65] would be eliminated.

5. *Other Exempt Income*

The proposal creates a new category called "other exempt income," defined as the "sum of exempt Subpart F income and exempt unitary dividends."[66]

Exempt Subpart F income is income received from a controlled foreign corporation that is conducting a unitary business with the taxpayer but is not included in the combined group.[67]

Exempt unitary dividends are dividends from unitary corporations not in the combined group.[68] A unitary corporation may be excluded from the combined group if it is: (1) taxable under another tax article; (2) an alien corporation with no effectively connected income; or (3) less than 50 percent directly or indirectly owned.

6. *Attribution of Expenses*

Under the Budget Bill, investment income and other exempt income may be reduced by the interest expenses attributable to such income. Practically speaking, because under the proposal the investment income and other exempt income would be exempt from tax, the deductions for interest expenses attributable to such income would be disallowed. If the interest expense attribution exceeds investment income and other exempt income, the excess expenses would be added back to the entire net income.[69] The proposal would eliminate the requirement to attribute expenses, other than interest, to investment income and other exempt income. This is a positive development considering the compliance burden under the current law.

In lieu of computing actual interest expenses attributable to investment income and other exempt income, taxpayers could elect to reduce investment and other exempt income by 40 percent.[70] The actual attribution methodology for taxpayers not making the 40 percent election, based upon current rules, would be detailed in revised guidance issued by the Department.

[64] NYCRR § 3-3.2.

[65] *See id.* at § 3-3.2.

[66] Proposed Tax Law § 208.6-a(a).

[67] *Id.* at § 208.6-a(b).

[68] *Id.*at § 208.6-a(c).

[69] Proposed N.Y. Tax Law §§ 208.6; 208.6-a.

[70] *Id.*

The computation of expense attribution for a combined group would be done on a "one company" basis. If the taxpayer chooses the 40 percent election, it would apply to all members of the combined group.[71]

C. Comments

The Budget Bill does a commendable job of simplifying what has become an arcane and overly complicated tax regime. Also, although the current tax regime was intended to attract company headquarters to New York, that incentive has somewhat eroded over the years.

We have several specific comments on the proposed legislation:

Under the proposal, the concepts of "entire net income" and "business income" seem to be one and the same. Under the historic regime, entire net income consisted of both business and investment income, and served as one of the four tax bases. Now with the investment capital excluded from tax, the two concepts should be integrated under "business income."

For purposes of the investment capital calculation, stock is defined as a "direct interest." (Proposed N.Y. Tax Law § 208.4). We assume that use of the term "direct" is designed to ensure that to qualify for investment capital treatment, the stock must be held directly by the taxpayer and not through a subsidiary. The term "direct" may also signify that only direct ownership of stock constitutes investment capital. Consequently, we further assume the intent of the proposal is to no longer include stock rights, options, warrants, and hedges (such as futures and forward contracts) in the definition of investment capital. We note that, under existing regulations, a corporate partner (or member) includes in investment capital its proportionate share of stocks held for investment by a partnership (or a disregarded entity).[72] Accordingly, we recommend that the proposed definition of "stock" explicitly provide that for investment capital purposes, stock held by a pass-through or disregarded entity qualifies as a "direct" interest in stock.

The Budget Bill provides that in lieu of computing actual interest expenses attributable to investment income and other exempt income, taxpayers may elect to reduce investment income and other exempt income by 40 percent. Presumably, the forty percent election is intended to impact the attribution of expenses to business income and we understand the election would operate as illustrated in the following examples:

Example #1

Assume a taxpayer with $255 in gross federal income, $100 of which is exempt investment income for New York State tax purposes. Also assume $95 in deductible interest expense, resulting in federal taxable income of $160, which is the starting point for New York entire net income ($255 - $95 = $160). Since the $160 of entire net income is comprised of $100 of exempt investment income, the taxpayer's business income in New York would be $60 before expense attribution ($160 - $100 = $60). Using the forty percent election, the taxpayer would be required to reduce its exempt investment income by $40, resulting in $60 of exempt investment income ($100 - $40 = $60). In turn, the taxpayer's taxable business income would be $100,

[71] *Id.* at § 208.10-C.4.

[72] 20 NYCRR § 3-3.2(a)(2)(v).

calculated by reducing entire net income by the amount of the reduced investment income ($160 - $60 = $100).

Example #2

Assume a taxpayer with $160 in gross federal income, $100 of which is exempt investment income for New York State tax purposes. Also assume $95 in deductible interest expense, resulting in federal taxable income of $65, which is the starting point for New York entire net income ($160 - $95 = $65). Since the $65 of entire net income is comprised of $100 of exempt investment income, the taxpayer's business income in New York would be $0 before expense attribution. Using the forty percent election, the taxpayer would be required to reduce its exempt investment income by $40, resulting in $60 of exempt investment income ($100 - $40 = $60). In turn, the taxpayer's taxable business income would be $5, calculated by reducing entire net income by the amount of the reduced investment income ($65 - $60 = $5).

We note that to the extent the exempt investment income in the examples above is not reduced by the forty percent election, taxpayers will still obtain a benefit with respect to taxable business income because the "unattributed" expenses remain deductible in calculating federal taxable income (which is the starting point for calculating entire net income). We presume that one of the goals of the forty percent election is to provide s "safe harbor" such that taxpayers will not have to undertake any actual expense attribution, which has proven to be a point of contention during audits and generally strains the time and resources of both taxpayers and the Department. Consequently, we further presume that if a taxpayer makes the forty percent election, it will not be subject to any expenses attribution by the Department during an audit. To the extent our understanding of the forty percent election is incorrect, we recommend that the operation of the election be clarified.

IV. Apportionment

A. Current Law

1. *Article 9-A*

In computing the portion of a corporation's entire net income that will be subject to tax by New York (if the resulting tax amount is greater than the amount computed under the three other tax bases),[73] entire net income (New York's term for taxable income) is first bifurcated into business income and investment income. Similarly, in computing the portion of a corporation's net capital that will be subject to tax by New York (if the resulting tax amount is greater than the amount computed under the three other bases), net capital is first bifurcated into business capital and investment capital. The next and final steps are to multiply business income and business capital by the taxpayer's "business allocation percentage" and to multiply investment income and investment capital by the taxpayer's "investment allocation percentage."

[73] The four bases are entire net income, net capital, alternative minimum taxable income, and a fixed-dollar minimum; the latter two bases are rarely used and will not be discussed herein.

The business allocation percentage is equal to the ratio of the taxpayer's "New York" receipts to its total receipts, with "receipts" generally meaning gross revenue. In general, New York receipts are those generated from (1) sales of tangible personal property shipped or delivered to the taxpayer's customers in New York, (2) sales of services to the extent the services were performed in New York, and (3) other activities to the extent the receipts were "earned" in New York.

The investment allocation percentage is determined by summing the "issuer's allocation percentages" of each of the taxpayer's investments, weighted by the portion of the taxpayer's total amount of investment originally made in each investment. The issuer's allocation percentage is the portion of the investment issuer's own capital attributable to New York (based on the issuer performing the computations set forth above to its own business and investment capital and then adding its subsidiary capital to the fraction).

The final entire net income tax base is the sum of (1) business income multiplied by the business allocation percentage and (2) investment income multiplied by the investment allocation percentage. Similarly, the final net capital base is the sum of (1) business capital multiplied by the business allocation percentage and (2) investment capital multiplied by the investment allocation percentage. Different tax rates apply to each of these two bases.

3. *Article 32*

In computing the portion of a banking corporation's entire net income that will be subject to tax by New York (if the resulting tax amount is greater than the amount computed under the gross assets base or under the alternative entire net income base),[74] entire net income is multiplied by a three-factor formula consisting of the deposits factor, the payroll factor (80% of compensation paid to employees other than general executive officers), and the receipts factor; the three factors are averaged, with the deposits factor being double-weighted, the payroll factor being single-weighted, and the receipts factor being double-weighed. The same formula generally applies in apportioning the gross assets base.

The deposits factor is the ratio of the taxpayer's deposits maintained at a New York branch to all deposits maintained to all of the taxpayer's branches. The payroll factor is the ratio of wages paid to the taxpayer's employees based in New York to all wages paid by the taxpayer. The receipts factor is the ratio

[74] The alternative entire net income base is rarely used and will not be discussed herein.

of receipts of the taxpayer arising from loans (including the taxpayer's portion of a participation in a loan) and financing leases within New York and all other business receipts earned within New York to the total amount of the taxpayer's receipts from loans (including the taxpayer's portion of a participation in a loan) and financing leases and all other business receipts.[75] For purposes of computing the numerator of the receipts factor, Article 32 sources receipts as follows:

- Receipts from loans and financing leases are sourced where the greater portion of income producing activity related to the loan or financing lease occurred, and to determine where the greater portion of income producing activity relating to a loan occurred, consideration is given to such activities as the solicitation, investigation, negotiation, final approval and administration of the loan or financing lease;[76]
- Receipts from lease transactions, other than financing leases, are sourced where the property subject to the lease is located;[77]
- With respect to receipts from bank, credit, travel and entertainment cards, (1) interest, and fees and penalties in the nature of interest, are soured to the mailing address of the card holder in the taxpayer's records; (2) service charges and fees are sourced to the mailing address of the card holder in the taxpayer's records; and (3) receipts from merchant discounts are sourced to the state where the merchant is located;[78]
- Net gains and other income from trading activities and from investment activities are sourced to New York based on the percentage that the average value of trading assets and investment assets attributable to New York bears to the average value of all such assets, and a trading asset or investment asset is attributable to the state where the greater portion of income producing activity related to the trading asset or investment asset occurred;[79]

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[75] Tax Law § 1454(a)(2)(A).

[76] *Id.* at § 1454(a)(2)(B): 20 NYCRR § 19-6.2.

[77] Tax Law § 1454(a)(2)(C).

[78] *Id.* at § 1454(a)(2)(D).

[79] *Id.* at § 1454(a)(2)(E). The Department's regulations provide that, in determining where the greater portion of income-producing activity occurred, consideration is given to such factors as: (1) where the

- Fees or charges from the issuance of letters of credit, travelers checks, and money orders are sourced to the state where such letters of credit, travelers checks or money orders are issued;[80]
- Receipts arising from management, administration, or distribution services performed for regulated investment companies are sourced based on a fraction, the numerator of which is the sum of the monthly percentages for each month of the investment company's federal taxable year that ends within the taxpayer's and the denominator of which is the number of monthly percentages, and the monthly percentage is determined by dividing the number of shares in the investment company that are owned on the last day of the month by shareholders that are domiciled in New York by the total number of shares in the investment company outstanding on that date.[81]
- All receipts from the performance of services not described above are sourced to New York based on the relative value of, or the amount of time spent in the performance of, such services within New York, or by some other reasonable method.[82]
- All "other receipts" are sourced in accordance with rules and regulations issued by the Commissioner and the current regulations provide that "[a]ll other business receipts earned by the taxpayer in New York State are allocated to New York State."[83]

C. Proposed Changes

The Budget Bill would eliminate the disparate apportionment schemes applied to general business corporations and banking corporations; the same rules would apply to both categories of corporations. In general, the Budget Bill would expand the "market-sourcing" regime that currently applies to sales of

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taxpayer's particular policies regarding trading and investment activities are established and guidelines set up; (2) where the day-to-day decisions regarding each trading or investment transaction are made; and (3) where the equipment and other support activities relating to trading and investment activities are located. 20 NYCRR § 19-6.5.

[80] Tax Law § 1454(a)(2)(F).

[81] *Id.*at § 1454(a)(2)(G).

[82] *Id.* at § 1454(a)(2)(H); 20 NYCRR § 19-6.7(c).

[83] Tax Law § 1454(a)(2)(I); 20 NYCRR § 19-6.9(b).

tangible personal property and to certain asset management and investment advisory service to all receipts "that are included in the computation of the taxpayer's business income for the taxable year" as follows:

- Receipts from sales of tangible personal property and electricity, except when such items are treated as commodities under IRC section 475, are sourced to where shipped or destined.
- Receipts from rentals of real and tangible personal property are sourced to the location of the property.
- Receipts from licensing intangible personal property, or royalties, are sourced to where the intangible property is used.
- Receipts from sales of closed-circuit and cable transmission of special events are sourced, on an apportioned basis, to where the transmissions are exhibited.
- Receipts from sales, licenses to use, and granting remote access to digital products – which includes electromagnetically delivered audio works, audiovisual works, visual works, books and other literary works, graphic works, games, information and entertainment services, digital storage services, and computer software – are sourced to where delivered or where assessed, determined pursuant to the following hierarchy (the taxpayer must exercise due diligence in attempting to obtain the information needed for each method before proceeding to the next method):
    -- Actual location which "may be demonstrated" by using the destination IP address, the location of the receiving equipment, or the bill of lading or invoice;
    -- The customer's billing address;
    -- The zip code or other geographic indicator of the customer's location;

-- The taxpayer's apportionment fraction for receipts from sales of digital products used for the preceding year (if no such taxable year, then the fraction determined for digital product sales that can be geographically sourced for the year will be used for those sales that cannot be geographically sourced).

- Receipts from engaging in financial transactions are generally sourced to the location of the customer or counterparty, except that a taxpayer may elect to utilize an 8% apportionment fraction (i.e., 8% of such receipts are included in the numerator and 100% are in the denominator) for receipts and gains from qualified financial instruments (those marked to market under IRC section 475 except for loans secured by real property). The "location" of the customer or counterparty is the billing address of individuals and the commercial domicile for a business entity, and receipts are sourced as follows:

-- Interest on loans secured by real property is sourced to the location of the real property;

-- Interest on loans not secured by real property is sourced to the location of the borrower;

-- Net gains from sales of loans secured by real property are sourced using the ratio of gross proceeds from sales of loans secured by New York real property to all sales of loans secured by real property;

-- Net gains from sales of loans not secured by real property are sourced using the ratio of gross proceeds from sales of such loans to purchasers located in New York to all sales of such loans;

-- Interest and net gains from sales of debt instruments issued by the United States or by any state or political subdivision thereof are excluded from the numerator; interest and net gain from sales or debt instrument issued by the United States and New York and its political subdivision are included in the denominator while 50% of such receipts related to debt instruments issued by other states and their political subdivisions are included in the denominator.

-- Interest from asset-backed securities (including those issued by a government agency (such as GNMA, FNMA, FHCMC, and the SBA) are subject to an 8% apportionment fraction (i.e., 8% of such receipts are included in the numerator and 100% of such receipts are in the numerator); receipts constituting net gain from sales of asset-backed securities issued by a government agency or sold through a registered securities broker or dealer or through a licensed exchange are also subject to the 8% apportionment fraction while receipts constituting net gain from sales of other asset-backed securities are sourced using the ratio of gross proceeds from such sales to purchasers located in New York to gross proceeds from all such purchasers;

-- Interest from corporate bonds are sourced to the commercial domicile of the issuing corporation; net gains from sales of such bonds through a registered securities broker or dealer or through a licensed exchange are subject to an 8% apportionment factors (i.e. 8% of such receipts are included in the numerator and 100% of such receipts are in the numerator); net gains from other sales of corporate bonds are sourced using the ratio of gross proceeds from sales to purchasers located in New York to gross proceeds from all such sales;

-- Net interest income from reverse repurchase agreements and securities borrowing agreements are subject to an 8% apportionment fraction (i.e., 8% of such receipts are included in the numerator and 100% of such receipts are in the numerator); net interest is the sum of all such interest income less the sum of all interest expense from the taxpayer's repurchase agreements and securities lending agreements;

-- Net interest from federal funds are subject to an 8% apportionment fraction (i.e., 8% of such receipts are included in the numerator and 100% of such receipts are in the numerator); net interest in all such interest less interest expense from federal funds;

-- Dividends from stock and net gains from sales of stock and partnerships interest are excluded from the apportionment formula;

-- Interest from "other financial instruments" is sourced to the location of the payor;

-- Net gains from sales of "other financial instruments" are sourced to the location of the purchaser or payor except if the purchaser or payor is a registered securities broker or dealer of the transaction is made through a licensed exchange, the 8% apportionment fraction applies (i.e., 8% of such receipts are included in the numerator and 100% of such receipts are in the numerator);

-- Net income from sales or physical commodities are apportioned to New York using the ratio of the amount of receipts from sales of physical commodities actually delivered to a point in New York (where there is no actual delivery, then such sales to customers located in New York) to all such receipts.

- Other receipts from broker or dealer activities are sourced as follows:

-- Brokerage commissions, margin interest, securities, underwriting fees, account maintenance fees, management and advisory fees (except those receipts from services rendered to investment companies) are sourced to the address of the customer responsible for paying such amounts;

-- Receipts constituting primary spread from underwriting securities are sourced to the location of the customer.

- Receipts from engaging in credit card and similar activities are sourced as follows:

-- Interest, fees, penalties and service charges are issued to the card holder's mailing address.

- -- Merchant discount is sourced to the location of the merchant's related sales with the presumption that all sales are made at the merchant's address shown on its invoice submitted to the taxpayer.

- Receipts constituting amounts received for rendering management, advisory, distribution (including selling), and administrative services to investment companies (as defined in IRC section 851), including partnerships subject to IRC section 7704(a) due to IRC section 7704(c)(3), that meet the requirements of IRC section 851(b) are sourced, on a monthly basis, to the domicile of the investment company's shareholders; individuals, estates and trusts are deemed located at his, her or its mailing address and business entities are deemed located at their commercial domiciles, determined pursuant to the following hierarchy (the taxpayer must exercise due diligence in attempting to obtain the information needed for each method before proceeding to the next method):
  - -- the entity's treasury function;
  - -- the seat of management and control of the entity;
  - -- the entity's billing address.
- Receipts from conducting railroad and trucking business are sourced and apportioned based on the "miles in such business."
- Receipts from conducting air freight forwarding are sourced half to the place of pickup and half to the place of delivery.
- Receipts from conducting aviation services other than freight forwarding are sourced pursuant to an evenly weighted three-factor formula (i.e., sourcing is determined by using the arithmetic average of the factors) with

only 60% of the New York receipts being included in the numerator of each factor; the factor are:

- -- the location of arrivals and departures (excluding those for ferry, training, and emergency purposes);
- -- the location of the airport where revenue tons are handled (where passengers and freight are first received or finally discharged);
- -- the location of originating revenue (where passengers and freight are first received or finally discharged);

- Receipts from sales of advertising are sourced to the location of the audience (where print media is delivered; where listeners or viewers of electronic media, such as television and radio, are located);
- Receipts from the transportation with transmission of gas are sourced based on the location of transportation units (the transporting of one cubic foot of gas for a distance of one mile);
- Receipts from activities not specifically provided are sourced to the location of the customer according to the following hierarchy (the taxpayer must exercise due diligence in attempting to obtain the information needed for each method before proceeding to the next method):
  - -- The customer's location when services are performed for "a customer's particular location";
  - -- Customer's billing address;
  - -- Zip code or other geographic indicator of customer's location;
  - -- The percentage used by the taxpayer for the preceding year to apportion "other" receipts;

As in current law, the Commissioner is provided discretion to apply alternative methods rather than the specific methods set forth in the statute "to effect a fair and proper apportionment of the business income and capital reasonably attributed to the state" when the standard statutory scheme "does not result in a proper reflection of the taxpayer's business income or capital within the state."

C. Comments

As an overarching matter, the Budget Bill's market state approach to determine the portion of a corporation's taxable income that is subject to New York taxation is to be highly commended; both the focus on the nature of the receipts and the activities that generate such receipts, rather than the formal classification of the taxpayer, as well as the codification of rather narrow, specific categories, rather than ill-defined generalizations, should be very helpful in making tax compliance fairer, easier, and less subject to controversy.

This detailed approach should dramatically reduce the extent of audit controversies in New York. For example, there has been a great deal of activity under current law regarding the sourcing of receipts earned from performing services that are delivered or made available electronically or through the Internet. The Budget Bill should help clarify where such receipts are earned.

While we commend the detailed approach in the Budget Bill, there are several aspects of the apportionment provisions that require further clarification, but that we believe would be best addressed in regulations. For example:

- Section 210-A.2(b) would source receipts from sales of electricity to where "delivered." The Tax Section recommends that a regulation be promulgated to clarify whether this means the transfer point on a grid (which is commonly used in the context of "transmission" of electricity) or the ultimate point of delivery, perhaps via a formula (which is commonly used in the context of "distribution" of electricity).
- Section 210-A.3(b) would source royalties to where the licensed intangible property is "used." The Tax Section recommends that a regulation be promulgated to clarify where,

for example, a marketing intangible is used[84] (e.g., where a trademark is sewn onto a garment or where the garment is ultimately sold; if the latter, consideration will need to be given to the licensor not always having information or to the licensee's distribution of the product).

Although the Tax Section will not comment on the overall shift in policy from taxing based on the factors of production to taxing based on the market, we note that the shift—accomplished both by substituting the single sales factor formula for the traditional "Massachusetts" apportionment formula which utilized the factors of property, payroll, and receipts to apportion a corporation's income for state tax purposes and by using market sourcing for all receipts (rather than just for receipts from sales of tangible personal property)—is consistent with the trend throughout the country and may be necessary to enhance New York's business climate.

If the Budget Bill were to be enacted, a new Section 210-A.2(a) would provide that receipts from sales of tangible personal property are to be sourced to where shipments are made or to where the goods' destination is located. The use of the two concepts may be confusing; if the intent is to codify a "dock sales" rule (whereby a sale is sourced to the customer's ultimate destination, even when the customer picks up the goods itself), that should be made more explicit in either the Budget Bill or in regulations. This issue is addressed in the current regulations, which clarify that receipts from tangible personal property are sourced to the customer's ultimate destination.[85]

Section 210-A.5(b)(3)(B) would source receipts from underwriting primary spread, to "the extent" the customer is located within or without New York. Clarification of whether "extent" implies some type of sub-apportionment (based on the degree of the customer's presence within New York) would be helpful.

Section 210-A.5(c) would adopt the Article 32 sourcing rules for certain receipts relating to certain credit, travel, and entertainment card activities as follows: (1) interest, fees, penalties and service charges are sourced to the cardholder's mailing address, and (2) merchant discount is sourced to the location of the

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[84] Currently, the regulations merely provide that licensed intangible property is used in New York "to the extent that the activities thereunder are carried on in New York." 20 NYCRR § 4-4.4.

[85] 20 NYCRR § 4-4.2

merchant's related sales with the presumption that all sales are made at the merchant's address shown on its invoice submitted to the taxpayer. However, it is unclear if these rules are intended to apply to only issuer and acquirer banks (who were formerly subject to this sourcing regime under Article 32), or if they are also intended to apply to credit processors (who typically perform services for issuer and acquirer banks and may not have access to a card holder's mailing address).

Section 210-A.5(d) would continue New York's "Dreyfus" rule whereby receipts from providing certain services to an investment companies are sourced to the investment company's shareholders' "domicile." However, the subsequent sections use the term "located" rather than "domiciled." We assume this was a drafting error and recommend replacing the word "located" with "domiciled". Additionally, Tax Law section 210-A.5(e) sets forth a hierarchy for determining the commercial domicile of a business but uses the term "billing address." It is not clear that an investment company shareholder would have a "billing address."

The Budget Bill does not explicitly address gains from the sale of real property or gains from the sale of intellectual property. Therefore, it appears that such gains would be sourced under the hierarchy provided for "other services and other business receipts." Additionally, like current statutory law, there is no explicit provision for extraordinary gains. Consequently, unless addressed by regulation (as exists in current law), there could be some circumstances in which extraordinary gains could be included in the apportionment factor to the extent they are included in the computation of a taxpayer's "business income," Under existing regulations, extraordinary gains (gains from the sale of property that is not held by the taxpayer for sale to customers in the regular course of business) are not included in a taxpayer's apportionment factor or are excluded by the Commissioner exercising his discretionary authority in a specific case.[86]

Section 210-A.11 would provide the Commissioner with discretionary authority to alter the specific apportionment rules set forth in the statute when those rules do "not result in a proper reflection of the taxpayer's business income or capital within" New York; the Commissioner may use any method to effect a "fair and proper apportionment." Taxpayers, presumably (under New York case law) have the right to seek such alternative apportionment (as the Commissioner denying such a request would be an

[86] 20 NYCRR § 4-4.6.

abuse of discretion). As is evident from the plethora of alternative apportionment controversies raging throughout the country, this area could be enhanced through statutorily indicating which party—the Commissioner or the taxpayer—has the burden of proving that the standard statutory scheme does not result in "proper reflection" and that the proposed alternative is "fair and proper." Our view is that the party seeking alternative apportionment should bear the burden of proof. This is the rule that has been adopted in most states[87] and is justified on the grounds that where the legislature has made a judgment as to how income is to be apportioned, the burden of proof to justify an alternative approach should be on the party that seeks to reject the legislature's judgment. In addition, the statute should define "fair" and "proper" as those are inherently subjective terms.

V. Apportionment (Digital Products)

To date, the Tax Law has not explicitly addressed allocation of revenue from digital products. As a result, a significant amount of controversy has arisen regarding whether such income should be apportioned to New York based on a cost of performance methodology or a market-based methodology. Because of the prevalence of this issue in ongoing audits and litigation, it is separately addressed below.

A. Current Law

The New York State Department of Taxation and Finance treats revenue from digital products as "other business receipts" sourced to where they are earned.[88] Based on this rule, the Department has asserted that receipts from digital products are sourced to

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[87] *See, e.g., Microsoft Corp. v. Franchise Tax Bd.*, 39 Call. 4th 750, 139 P.3d 1169 (2006); *Union Pac. Corp. v. Idaho State Tax Comm'n*, 139 Idaho 572, 83 P.3d 116, 120 (2004); *Payne & Dolan v. Department of Treasury*, 138 Mich. App. 418, 360 N.W.2d 208, 210 (1984); *Montana Dep't of Revenue v. United Parcel Serv., Inc.*, 252 Mont. 476, 830 P.2d 1259 (1992); *Crocker Equip. Leasing, Inc. v. Department of Revenue*, 314 Or. 122, 838 P.2d 552, 557 (1992); *CarMax Auto Superstores W. Coast, Inc. v. SC Dep't of Revenue*, 397 S.C. 604, 725 S.E.2d 711, 714 (Ct. App. 2012); *Bellsouth Advert. & Publ'g Corp. v. Chumley*, 308 S.W.3d 350, 362 (Tenn. App. 2009); *Deseret Pharm. Co. v. State Tax Comm'n*, 579 P.2d 1322, 1326 (Utah 1978); but compare with *Equifax, Inc. v. Department of Revenue*, 125 So.3d 36 (Miss. 2013).

[88] Tax Law Sec. 210.3(a)(2)(D).

New York when the customer's "modems and other transmission equipment" are located in New York[89] and where the customer that accessed the taxpayer's website was in New York.[90] Application of these rules as a practical matter has been the source of substantial controversy, in part because the existing guidance does not address the complex issues associated with mobile customers or multiple points of use.

B. Proposed Changes

The Budget Bill proposes a hierarchy of sourcing methods for digital products. A taxpayer would be required to exercise due diligence under each method before rejecting it and moving to the next method in the hierarchy. Under the hierarchy, a digital product is deemed delivered within the state if the location from which the purchaser or its authorized user accesses or uses the digital product is in the state.[91] The proposed amendments provide for a variety of alternate methods for determining the destination: internet protocol address, geographic location of the equipment to which the product is delivered or by which it is accessed, or the delivery destination indicated on the bill of lading or purchase invoice.[92] The statute states that a digital product accessed or used in multiple locations is delivered in the state to the extent accessed or used in the state.[93]

If the above inquiry is not successful, the taxpayer would next be required to utilize the billing address of the purchaser,[94] or if unsuccessful, the zip code or other geographic indicator of the purchaser's location.[95] If these methods do not work, the taxpayer would have to utilize the fraction for the prior year

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[89] TSB-A-99(16)C; TSB-A-00(15)C).

[90] TSB-A-02(3)C; TSB-A-11(8)(C).

[91] Budget Bill, Proposed Section 210-A.4(c)(1).

[92] *Id.*

[93] *Id.*

[94] *Id.* at § 210-A.4(c)(2).

[95] *Id.* at § 210-A.4(c)(3).

or, if inapplicable, the fraction for those digital products that can be sourced using the hierarchy of sourcing methods.[96]

The proposed law also contains a definition of digital products. Such products are defined as any property or service, or combination thereof, of whatever nature delivered by various electronic communication media, and includes specific enumerated examples and exclusions.[97]

C. Comments

The Budget Bill provides a logical market-based method for addressing a complex area that is consistent with the approach in existing New York administrative guidance, and addresses some of the difficult issues not dealt with in the existing guidance. Section 210-A.4(c) would provide a sourcing hierarchy for receipts from sales of digital products. While the Tax Section notes that the methodologies for allocation of income from digital goods utilized for this purpose by different jurisdictions and proposed under UDITPA/SSUTA differ widely, we do not express an opinion as to the worthiness of the various methodologies. We do, however, recommend that consideration be given to attempting to conform the concepts and terminology in this hierarchy to the hierarchies adopted by other states in both the apportionment context and the sales and use tax context. We note that unlike the 2009-2010 proposal, on which they are based, the proposed amendments do not address the sourcing of digital products for sales tax purpose (or the application of sales tax to such products).[98]

The Tax Section believes that the Budget Bill could be clarified to address a number of issues. First, we would suggest that the inclusion of the delivery destination indicated on the bill of lading or purchase invoice in the first tier of allocation methods be revisited. The first tier is intended to reflect the location of actual usage, not the address of record, and inclusion of the delivery address as an option is therefore inappropriate. We note the three alternative methods for determining the destination within the

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[96] *Id.* at § 210-A.4(c)(4).

[97] Budget Bill, Proposed Section 210-A.4(a).

[98] The federal Digital Goods and Services Tax Fairness Act, most recently proposed in 2013, proposed sourcing rules in the sales tax area that are notably different from those in the proposed amendments; if these rules were to become the national standard in the sales tax area, conforming the income tax sourcing regime may merit consideration.

first tier are not hierarchical, and that taxpayers would therefore have the ability to select the delivery address rather than the more precise locations afforded by the other methods under the law as drafted.

The Budget Bill does not address the manner in which usage in multiple locations is to be determined and whether reliance on customer statements is permitted, as in the sales tax context. While we believe that the omission of this issue from the statute is appropriate, administrative guidance would be helpful. As previously noted, there is guidance on this issue in the sales tax area, in which New York permits reliance by the vendor on a statement provided by the purchaser with respect to allocation of uses, which could provide the basis for such guidance.[99]

The definition of digital product includes a reference to "information or entertainment services." We are concerned that this may generate confusion as the definition of information services intended is different from the definition in the sales tax area, and suggest that the statute make clear that the definition of information services is not coextensive with the definition for sales tax purposes. Also it is unclear if data processing services are intended to be included within the definition of "digital products."

VI. Combined Reporting

A. Current Law

Section 18 of Part A of the Budget Bill would overhaul the current framework under Article 9-A for combined reporting in New York by adopting mandatory combined reporting for all unitary corporations that meet certain ownership requirements and by providing taxpayers with the ability to elect to file a combined return with a commonly owned group of corporations. Due to the repeal of Article 32 in Section 1 of Part A of the Budget Bill, the new combined reporting regime would apply to general business corporations that are currently subject to tax under Article 9-A as well as banking corporations[100] that are currently subject to tax under Article 32.

1. *Article 9-A*

a. *Determining the Combined Group*

[99] *See* TSB-A-03(5)S; TSB-A-09(55)(S).

[100] Tax Law § 1452 currently defines a "banking corporation."

For tax years beginning on or after January 1, 2007,[101] a taxpayer[102] that owns or controls, directly or indirectly, substantially all[103] of the capital stock[104] of one or more other corporations or substantially all of the capital stock of which is owned or controlled, directly or indirectly, by one or more other corporations or by interests that own or control, directly or indirectly, substantially all of the capital stock of one more other corporations (collectively, "related corporations") is required to file a combined report with the related corporations if there are "substantial intercorporate transactions" among the related corporations, regardless of the transfer price for those intercorporate transactions.[105] In addition, even if there are no substantial intercorporate transactions among related corporations, the Department may permit or require a combined report if the Department deems it necessary to properly reflect the tax liability because of some intercompany transactions or some agreement, understanding, or arrangement or

[101] For tax years beginning before January 1, 2007, the Department could permit or require a taxpayer that owned or controlled, directly or indirectly, substantially all the capital stock of one or more other corporations, or substantially all the capital stock of which was owned or controlled, directly or indirectly, by one or more other corporations or by interests that owned or controlled, directly or indirectly, substantially all the capital stock of one or more other corporations (collectively, "related corporations") to file a combined report with the related corporations if reporting on a combined basis was necessary to properly reflect the tax liability because of intercorporate transactions or because of some agreement, understanding, arrangement, or transaction among the corporations ("distortion"). Tax Law § 211.4 (in effect before Jan. 1, 2007). The distortion requirement was presumed met if the corporations engaged in substantial intercorporate transactions but that presumption could be rebutted if the intercorporate transactions were conducted at arm's-length rates pursuant to the standards under section 482 of the Internal Revenue Code. 20 NYCRR § 6-2.1, 6-2.3 (former).

[102] A "tax payer" is defined as "any corporation subject to tax under [Article 9-A]." Tax Law § 208.2.

[103] The Department's regulations define the term "substantially all" to mean ownership or control of 80% or more of the voting power of the issued and outstanding stock. 20 NYCRR § 6-2.2(a)(3).

[104] The Department's explanation accompanying the release of the final combined reporting regulations in 2012 indicated that "voting power for the election of the board of directors is generally determinative of control for the purpose of the capital stock requirement and will be considered for the test" but it declined to so indicate in the regulations because "it is possible that there could be other arrangements whereby the voting power for the election of the board of directors is not so determinative." See Department's Assessment of Public Comments published in January 2, 2013 edition of the State Register.

[105] Tax Law § 211.4(a). The Department's regulations provide that the substantial intercorporate transactions requirement is met when either 50% or more of a corporation's receipts are received from a related corporation or 50% or more of a corporation's expenditures are paid to a related corporation. 20 NYCRR § 6-2.3(b)(3)(i) & (b)(3)(ii).

transaction among the corporations ("distortion").[106]

The Department's regulations clarify that corporations must also be engaged in a unitary business to be included in a combined report.[107]

Certain corporations cannot be included in a combined report, even if the previously described substantial intercorporate transaction or distortion, ownership, and unitary business requirements are met, specifically alien corporations (corporations organized under the laws of a country other than the United States) and certain corporations that use special allocation provisions (aviation corporations and railroad and trucking corporations).[108] Additionally, the Department's regulations suggest that a pure holding company would not be properly includable in a combined report.[109]

Special combination rules apply to captive REITs, captive RICs, and overcapitalized captive insurance companies.[110]

b. *Computation of Tax*

Tax in a combined report is measured by the combined entire net income, combined minimum taxable income, or combined capital of the corporations included in the combined report.[111] In computing combined entire net income and combined minimum taxable income, intercorporate dividends must be eliminated.[112] In computing combined business and investment capital, incorporate stockholdings;

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[106] Tax Law § 211.4(a)(4).

[107] 20 NYCRR § 6-2.1(a).

[108] Tax Law § 211.4(a)(2), (3), and (5).

[109] 20 NYCRR § 6.2.3(e), Example 2.

[110] The terms "captive REIT," "captive RIC," and "overcapitalized captive insurance company" are defined in section 2 of the Tax Law. A captive REIT, captive RIC, or overcapitalized captive insurance company must be included in a combined report with the corporation that directly owns or controls over 50% of the voting stock of the captive REIT, captive RIC, or overcapitalized captive insurance company, or if that corporation is not subject to tax or included in a combined report under Article 9-A, be included in a combined report with the closest controlling stockholder. Tax Law § 210.4(a)(6), (7).

[111] Tax Law § 210.4(b)(1).

[112] Tax Law § 210.4(b)(2).

intercorporate bills, notes, and accounts receivable and payable; and other intercorporate indebtedness must be eliminated.[113] In computing combined subsidiary capital, intercorporate stockholdings must be eliminated.[114]

2. *Article 32* (Franchise Tax on Banking Corporations)

a. *Determining the Combined Group*

Article 32 currently has several standards for determining the banking corporations and bank holding companies that should be included in a combined group depending on the ownership relationship of the corporations at issue.

Mandatory Combination. An Article 32 taxpayer that owns or controls, directly or indirectly, 80% or more of the voting stock of one or more banking corporations or bank holding companies, or whose stock is owned or controlled, directly or indirectly, 80% or more by another banking corporation or bank holding company, is *required* to file a combined return with those banking corporations or bank holding companies, unless the Department or the taxpayer shows that the inclusion of the affiliated corporation fails to property reflect the tax liability of the corporation.[115] However, if a banking corporation or bank holding company meeting the 80% ownership requirement is not a "taxpayer" in New York, combined reporting may only be required if the banking corporation's or bank holding company's inclusion in the combined report is necessary in order to properly reflect the tax liability of one or more of the banking corporations or bank holding companies included in the combined group because of intercompany transactions or some agreement, understanding, arrangement or transaction existing between the taxpayer and any other combinable corporation, whereby the activity, business, income or assets of the taxpayer within New York State is improperly or inaccurately reflected.[116]

Discretionary Combination. An Article 32 taxpayer that owns or controls, directly or indirectly, 65% or more of the voting stock of one or more banking corporations or bank holding companies, or whose

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[113] *Id.*

[114] *Id.* at § 210.4(b)(2).

[115] *Id.* at §1462(f)(2)(i).

[116] Tax law § 1462(f)(2)(i).

stock is owned or controlled, directly or indirectly, 65% or more by a banking corporation or bank holding company, *may be required or permitted* to file a combined report with those banking corporations or bank holding companies if a combined report is necessary to "properly reflect" the tax liability of one or more of the banking corporations or bank holding companies.[117]

Similarly, banking corporations or bank holding companies that are 65% or more owned or controlled, directly or indirectly, by the same interest (i.e., entities in a brother-sister relationship) *may be permitted or required* to make a return on a combined basis if at least one of the banking corporations or bank holding companies is doing business in New York and a combined return is necessary to "properly reflect" the tax liability of any one or more of the banking corporations or bank holding companies.[118]

Tax liability of a banking corporation or bank holding company may be deemed to be "improperly reflected" because of intercompany transactions or where a taxpayer conducts its activity of business under any agreement, arrangement or understanding in such manner as either directly or indirectly to benefit its members or stockholders by entering into any transaction at more or less than fair price, or where a taxpayer has entered into any transaction with another corporation on such terms as to create an improper loss or net income.[119]

The Department's regulations clarify that corporations must also be engaged in a unitary business to be included in a combined report.[120]

Special combination rules apply to bank holding companies that, on or after January 1, 2000 and before January 1, 2015, register for the first time under the federal bank holding company act and elect to be a financial holding company and that own 65% or more of the voting stock of one or more banking corporations, which allow such bank holding companies to elect whether to be included in a combined return with its banking corporation subsidiaries.[121]

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[117] *Id.* at § 1462(f)(2)(ii).

[118] *Id.* at § 1462(f)(2)(iii).

[119] *Id.* at § 1462(f)(5), (g).

[120] 20 NYCRR § 21-2.3(b).

[121] Tax Law § 1452(f)(2)(iv).

Special combination rules also apply to certain credit card banks that that are subject to tax in New York solely by reason of the economic nexus provisions in section 1451(c)(1).[122]

Special combination rules also apply to captive REITs, captive RICs, and overcapitalized captive insurance companies.[123]

Alien corporations (corporations organized under laws of a country other than the United States) cannot be included in a combined return with domestic corporations (corporations organized under the laws of the United States).[124]

b. *Computation of Tax*

Tax in a combined return is measured by the combined entire net income, combined alternative net income, or combined assets of all of the corporations included in the return.[125] In computing combined entire net income and combined alternative net income, intercorporate dividends and all other intercorporate transactions are eliminated.[126] In computing combined assets, intercorporate stockholdings;

[122] Such credit card banks that meet the 80% ownership requirement described above cannot be included in a combined report unless inclusion of the credit card bank is necessary to properly reflect the tax liability of the credit card bank, banking corporation, or bank holding company. Tax Law § 1462(f)(2)(v). (Special rules also apply to credit card banks that were included in a combined return for its last taxable year beginning before January 1, 2008.) In addition, such credit card banks are *required* to file combined returns with banking corporations or bank holdings companies that are not "taxpayers" and that meet the 65% ownership requirements described above if the banking corporation or bank holding company provides services for or support to the credit card bank's operations, unless the credit card bank or Department shows that inclusion of any of those corporations in the combined return fails to properly reflect the tax liability of the credit card bank. *Id.*

[123] The terms "captive REIT," "captive RIC," and "overcapitalized captive insurance company" are defined in section 2 of the Tax Law. A captive REIT, captive RIC, or overcapitalized captive insurance company must be included in a combined report with the corporation that directly owns or controls over 50% of the voting stock of the captive REIT, captive RIC, or overcapitalized captive insurance company, or if that corporation is not subject to tax or included in a combined report under Article 32, be included in a combined report with the closest controlling stockholder. Tax Law § 1452(f)(2)(v) and (vi).

[124] Tax Law § 1452(f)(4).

[125] *Id.* at § 1462(f)(3).

[126] *Id.*

intercorporate bills, notes, and accounts receivables and payables; and other intercorporate indebtedness are eliminated.[127]

The allocation percentage for the combined group is computed based on the combined factors of all the corporations included in the combined return.

B. Proposed Changes

Section 18 of Part A of the Budget Bill would repeal the current combined reporting provisions in section 211.4 and would adopt a new combined reporting regime in new section 210-C. In addition, the combined reporting provisions in section 1462(f) would be repealed by reason of the repeal of Article 32 in Section 1 of Part A of the Budget Bill and corporations currently subject to those provisions would be subject to the combined reporting regime in new section 210-C.

1. *Determining the Combined Group*

Under new section 210-C.2, a taxpayer[128] would be *required* to file a combined report with other corporations that are engaged in a unitary business with the taxpayer if (1) the taxpayer owns or controls, directly or indirectly, more than 50% of the capital stock of one or more other corporations, (2) more than 50% of the capital stock of the taxpayer is owned or controlled, directly or indirectly by one or more other corporations, or (3) more than 50% of the capital stock of the taxpayer and of one or more other corporations is owned or controlled, directly or indirectly, by the same interests. Thus, all taxpayers engaged in a unitary business and that meet the required ownership thresholds would be required to file a combined report (except as provided below). The presence (or lack) of substantial intercorporate transactions or distortion would no longer be relevant to determining the combined group, representing a significant departure from the current combined reporting regimes in Article 9-A and Article 32. The more-than-50% common ownership requirement for corporations included in a combined report is also

[127] *Id.*

[128] The term "taxpayer" is still defined by Tax Law § 208.2 as "any corporation subject to tax under [Article 9-A]."

lower than the current 80% ownership threshold in Article 9-A and the current 80% and 65% ownership thresholds in Article 32.

In addition, under new section 210-C.3, a taxpayer may elect to treat as its combined group all corporations that meet the more-than-50% ownership requirements described above ("commonly owned group"), regardless of whether the corporations are part of a single unitary business. This election must be made on an original timely filed return of the combined group. Any corporation entering the commonly owned group after the year of the election will be included in the combined group. The election will be irrevocable and binding for the year in which it was made and for the next six taxable years. After the election has been in effect for seven taxable years, the election will automatically be renewed for another seven taxable years unless it is affirmatively revoked on an original, timely filed return for the first taxable year after the completion of the seven year period. If the election is revoked, a new election will not be permitted for any of the three immediately following taxable years. Short taxable years would not be considered or counted for purposes of determining the seven-year and three-year periods for purposes of the election. This elective commonly owned group concept would also be a significant departure from current law, as current law does not provide for such an election.

Corporations includible in a combined report would include captive REITs and captive RICs[129] if the captive REIT or captive RIC is not required to be included in a combined report under Article 33, combinable captive insurance companies, and alien corporations if the alien corporation is treated as a "domestic corporation" as defined in section 7701 of the Internal Revenue Code or the alien corporation has "effectively connected income" for the taxable year.

Although captive REITs and captive RICs are already includible in combined reports under current law, the treatment of captive insurance companies and alien corporations under the proposal would be a significant departure from current law. Alien corporations are not currently permitted to file combined reports with domestic corporations; the proposal would eliminate this prohibition in the case of alien corporations treated as domestic corporations or with effectively connected income. Also, under current law, only "overcapitalized captive insurance companies" are includible in a combined report, and an "overcapitalized captive insurance company" is a captive insurance company that, among other things, has

[129] These terms are still defined in section 2 of the Tax Law.

50% or less of its gross receipts for the taxable year from premiums ("overcapitalization requirement"). The proposal would rename an "overcapitalized captive insurance company" as a "combinable captive insurance company" and repeal the overcapitalization requirement, meaning that a broader group of captive insurance companies will be included in combined reports.

The following corporations may not be included in a combined report (even if a commonly owned group election is made): (1) a corporation that is taxable under Article 9 or Article 33, (2) a REIT or RIC that is not a captive REIT or a captive RIC, (3) a New York S corporation, (4) a corporation that is subject to tax under Article 9-A solely as a result of its ownership of a limited partnership interest in a limited partnership that is doing business, employing capital, owning or leasing property, maintaining an office, or deriving receipts from activity in New York, and (5) an alien corporation that has no effectively connected income for the taxable year.

The combined report must be filed by the designated agent of the combined group.

2. *Computation of Tax*

Tax on a combined report (whether filed by a unitary combined group required to file a combined report or a commonly owned group electing to file a combined report) would be imposed on the highest of (1) the combined business income base multiplied by the tax rate specified in 210.1(a) applicable to the business income base, (2) the combined capital base multiplied by the tax rate specified in 210.1(b) applicable to the capital base (but not exceeding the limitations in 210.1(b)), or (3) the fixed dollar minimum tax attributable to the designated agent of the combined group. Tax on a combined report would also include the fixed minimum tax for each member of the combined group (other than the designated agent) that is a "taxpayer." In computing the tax bases for a combined report, the combined group will generally be treated as a single corporation.

The combined business income base would be the amount of the combined business income of the combined group that is apportioned to New York reduced by any net operating loss deduction for the combined group. In computing combined business income, all intercorporate dividends must be eliminated, and all other intercorporate transactions must be deferred in a manner similar to the section 1502 of the Internal Revenue Code.

A net operating loss deduction would be allowed in computing the combined business income base and will reduce the tax on the combined income base to the higher of the tax on the combined capital base or the fixed dollar minimum. The combined net operating loss deduction will be equal to the amount of combined net operating loss or losses from one or more taxable years that are carried forward to a particular income year. A combined net operating loss is the combined business loss incurred in a particular taxable year multiplied by the combined apportionment fraction for that year and is subject to the provisions in section 210.1(a)(viii). The combined net operating loss deduction is determined as if the combined group is a single corporation and is subject to the same limitations that would apply for federal income tax purposes as if such corporations had filed a consolidated federal income tax return with the same corporations included in the combined report. The portion of a combined loss attributable to any member of the group that files a separate report for a succeeding taxable year will be an amount bearing the same relation to the combined loss as the net operating loss of such corporation bears to the total net operating loss of all members of the group having such losses to the extent they are taken into account in computing the combined net operating loss.

In determining the apportionment factor for a combined report, the receipts, net income, net gains and other items of all members of the combined group, regardless of whether they are taxpayers, would be included. This approach (known as the "*Finnigan*" approach) would codify the decision in *Disney Enterprises, Inc. v. Tax Appeals Tribunal.*[130] All intercorporate receipts, income, and gains are eliminated.

The combined capital base would be the amount of the combined capital of the combined group that is apportioned to New York. In computing combined capital, all intercorporate stockholdings, intercorporate bills, intercorporate notes receivable and payable, intercorporate accounts receivable and payable, and other intercorporate indebtedness must be eliminated.

Qualification for credits, including any limitations thereon, will be determined separately for each of the members of the combined group, except as otherwise provided. However, credits will be applied against the combined tax of the group.

[130] 10 N.Y.3d 392 (2008)

Elections made pursuant to section 208.6(c) (relating to investment income), 208.6-a(b) and (c) (relating to other exempt income and exempt unitary corporation dividends), and 210-A.5(a) (relating to qualified financial instruments) shall apply to all members of the combined group.

3. *Other*

Every member of the combined group "that is subject to tax under [Article 9-A]" will be jointly and severally liable for the tax due pursuant to a combined report.

Each combined group will have one designated agent, which must be a "taxpayer." The designated agent is the parent corporation of the combined group, unless there is no such parent corporation or the parent corporation is not a "taxpayer," in which case another member of the combined group that is a "taxpayer" may be appointed as the designated agent. Only the designated agent may act on behalf of members of the combined group for matters relating to the combined report.

C. Comments

Ownership Requirements. With respect to the more-than-50% ownership requirement (which is met if (1) the taxpayer owns or controls, directly or indirectly, more than 50% of the capital stock of one or more other corporations, (2) more than 50% of the capital stock of the taxpayer is owned or controlled, directly or indirectly by one or more other corporations, or (3) more than 50% of the capital stock of the taxpayer and of one or more other corporations is owned or controlled, directly or indirectly, by the same interests), the term "capital stock" is not defined. Although the Department's current regulations indicate that capital stock is "voting stock,"[131] it is common for corporations to provide certain classes of stock with the right to vote only on particular issues. The statute should clarify that capital stock is stock that has voting rights. Additionally, we recommend that a regulation be adopted to provide a general rule that such stock must have voting rights for the election of the board of directors (unless it is shown that actual voting power over corporate activities resides elsewhere), which is an appropriate measure of ownership or control over a corporation. In this context, the regulations should also address stock that has the right to vote for directors only if a contingency occurs, which we believe should be treated as voting stock only if and when that contingency occurs.

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[131] 20 NYCRR § 6-2.2(a)(3).

With respect to the second prong of the more-than-50% ownership requirement test, we assume that the intent of this provision is to require a taxpayer to file a combined return with a parent corporation if that parent corporation owns, directly or indirectly, more than 50% of the taxpayer's capital stock. The spirit of unitary combined reporting is to capture the many unquantifiable transfers of value that take place among the components of a single business enterprise.[132] In a situation where no single corporation controls more than 50% of the capital stock of a taxpayer, the taxpayer and its owner should arguably be viewed as independent taxpayers. However, as drafted, a taxpayer could be required to file a combined report with multiple parent corporations if those parent corporations collectively own more than 50% of the taxpayer's capital stock; it is difficult to imagine how the unitary business requirement could be met in such a case due to lack of "control." Since control is a hallmark of unitary combined reporting, the Tax Section recommends amending the language of the more-than-50% ownership test to read "more than fifty percent of the capital stock of which is owned or controlled either directly or indirectly by another corporation."[133]

The "indirect" requirement (in clause 2 and 3 above) may also raise additional confusion in the application of this concept in a multi-tier subsidiary situation if it were applied in a way that allows a single corporation to be included in two separate combined returns. For example, suppose P, a taxpayer, owns 80% of S and S in turn owns 60% of T. Under the Budget Bill, P and S would file a combined report (assuming that they are unitary) and S and T would file a combined report (assuming that they are unitary). However, based on an application of the Budget Bill provisions, it is unclear as to whether P can be combined with T because P does not indirectly own 50% of T (P owns 48% of T). Alternatively, assume that P (a corporation) owns 100% of the stock of four subsidiaries (A, B, C and D) and A, B, C and D each own 25% of the stock of S (another corporation). If ultimate control is what is required (and should be required in the spirit of unitary combined reporting), such intention would be better served through a clear codification that the more-than-50% ownership test should be performed at each level. In the examples

[132] *See, e.g., Mobil Oil Corp. v. Comm'r of Taxes, Vermont,* 445 U.S. 425 (1980).

[133] Current section 211.4 contains this same "one or more other corporation" language, but the Department's regulations clarify that this ownership requirement is met only when "substantially all of the capital stock of the taxpayer is owned or controlled, either directly or indirectly, by another corporation." 20 NYCRR § 6-2.2 (emphasis added).

above, such a codification should result in all of the corporations being included in a single combined return.

Includable Corporations. Under the proposal, combination hinges on whether corporations are engaged in a unitary business. Since the substantial intercorporate transaction and distortion requirements are often at the center of controversies involving combined reporting, the elimination of those requirements could significantly reduce the controversies (both on audit and in litigation) surrounding composition of the combined group.

The Budget Bill does not define a unitary business and so controversies regarding what constitutes a unitary business could become common. Nonetheless, various tests for a unitary business have developed through federal and New York case law and through the Department's regulations, and such tests require a facts and circumstances analysis.

The Budget Bill also does not address situations where a corporation that is not includible in a unitary combined report (e.g., a corporation taxable under Article 33) provides the unitary link among a group of corporations that are taxable under Article 9-A.

Additionally, the proposal does not address combination with pure holding companies. To the extent that a holding company has no tangible assets and no employees, as a theoretical matter, such holding company may not be "unitary" with other members of the combined group. If exclusion of pure holding companies from the combined report is intended, such intention would be better served through a clear codification of such a requirement and a definition of a pure holding company. This is consistent with New York's current practice and is common throughout the country.

With respect to corporations that may not be included in a combined report, certain portions of new subsections 210-C.2(b) and (c) are confusing and potentially contradictory. First, new section 210-C.2(c)(iv) provides that corporations "required or permitted" to file a combined report do not include "a corporation that is subject to tax under [Article 9-A] solely as a result of its ownership of a limited partnership interest in a limited partnership that is doing business, employing capital, owning or leasing property, maintaining an office, or deriving receipts from activity in [New York] [(i.e., "corporations with limited partnership nexus")], *provided that the corporation is not otherwise required to file a combined* *report pursuant to this section"*[134] The italicized language in the preceding quote appears to conflict with the introductory clause of 210-C.2(c), which states that "a corporation *required or permitted* to make a combined report under this section does not include...."[135] If the intent of this provision is *include* corporations with limited partnership nexus in a mandatory unitary combined report but to *exclude* them from the elective commonly owned group report, clarifying edits are be needed to this section. If the intent of this provision is to exclude corporations with limited partnership nexus from *all* combined reports (required unitary combined reports and elective commonly owned group reports), the "provided that the corporation is not otherwise required to file a combined report pursuant to this section" language should be deleted.

New section 210-C.2(b) states that alien corporations that meet the more-than-50% ownership and unitary business requirements must be included in a combined report if the corporation is treated as a "domestic corporation" as defined in section 7701 of the Internal Revenue Code *or* if it has "effectively connected income" as determined under section 882 of the Internal Revenue Code for the taxable year. New section 210-C.2(c)(v), on the other hand, excludes from corporations "required or permitted" to file a combined report "an alien corporation that has no effectively connected income for the taxable year." If the intent is to include alien corporations that are "deemed domestic" corporations in a combined report, the language in section 210-C.2(c)(v) should be clarified inasmuch as the concept of "effectively connected income" under section 882 of the Internal Revenue Code does not apply to alien corporations that are treated as "domestic corporations."

Apportionment Issues. As previously noted, the Budget Bill adopts the so-called *Finnigan* approach in determining the apportionment factor for a combined report by including the receipts, net income, net gains and other items of all members of the combined group, regardless of whether they are taxpayers. This approach has been approved by the New York State Court of Appeals.[136] An alternative approach that state's have taken is to adopt the so-called *Joyce* approach, under which the apportionment

[134] Emphasis added.

[135] Emphasis added.

[136] *In the Matter of Disney Enterprises, Inc. v. Tax Appeals Tribunal,* 10 N.Y.3d 392,888 N.E.2d 1029, 37, 859 N.Y.S.2d 87 (2008).

factor for a combined report is determined by including in the numerator of the receipts factor the receipts, net income, net gains and other items of only members of the combined group that are taxpayers in the state.

Computation Issues. With respect to computing the tax in a combined return, the Budget Bill's approach should be commended. Under current law, there is only limited guidance with respect to intercorporate transactions. The proposal provides clear rules for taxpayers and the Department by providing that intercorporate dividends are to be eliminated and by requiring that all other intercorporate transactions be deferred in a manner similar to section 1502 of the Internal Revenue Code. In addition, under current law, there is sparse guidance regarding the treatment of net operating losses and credits in a combined report so the additional guidance in the proposal with respect to net operating losses and credits should provide more clarity to taxpayers and the Department. These changes should facilitate tax compliance.

The proposal provides useful guidance on how net operating losses and net operating loss deductions would be computed when a corporation leaves a combined group that has net operating loss carryovers. However, the proposal does not explain how net operating loss deductions will be computed or applied when a corporation with net operating loss carryovers joins a combined group.

Additionally, the Budget Bill does not address the consequences or transitional effects of corporations leaving existing combined report groups or joining existing or new combined report groups. For example, certain tax consequences (deferred intercompany gains, etc.) can be triggered when a corporation leaves a combined group. In addition to corporations moving from one article (Article 32) to another (Article 9-A), corporations may be joining existing combined groups for the first time because of the reduction of the stock ownership requirement from 80% under the current law to 50% under the new law and the inclusion of additional types of corporations in a combined group (e.g., certain alien corporations and combinable captive insurance companies). Given the potential tax consequences that could result from such a transition, it may be prudent to provide that gain or loss will not be triggered as a result of changes in the composition of the New York combined report groups as a result of this legislation in the first taxable year in which this legislation is effective.

VII. Tax Attributes

A. Proposed Changes (Net Operating Losses)

Section 12 of Part A of the Budget Bill establishes a new regime for net operating loss ("NOL") carryovers and deductions. Section 18 contains rules for computing an NOL deduction in the case of an Article 9-A combined report. Although the Budget Bill does not allow NOL carryovers originating in tax years beginning prior to January 1, 2015, it permits those existing NOL carryover amounts to be converted into a "prior NOL conversion tax subtraction" available to taxpayers over a prescribed period.

1. *NOL Deduction and Carryforward*

Under the Budget Bill, a corporate taxpayer's Article 9-A NOL deduction for a tax year would no longer be limited to the "amount allowed" for federal income tax purposes under IRC § 172. In addition, it would not require that the claimed NOL deduction originate in the same source year as the federal NOL deduction for that tax year. This avoids two of the more vexing problems currently faced by taxpayers. First, the existing law limits a taxpayer's NOL deduction to the amount actually deducted for federal income tax purposes for that year (which, because of various adjustments that can increase Article 9-A taxable income beyond federal taxable income, often denies to taxpayers the full NOL benefit). Second, under existing law, the NOL deduction must have arisen in the same source year as the losses deducted for federal purposes. Both of these limitations have resulted in litigation, much of which has been unfavorable to taxpayers.[137] The Budget Bill retains the requirement that an NOL deduction is not allowed for an NOL generated in a year in which the taxpayer was not subject to tax in New York.

Section 12 of Part A also codifies the existing policy that where a taxpayer files on a federal consolidated basis, but files separately under Article 9-A, the Article 9-A NOL deduction is computed as "as if" the taxpayer had filed on a separate basis for federal income tax purposes. In the case of an Article 9-A combined report, the Budget Bill would continue the separate return limitation year rules applicable for federal income tax purposes that currently exist under the Article 9-A regulations.

The Budget Bill would conform the Article 9-A carryforward period to the 20-year federal carryforward period. In doing so, it would eliminate the existing Article 9-A NOL carryback, which only

[137] *See, e.g., Aetna Casualty & Sur. Co. v. Tax Appeals Trib.*, 214 A.D.2d 238 (3d Dep't 1995); *Matter of Refco Properties, Inc.*, DTA NO. 812292 (N.Y.S. Tax App. Trib., Jul. 11, 1996); *Matter of Lehigh Valley Indus., Inc.*, DTA No. 801617 (N.Y.S. Tax App. Trib., May 5, 1988).

applies to the first $10,000 of loss. Since net investment income would no longer be subject to tax, the NOL carryforward would arise from business losses only, and could be offset against a corporate taxpayer's apportioned business income. The amount of the NOL available for carryforward would be computed after the NOL has been used to reduce business income in a tax year to the amount that triggers either the tax on capital or the fixed dollar minimum tax.

2. Prior *NOL Conversion Subtraction*

Section 12 of Part A of the Budget Bill contains an important provision regarding NOL carryovers generated in earlier tax years, which would no longer be available for carryforward. The Budget Bill provides that taxpayers would be allowed to convert their existing unabsorbed NOL carryforward amounts into a "prior NOL conversion subtraction" that could be used to reduce the taxpayer's business income to the amount that results in the highest tax being the tax on capital or the fixed dollar minimum tax in tax years beginning on or after January 1, 2015. The Budget Bill first provides for the calculation of a "prior NOL conversion subtraction pool" ("NOL subtraction pool") calculated as follows: For a taxpayer's last tax year beginning on or after January 1, 2014 and ending before January 1, 2015 ("base year"), the taxpayer would first multiply the amount of its unabsorbed NOL which "was eligible for carryover" on the last day of the base year by its base year business income apportionment percentage ("BAP"), and then multiply that amount by its base year tax rate (for most corporate taxpayers, at 7.1%). The taxpayer would then divide that amount by 6.5% (or 5.7% for qualified New York manufacturers) to arrive at its NOL subtraction pool amount available for future use.

Other than for small business corporations, the amount of a taxpayer's prior NOL conversion subtraction ("NOL conversion subtraction") available in a tax year would equal 1/10 of the NOL subtraction pool amount, plus any amount of its unused NOL conversion subtraction from prior year.. Small businesses, however, could claim the entire NOL conversion subtraction in a single taxable year. Any amount of a taxpayer's unused NOL conversion subtraction would be available for future use until the years beginning on or after January 1, 2036. In all cases, the taxpayer must first claim the NOL conversion subtraction for the tax year before it claims any net operating loss deduction for that year.

In the case where taxpayers file an Article 9-A combined report for the base year and the members of the combined group for that year are the same as the members of the combined group for the tax year immediately succeeding the base year, the combined group would calculate its NOL subtraction pool amount using the combined group's total unabsorbed NOL, base year BAP, and base year tax rate. Where an Article 9-A combined report for post-2014 tax years includes additional members that were not previously included in the combined report in the base year, each individual combined group and separately filing taxpayer would calculate its own NOL subtraction pool amount for the base year. The sum of those amounts would be the NOL subtraction pool amount for the entire Article 9-A combined group.

B. Comments (Net Operating Losses)

We agree with the approach in the Budget Bill to include detailed NOL rules, rather than leaving them for interpretation by regulation or possibly through litigation. Under the existing law, the Article 9-A NOL deduction is tied to the amount actually deducted for federal income tax purposes. Although this affords some level of certainty to taxpayers, it can result in the forfeiture of bona fide NOL deductions in a situation where a taxpayer's Article 9-A taxable income, because of New York State additions to federal income, exceed its federal taxable income for that same year.

Although we have not considered whether there is a more straight-forward way of allowing taxpayers to utilize existing NOLs in future tax years, we believe the NOL subtraction pool provision, as drafted, will preserve the existing NOLs for future use over a reasonable period of time.

We believe, however, that there may be an ambiguity under the Budget Bill regarding the calculation of the NOL subtraction pool amount. Section 12 of Part A provides that the taxpayer must start the calculation of the NOL subtraction pool by multiplying its "unabsorbed net operating loss" by its base year BAP and base year tax rate. The taxpayer's "unabsorbed net operating loss" is defined as the unabsorbed portion of its NOL under the law that 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 loss sustained by the taxpayer during the base year." (emphasis added). One way of interpreting this language is to treat the existing NOL limitations -- requiring conformity with both the federal source year and with the amount actually deducted for federal purposes -- as applying only in determining the NOL *deduction*, and not in determining the amount "eligible for carryover." Under that interpretation, a taxpayer that as of the close of the base year had $100 of Article 9-A NOL, but only $60 of federal NOL carryforward, would calculate its NOL subtraction pool amount using the $100 NOL amount as being the amount "eligible for carryover."

The more likely—but by no means clear—interpretation of the phrase "eligible for carryover" is that it refers to the NOL amount that could have carried forward and deducted under the law as it existed on December 31, 2014. In that case, the federal source year and actual deduction amount limitations in the above example would have resulted in an NOL available for use of only $60. This would appear to be consistent with the intent of the Budget Bill to allow taxpayers to preserve through the NOL conversion subtraction what the law as it existed on December 31, 2014 would have allowed them to claim as an NOL deduction. If that is what is intended, for clarity we suggest the insertion of the following underscored language to the definition of "unabsorbed net operating loss" contained on page 4 of the Executive Budget 30-Day Amendment Sheet, making changes to page 45, line 22 of the Budget Bill:

> (II) "Unabsorbed net operating loss" mean the unabsorbed portion of net operating loss as calculated under [§208(9)(f) of Article 9-A or §1453(k-1) of Article 32], as such sections were in effect on [December 31, 2014], that was not deductible in previous taxable years, and was eligible for carryover <u>subject to the limitations for deduction under those sections</u>, on the last day of the base year, including any net operating loss sustained by the taxpayer during the base year.

To avoid the potential uncertainty regarding the amount of the NOL subtraction pool available for carryforward, if the Budget Bill is enacted, we recommend that the Department establish an administrative procedure so that taxpayers can timely obtain binding approval of the NOL subtraction pool amount for the base year.

C. <u>Proposed Changes (Tax Credits)</u>

Under Section 17 of Part A of the Budget Bill, nearly all of the existing tax credits under Article 9-A and the bank tax will remain in effect, in addition to certain new tax credits.[138] The Budget Bill would impose a limitation on a taxpayer seeking to avail itself of a tax credit. Specifically, for any tax

[138] Section 15 of the Part A repeals the existing tax credits, and Section 17 reenacts the credits, except to the extent covered in Part R of the Budget Bill.

year in which a tax credit is sought, the taxpayer would be required to claim the credit "on its originally filed report for such taxable year," and may "not first claim a credit on an amended report," except in certain limited circumstances. Specifically, the Budget Bill would permit a taxpayer to first claim a credit on an amended report only if one or more of the following circumstances apply: (i) the taxpayer's eligibility for, or the amount of, the credit is determined by a government agency (other than the Department of Taxation and Finance); (ii) at the time the taxpayer filed its original report for the tax year, it had not received an information return containing the information necessary to determine its eligibility for, or the amunt of, the credit; or (iii) the taxpayer was required to file an amended report in order to report final federal changes for reasons that also impacted the taxpayer's eligibility for, or the amount of, the tax credit.

1. *Investment Tax Credit Changes*

Part R of the Budget Bill would make significant changes to the investment tax credit ("ITC") for qualified manufacturing. In addition, the Budget Bill would repeal in its entirety the ITC available to the financial services industry. Those changes would be effective for tax years beginning on or after January 1, 2014, one year earlier than the effective date for the rest of the Budget Bill.

With respect to the ITC available for manufacturing, the Budget Bill would restrict its availability principally to "qualified New York manufacturers," a term derived from the existing definition of manufacturers that qualify for a reduced Article 9-A tax rate.[139] A "qualified New York manufacturer" would be defined as a manufacturer with property in New York State that is used in manufacturing and either (i) the fair market value of that New York State property at the close of the tax year is at least $10 million, or (ii) all of the manufacturer's real and personal property is located in New York State. The term "qualified New York manufacturer" would also include a taxpayer or combined group that does not qualify as a "manufacturer" under the tax law, but that employs during the taxable year at least 2,500 employees in manufacturing in the State and has property used in manufacturing in the State with a federal income tax adjusted basis at the close of the tax year of at least $100 million.

[139] The ITC would also be available to qualified New York agricultural businesses and qualified New York mining businesses.

The Budget Bill also restricts the application of the ITC to tangible personal property used by a taxpayer in the production of goods "for sale" (or to research and development property). Property used in the production of goods "for sale" includes tangible personal property principally used in the repair and service of tangible property used for the production of goods for sale, and includes "all facilities used in the production operation including storage of material to be used in the production and the products that are produced." This is a somewhat narrower definition than under current law, which does not specifically require that the manufactured goods be "for sale."

An existing business may carry over any excess credit and claim it against its tax over the next 15 years. A new business may elect to treat the carryover amount as an overpayment of tax to be credited or refunded at its option.

2. *Repeal of ITC for the Financial Services Industry*

Under the Budget Bill, the ITC available to the financial services industry would be completely repealed, effective for tax years beginning on or after January 1, 2014. Part R, §23. Section 17 of Part A provides that taxpayers may "utilize any carryforward amounts of credits to which the taxpayer was entitled as of the close of the taxable year beginning on or after [January 1, 2014] and before [January 1, 2015]."

D. Comments (Tax Credits)

We question the need for imposing a new limitation on the ability of a taxpayer to claim tax credits on an amended report. Imposing this limitation would have the effect of penalizing taxpayers that make an innocent mistake on their originally filed report in not claiming the tax credit. A taxpayer would not ordinarily have an incentive for delaying a bona fide tax credit claim on its originally filed report. Moreover, a taxpayer that first claims a tax credit on an amended Article 9-A report would not be entitled to interest on any resulting refund for the period prior to the date the amended report was filed.[140]

Although the Budget Bill does contain certain limited exceptions under which a taxpayer would be entitled to first claim tax credits on an amended report, we believe that whether or not a taxpayer qualifies for the exception will sometimes not be clear. For example, a taxpayer first claiming a tax credit on an amended report because it did not timely receive an information return will be forced to prove to the

[140] Tax Law §1088(a)(3).

Department not only that it did not timely receive the information return, but that it did not otherwise have access to the necessary information when it filed its original report. This could lead to audit disputes, all merely to enable a taxpayer to claim entitlement to a tax credit for a year in which the statute of limitations for credit or refund remains open.

The requirement in the Budget Bill that the credit must be claimed on a taxpayer's originally filed report, except under certain limited circumstances, is more consistent with the common law "doctrine of election." Under that doctrine, once a taxpayer makes an elective choice to file a tax return in a certain way, fairness and ease of administration require that the taxpayer be bound by its initial choice as reflected on its original tax return.[141] Since a tax credit is not a taxpayer "election," we believe that so long as the tax year remains open for assessment or refund, a taxpayer should not have its right to claim a tax credit on an amended report restricted in such a potentially harsh and arbitrary way.

Although we express no view as to the appropriateness of the repeal of the ITC for the financial services industry as a matter of policy, we believe the law should safeguard taxpayers that detrimentally relied on the availability of the ITC prior to the release of the Budget Bill on January 21, 2014. Section 46 of Part A permits a taxpayer to carry forward the repealed ITC "to which the taxpayer was entitled" as of the close of the tax year beginning on or after January 1, 2014 and January 1, 2015. However, in order to claim the ITC, the qualifying property must have been both purchased and placed in service by the taxpayer. Thus, the Budget Bill appears to deny any ITC for qualifying property not purchased and placed in service prior to January 1, 2014.

We believe that, notwithstanding its repeal, the ITC should continue to be available for a taxpayer that on or before January 20, 2014 entered into a binding written contract to purchase the qualifying property, regardless of when the property was eventually placed in service. If preferable for fiscal reasons, this grandfathering protection could be further limited by requiring that the purchased property be placed in service no later than December 31, 2014.

VIII. Metropolitan Transportation Business Tax Surcharge ("MTA Surcharge")

A. Current Law

[141] *Pacific National Co. v. Welch*, 304 U.S. 191 (1938); *United States v. Helmsley*, 941 F.2d 71 (2d. Cir. 1991).

For tax years beginning after 1981 and ending before December 31, 2018, corporations exercising a corporate franchise, doing business, employing capital, or owning or leasing property in the metropolitan commuter transportation district ("MCTD") are subject to the MTA surcharge.[142] The metropolitan commuter transportation district includes the city of New York and the counties of Dutchess, Nassau, Orange, Putnam, Rockland, Suffolk and Westchester.[143]

The MTA surcharge is computed on that portion of the taxpayer's tax attributable to its business activities carried on within the MCTD. The allocation percentage is the average gross assets of the taxpayer employed in any business in the MCTD during the tax year divided by the average gross assets of the taxpayer employed in any business within New York State during the same period.[144]

B. Proposed Changes

Part A of the Budget Bill appears to make the MTA surcharge permanent as imposed under all articles.[145]

In addition, the MTA base and apportionment rules for the MTA surcharge imposed under Article 9-A would conform to the proposed New York Article 9-A rules, including the imposition of economic nexus with a de minimus standard.[146] The base used to compute the MTA surcharge would be the tax imposed under Article 9-a before

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[142] Tax Law §§ 183, 183-a, 184, 184-a, 186-a, 186-e, 189.

[143] *Id.*

[144] NYCRR20 § 40.1.

[145] Budget Bill Part A § 7; Tax Law § 209-B.

[146] *Id.*

credits, instead of the current rule allowing for the base to be based on tax after credits.[147] Further, the tax rate would be increased to 24.5%.[148]

C. Comments

In order to ensure ease of administrability and avoid the existence of compliance burdens, the Tax Section supports the conformity of the base and apportionment rules of the MTA surcharge to those under Article 9-A.

IX. Other Provisions

A. Repeal of the Organization Tax and Taxes on Changes of Capital on Domestic Corporations

1. Current Law

In general, section 180 provides that every stock corporation incorporated under any law of New York and every corporation formed under the business corporation law of New York, shall pay tax upon the amount of the par value of all shares of stock with a par value that such a corporation is authorized to issue and a tax on each share of stock without par value that such a corporation is authorized to issue, and a like tax upon any shares subsequently authorized. The tax is either one-twentieth of one per centum upon the amount of the par value of all the shares with a par value or five cents on each share without a par value. In no case, however, shall the tax be less than ten dollars. Such tax is due and payable upon the incorporation of such corporation and upon any subsequent increase of par value or change in number of authorized or issued shares of stock.

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[147] *Id.*

[148] *Id.*

2. Proposed Changes

Part A, section 2 of the Budget Bill proposes to repeal section 180 in its entirety.

3. Comments

The proposal is beneficial, and we recommend its adoption and passage. The elimination of this tax will decrease compliance burdens imposed upon taxpayers and the business community. Simplification and the streamlining of the Tax Law by eliminating this tax will also correspondingly ease administration burdens imposed upon the Department of Taxation and Finance. Further, as a general matter, tax policy should encourage business formation and the elimination of a tax imposed upon business formation or which otherwise restricts flexibility in changing capital structure, even modestly, should foster this goal. Particularly in light of the relatively modest tax receipts generated by this tax, the benefits of simplification favor repeal.

B. Repeal of the License and Maintenance Fees on Foreign Corporations

1. Current Law

In general, section 181 provides that every foreign corporation (with the exception of several exempt corporation types—including banking corporations and certain insurance corporations) doing business in New York shall pay a license fee for the privilege of exercising a corporate franchise or carrying on business in New York. The fee is one-twentieth of one per centum on such corporation's issued par value capital stock employed within New York and five cents on each share of such corporation's capital stock without par value employed within New York. The license fee is in addition to the annual corporate franchise tax and is payable only once, unless such corporation's capital share structure has changed or the amount of its capital stock employed in New York has increased since the last license fee return was filed.

Section 181 also provides that every foreign corporation (with the exception of several exempt corporation types—including banking corporations and certain insurance corporations) shall pay an annual maintenance fee of approximately $300.00. The fee is payable annually until (a) such time that the corporation has filed a certificate of surrender of authority, (b) the time to annul the suspension of authority of the corporation to do business in New York has expired, or (c) the authority of the corporation to do business in New York has been annulled. The annual maintenance fee paid by such foreign corporations may be claimed as a credit against the corporate franchise tax.

2. Proposed Changes

Part A, section 3 of the Budget Bill proposes to repeal section 181 in its entirety.

3. Comments

The proposal is beneficial, and we recommend its adoption and passage. The elimination of this tax, similar to the elimination of the tax imposed under Section 180 of the Tax Law, will decrease compliance burdens imposed upon taxpayers and the business community. Simplification and the streamlining of the Tax Law by eliminating this tax will also correspondingly ease administration burdens imposed upon the Department of Taxation and Finance. Particularly in light of the relatively modest tax receipts generated by this tax, the benefits of simplification favor repeal.

C. Repeal of the Stock Transfer Tax

1. Current Law

In general, Tax Law § 270 imposes an excise tax on the sale, delivery or transfer in New York of shares or certificates of stocks and stock rights. The tax is either two and one-half cents for each share or, in cases where the shares or certificates are sold, the tax shall be at the rate of one and one-quarter cents for each share where the selling price is less than five dollars per share; two and one-half cents for each share where the selling price is five dollars or more per share and less than ten dollars per share; three and three-quarters cents for each share where the selling price is ten dollars or more per share and less than twenty dollars per share; and five cents for each share where the selling price is twenty dollars or more per share. The maximum tax for any transaction cannot exceed $350. However, since October 1981, all taxpayers are entitled to a 100% rebate of the tax paid, provided a rebate claim is made within two years of payment.

2. Proposed Change

Part CC, section 1 of the Budget Bill proposes to repeal the stock transfer tax in its entirety.

3. Comments

Consistent with our prior recommendations, the Tax Section strongly supports the repeal of the stock transfer tax in its entirety. Since October 1981, the stock transfer tax has generated minimal revenue. However, it could not be repealed in 1981 because the revenues were pledged to secure certain MAC bonds. Under the terms of the Municipal Assistance Corporation Refinancing Act, all MAC bonds were retired as of July 1, 2008. As such, as of that date, revenues from the stock transfer tax were no longer needed to secure MAC bonds. With little to no current beneficial impact, the implementation of the tax merely serves to create unnecessary compliance and administrative burdens on taxpayers and the Department.

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Section Chair: David H. Schnabel, Esq.