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On the Subject

State & Local Tax

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This is the fifth installment of a series that takes an inside look at the corporate tax reform proposals in Governor Andrew Cuomo's 2014–15 New York Budget Bill. This proposed reform is sweeping and, if enacted, is likely to result in major changes for many New York corporate taxpayers. This installment of Inside the New York Budget Bill examines the Budget Bill's provisions regarding net operating losses and the most significant changes and additions regarding tax credits.

Inside the New York Budget Bill

Part Five: Net Operating Losses and Tax Credits

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Since the release of the Budget Bill, there have been amendments made to the Budget Bill itself (the so-called 21-day and 30-day amendments), and the Assembly and the Senate each have released versions of the proposed legislation, with the most recent versions being the "C" bills, Assembly Bill No. 8559C and Senate Bill No. 6359C. Each bill differs from the Budget Bill in certain respects. Since it is expected that the legislature and governor will continue to debate various key provisions of the proposed legislation (the constitutional deadline for enactment is April 1, 2014), this installment of Inside the New York Budget Bill addresses the Budget Bill's proposals, as well as significant changes made to the Budget Bill's proposals by the Assembly and Senate, regarding net operating losses (NOLs) and tax credits, as relevant.

Net Operating Losses

Under current law, taxpayers are allowed an NOL deduction based on the federal NOL deduction amount. The Budget Bill (and both the Assembly and Senate C bills) would allow for NOL deductions, but, in a departure from current law, a taxpayer's NOL deduction would be computed without reference to its federal NOL deduction. Because the new computation differs from the current method and will be prospective, transition rules would apply for purposes of computing the allowable deductions for NOLs incurred prior to the effective date of the new legislation.

Thus, in computing the business income base (currently called the entire net income base; see part two of this series for a discussion of the changes to various tax bases), the bills would allow taxpayers two NOL-related deductions:

- A "prior NOL conversion subtraction" (Conversion Subtraction), which is a deduction for NOLs generated under the current law, and
- A deduction for NOLs generated in years beginning on or after January 1, 2015 (NOL Deduction).

The Conversion Subtraction for Prior Year NOLs

The Conversion Subtraction would provide taxpayers with the ability to reduce taxable business income using NOLs generated (and calculated on a pre-apportionment basis) in years beginning before the new law applies to the taxpayer (*i.e.*, January 1, 2015, for calendar year filers). However, such prior year NOLs are not simply carried forward. Instead, taxpayers would compute a modified carryforward amount.

First, the taxpayer would determine the amount of NOL carryforward it would have had on the last day of the "base year"—December 31, 2014, for calendar year filers, or the last day of the taxpayer's last taxable year before it is subject to the Budget Bill's provisions—using the current (*i.e.*, 2014) Tax Law. This amount will be referred to as the "unabsorbed NOL." Next, the taxpayer would determine its apportionment percentage (referred to in the statute as the business allocation percentage (BAP)), for that base year, again using the current (*i.e.*, 2014) Tax Law; this would be the BAP reported on the taxpayer's Franchise Tax report for the base year. Third, the taxpayer would multiply the amount of its unabsorbed NOL by its base year BAP and then would multiply that amount by the tax rate that would have applied to the taxpayer in the base year. The resulting amount would be divided by a percentage, which is the tax rate imposed for 2015 (the Assembly bill requires 7.1 percent for most corporations and 5.7 percent for "qualified New York manufacturers"; the Senate bill requires 6.5 percent and 5.7 percent, respectively). The result of these computations will be called the "Conversion Subtraction pool."

The amount of a taxpayer's Conversion Subtraction will be a portion of its Conversion Subtraction pool computed above. The Senate Bill limits that portion to either (1) one-half of the Conversion Subtraction pool for two consecutive years, or (2) one-tenth of the Conversion Subtraction pool, plus, in subsequent years, any amount of unused Conversion Subtraction from prior years. The Assembly Bill does not include the one-half for two years option.

A taxpayer would use the Conversion Subtraction to reduce apportioned business income. It must be applied before any NOL Deduction (*i.e.*, the deduction for NOLs generated in taxable years beginning on or after January 1, 2015, as discussed below). Any unused Conversion Subtraction may be carried forward through the end of 2035.

The Current Year NOL Deduction

Under current law, the NOL deduction for Franchise Tax purposes is generally the same as the federal NOL deduction computed pursuant to Internal Revenue Code section 172, with some modifications. Additionally, NOLs are computed and carried forward on a pre-apportionment basis, and the NOL deduction is applied on a pre-apportionment basis.

Under the Budget Bill, the NOL Deduction is the amount of NOLs carried forward to a particular income year. An NOL is the amount of "business loss" incurred in a tax year multiplied by the taxpayer's apportionment percentage for that year. While "business loss" is not defined in the Budget Bill, it most likely means the "entire net income" less "investment income" and "other exempt income" as each term is defined in the bill (see part two of this series) when the result of that computation is a negative number. Because NOLs are computed on a post-apportionment basis, a taxpayer's degree of presence in New York in the year the NOL is generated will directly affect the amount of NOL available to be carried forward and deducted from future business income (a significant departure from current law, under which NOLs are computed on a pre-apportionment basis).

Significantly, under the Budget Bill, the NOL Deduction computation is decoupled from the federal computation. In addition, the Budget Bill would not require that the NOL giving rise to the NOL Deduction originate in the same source year as the NOL giving rise to the federal NOL deduction for that tax year. This avoids two of the most contentious NOL issues currently faced by New York taxpayers as a result of the requirements in current law that a taxpayer's NOL deduction (1) not exceed its federal NOL deduction and (2) arise from the same source year as its federal NOL deduction.

Under the Budget Bill, the maximum amount of NOL Deduction allowed in a taxable year would be the amount that reduces the taxpayer's tax on allocated business income to the higher of the tax on capital or the fixed dollar minimum. The New York State Department of Taxation and Finance has taken the position on audit and in litigation that taxpayers are required to deduct NOL carryforwards to the extent used for federal income tax purposes until entire net income is reduced to zero, even if the taxpayer pays Franchise Tax on an alternate base (*e.g.*, capital base, minimum tax). The Budget Bill will eliminate this controversy.

The Budget Bill would provide a 20-year carryforward period for NOLs, with NOLs to be deducted on a first in, first out basis.

The Conversion Subtraction for Combined Groups

Changes to the combined reporting rules were discussed in part one of this series. The Budget Bill would provide special rules for computing the Conversion Subtraction for a taxpayer that was included in a combined return in the "base year" (as described above, this is 2014 for calendar year taxpayers; the last year before the Budget Bill would apply to calendar year filers).

If a taxpayer was properly included in a combined report for the base year and is included in a combined group consisting of the same members in the first year that the Budget Bill provisions apply to the group, then the Conversion Subtraction pool will be computed using the group's combined unabsorbed NOL, the group's base year BAP and the group's base year tax rate.

If a taxpayer was properly included in a combined report for the base year and is included in a combined group consisting of additional members in the first year that the Budget Bill provisions apply to the group, then the Conversion Subtraction pool will be computed based on the sum of the Conversion Subtraction pools computed separately for the group and for the additional members (if the additional members were themselves a group or groups, they would compute on a group basis).

If a taxpayer was properly included in a combined report for the base year but begins to file separately, its Conversion Subtraction pool will be computed based on the portion the taxpayer contributed to the group's Conversion Subtraction pool. Similarly, if a combined group included members in the base year that are no longer included, the group's Conversion Subtraction pool will be computed based on the portion the remaining group members contributed to the group's Conversion Subtraction pool.

The NOL Deduction for a Combined Group

In addition to the rules and limitations described above with respect to the NOL Deduction, rules and limitations apply when computing the NOL Deduction on a combined group basis. Federal separate return limitation year (SRLY) rules apply when a combined group in an NOL Deduction year differs from the group in the year in which the NOL was generated.

Credits

Under the Budget Bill, most of the existing tax credits under Article 9-A and Article 32 will remain in effect, albeit in a new section of the Tax Law and with some noteworthy changes. The Budget Bill also would provide new and expanded tax credits to certain taxpayers under certain circumstances.

Additionally, the Budget Bill and the Assembly Bill would create a new procedural impediment for claiming tax credits. Specifically, for any tax 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 only claim a credit, for the first time, on an amended report in the following limited circumstances:

- 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);
- 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 amount of, the credit; or
- The taxpayer was required to file an amended report in order to report final federal changes for reasons that also affected the taxpayer's eligibility for, or the amount of, the tax credit.

These provisions seem to penalize taxpayers that made an inadvertent error on an originally filed return. The Senate Bill does not contain these provisions.

Investment Tax Credit Changes – Original Proposal

The Budget Bill would make significant changes to the investment tax credit (ITC) by restricting the application of the ITC to certain manufacturers, agricultural businesses and mining businesses, thereby repealing in its entirety the ITC available to other industries, such as the financial services industry and certain film production facilities. 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 corporate tax reform provisions of the Budget Bill. The Budget Bill would permit 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 before 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, effectively denying the ITC for qualifying property not purchased and placed in service prior to January 1, 2014.

The Budget Bill also would limit the availability of the manufacturing ITC to "qualified New York manufacturers," defined as a manufacturer with property in New York State that is used in manufacturing, provided that either (1) the fair market value of that New York State property at the close of the tax year is at least $10 million, or (2) all of the manufacturer's real and personal property is located in New York State. The term "qualified New York manufacturer" also would 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.

For purposes of determining whether a taxpayer is engaged in the business of "manufacturing" for purposes of being a "qualified New York manufacturer," a new, restrictive definition of "manufacturing" is proposed. The Budget Bill would specifically exclude from the definition of "manufacturing" the following types of activities:

- The generation and distribution of electricity, the extraction and distribution of natural gas, and the production of steam associated with the generation of electricity,
- The creation, production or reproduction of a film, television show or commercial, and
- The blending of two or more fuels.

Thus, taxpayers in these industries that once qualified for the ITC would no longer qualify.

In another significant departure from the current manufacturing ITC, the Budget Bill restricts the application of the ITC to tangible personal property used by a taxpayer in the production of goods "for sale," and 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." The addition of the "for sale" language likely will reduce further the number of taxpayers that can qualify for the manufacturing ITC.

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Investment Tax Credit Changes – Updates

As discussed above, both the Senate and the Assembly have made modifications to the Budget Bill. The latest version of the Assembly Bill would leave the current ITC intact, meaning that the new restrictive definition of "manufacturing" and the "for sale" language would be irrelevant, and the credit currently available to taxpayers other than manufacturers—for example, taxpayers in the financial services industry—would be restored. However, the Senate has been less generous. The Senate Bill would reinstitute the current ITC for many taxpayers (*e.g.*, certain film production facilities) but would continue to require the repeal of the ITC for the financial services industry.

New Credits – Original Proposals

Under the Budget Bill, "qualified New York manufacturers" (as defined above) generally would be eligible to claim a refundable tax credit under the Franchise Tax (or the personal income tax) equal to 20 percent of such manufacturer's real property tax paid on property used for manufacturing in New York (this would take effect as of January 1, 2014).

The Budget Bill also would provide a refundable credit for telecommunications excise taxes paid by START-UP New York companies, beginning on or after January 1, 2014.

New Credits – Updates

Both the Senate and the Assembly have made modifications to the Budget Bill's proposal with respect to the real property tax credit that would be available to "qualified New York manufacturers." The latest version of the Assembly Bill would eliminate this credit in its entirety, while the Senate Bill would retain the credit but would expand it to all manufacturers as defined under current law (not just qualified New York manufacturers).

Both the Senate and the Assembly have left the proposed credit for telecommunications excise taxes paid by START-UP New York companies intact.

New York City

As noted in prior installments of Inside the New York Budget Bill, the Budget Bill's proposals would not automatically apply to New York City. With respect to the application of NOL Deductions and the computation of NOL carryforward amounts, this divergence will add to compliance difficulties when filing returns.

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