McDermott Will & Emery

Inside the New York Budget Bill: 2015 – 2016 Budget Legislation

April 9, 2015

By: Maria P. Eberle, Lindsay M. LaCava and Alysse McLoughlin

SPECIAL REPORT

McDermott Will & Emery

SPECIAL REPORT

I. Technical Corrections ... 3

A. Economic Nexus ... 3
B. Tax Base and Income Classifications ... 4

1. Investment Capital ... 4
2. Investment Income ... 5
3. Expense Attribution ... 6

C. Tax Rates and Qualified New York Manufacturers ... 6

1. Qualified New York Manufacturers ... 6
2. Other Tax Rate Changes ... 7

D. Apportionment ... 7

1. Treatment of Excess Investment Income ... 7
2. Description of QFI ... 7
3. Marked to Market Income ... 8
4. Sourcing Hierarchy ... 9
5. Treatment of Physical Commodities ... 9

E. Combined Reporting ... 9

1. Investment Income ... 9
2. Designated Agent ... 9

F. Net Operating Losses and Investment Tax Credit ... 10

1. Net Operating Losses – Prior NOL Conversion Subtraction ... 10
2. Net Operating Losses – Current Year ... 11
3. Investment Tax Credit ... 11

II. Sales Tax Provisions ... 11

A. Dodd-Frank Act Relief Provisions ... 11
B. New Sales and Use Tax Provisions for Boats and Aircraft ... 12
C. Additional Sales and Use Tax Provisions ... 13
D. Sales and Use Tax Provisions Not Included ... 13

III. New York City Corporate Tax Reform ... 13

A. Background ... 13
B. Differences Between New York State and City Tax Laws ... 14

The New York Legislature has passed bills related to the 2015–2016 budget (S2009-B/A3009-B and S4610-A/A6721-A, collectively referred to herein as the "Budget Bill") containing several significant "technical corrections" to the New York State corporate income tax reform enacted in 2014, along with sales tax provisions and amendments to reform New York City's General Corporation Tax.

I. Technical Corrections

In 2014, Governor Andrew Cuomo signed into law major corporate income tax reform that resulted in significant changes for many corporate taxpayers, including a complete repeal of Article 32 (the franchise tax imposed on banking corporations) and changes to the Article 9-A (the franchise tax imposed on general corporations) traditional nexus standards, combined reporting provisions, composition of tax bases and computation of tax, apportionment provisions, net operating loss calculation and tax credits. Most of those provisions were effective for tax years beginning on or after January 1, 2015.

The Budget Bill's technical corrections to last year's corporate income tax reform include changes to the economic nexus, tax base and income classification, tax rate (including clarifications to rules applicable to certain taxpayers, such as qualified New York manufacturers), apportionment, combined reporting, net operating loss and tax credit provisions. The technical corrections are effective on the same date as last year's corporate income tax reform.

A. Economic Nexus

The New York Tax Law provides that a corporation is subject to corporate income tax if it is "deriving receipts from activity in [New York]." A corporation is deemed to be "deriving receipts from activity in [New York]" if it has $1 million or more of receipts included in the numerator of its apportionment factor, as determined under the Tax Law's apportionment sourcing rules ("New York receipts"). Furthermore, a credit card company is deemed to be doing business in New York if it has issued credit cards to 1,000 or more New York customers; has contracts covering at least 1,000 merchant locations; or has at least 1,000 New York customers plus New York merchant locations. The Tax Law also has special rules (aggregation rules) for corporations included in combined reporting groups. This year's Budget Bill slightly modified those aggregation rules.

Under last year's corporate income tax reform, if a corporation does not meet the $1 million threshold itself, but has at least $10,000 of New York receipts, the $1 million test is to be applied to that corporation by aggregating the New York receipts of all members of the corporation's *combined reporting group* having at least $10,000 of New York receipts. Similarly, a credit card corporation that does not meet the 1,000 customer and/or merchant location threshold by itself, but has at least 10 New York customers, at least 10 New York merchant locations or at least 10 New York customers plus merchant locations, is subject to tax in New York if all members of its *combined reporting group* with 10 such customers and/or merchant locations, on an aggregated basis, have at least 1,000 New York customers, 1,000 New York merchant locations or 1,000 New York customers plus merchant locations.

As a result of this year's technical corrections, the $1 million New York receipts and 1,000 New York customers/merchant locations aggregation tests now apply to a corporation that is part of a *unitary group* meeting the ownership test of Tax Law section 210-C (more than 50 percent common ownership measured by voting power of capital stock), rather than a combined reporting group, thus eliminating the application of these aggregation rules to corporations or credit card corporations that are members of a combined reporting group solely as a result of a commonly owned group election.

For example, in determining whether the aggregation test must be applied with respect to a corporation, the test will be applied if a corporation has at least $10,000 of New York receipts and is part of a unitary group that meets the more-than-50-percent common ownership threshold of Tax Law section 210-C. However, once it is determined that the aggregation test must be performed, it is unclear if the unitary group is broadened for purposes of applying the test. One interpretation of the new law is that the corporation's receipts are aggregated only with corporations that are

unitary with the potential taxpayer *and* that meet the more-than-50-percent common ownership threshold of Tax Law section 210-C. Another interpretation is that the corporation's receipts are aggregated with all corporations that are unitary with the potential taxpayer, not just those that are part of the unitary group and meet the more-than-50-percent ownership threshold. While the first interpretation is the more logical and likely intended result, the revised provision may require taxpayers to look outside the group of corporations that would be required to be included in a combined report under Tax Law section 210-C to those corporations that are unitary but don't meet the more-than-50-percent ownership threshold (although, one can argue that without more than 50 percent ownership a unitary relationship cannot exist). Similar changes were made to the aggregation rules applicable to credit card corporations.

In revising the aggregation rules, the Budget Bill eliminates corporations that are excluded by statute from a combined article 9-A report from being included in either of the aggregation tests. Therefore, corporations taxable (or that would be taxable if subject to tax) under Article 9 (certain utilities) or Article 33 (insurance corporations), REITs or RICs that are not captive REITs or captive RICs, New York S corporations, and alien corporations that are not treated as domestic corporations under the Internal Revenue Code (IRC) and that have no effectively connected income for the taxable year will not be considered for purposes of determining whether the aggregation test applies or when applying the aggregation test.

Additional clarifications or technical corrections made to the economic nexus provisions include the following:

- Similar changes to the aggregation tests applicable to the metropolitan commuter transportation district surcharge; and
- A correction to the nexus exclusion for certain alien (non-U.S.) corporations related to IRC section 864(b) that makes it clear that the exclusion for section 864(b) activities will also apply to the economic nexus standard.

B. Tax Base and Income Classifications

Although the Budget Bill's modifications to last year's corporate income tax reform provisions are described as "corrections," the Budget Bill makes a number of substantive changes with respect to the income classification rules.

1. Investment Capital

Last year's corporate income tax reform narrowed the definition of investment capital to investments in stocks held by a taxpayer for more than six consecutive months but not held for sale to customers in the regular course of business, and excluding stock that is a "qualified financial instrument" for which the taxpayer has elected to use the 8 percent apportionment sourcing rule, stock in a unitary business, stock in a business that is included in a combined report with the taxpayer, and stock issued by the taxpayer.

This year's Budget Bill further narrows the definition of investment capital by extending the holding period from six months to one year, by tying the definition of investment capital to certain IRC provisions, and by requiring taxpayers to separately identify stock held as investment capital in their books and records. Investment capital now means investments in stocks that:

- Satisfy the definition of a "capital asset" under section 1221 of the IRC at all times the taxpayer owned the stock during the taxable year;
- Are held for investment for more than one year;
- The dispositions of which are, or would be, treated by the taxpayer as generating long-term capital gains or losses under the IRC;
- For stocks acquired on or after January 1, 2015, have never been held for sale to customers in the regular course of business at any time after the close of the day on which they are acquired; and
- Before the close of the day on which the stock was acquired, are clearly identified in the taxpayer's books and records as stock held for investment in the same manner as required under section 1236(a)(1) of the

IRC for the stock of a dealer in securities to be eligible for capital gain treatment (for stock acquired prior to October 1, 2015, that was not subject to section 1236(a) of the IRC, such identification must occur before October 1, 2015).

Stock in a unitary corporation, stock in a corporation that is included in a combined report with the taxpayer, and stock issued by the taxpayer continue to be excluded from investment capital.

These five new investment capital requirements will impose a number of new compliance burdens on taxpayers. Unlike individuals, corporations do not get preferential tax rates for capital gains for federal income tax purposes, so many corporations do not, as a practical matter, track the status of assets as "capital assets" for federal income tax purposes. Thus, the requirement to do so for New York corporate income tax purposes may impose an additional compliance burden on New York corporate taxpayers. In addition, taxpayers will have to implement processes and procedures for identifying stock as being held for investment at the time of purchase in the same manner as 1236(a)(1) of the IRC, which currently applies to securities dealers (although many securities dealers that are taxed as corporations do not actually follow these rules given the lack of a preferential tax rate for capital gains for federal income tax purposes).

The Budget Bill also amends the holding period presumption for stock acquired during the tax year. If stock that is a capital asset is acquired during the tax year, the stock is presumed to be held for more than one year for purposes of classifying that stock as investment capital for the year of acquisition. However, if the taxpayer does not in fact own that stock at the time it files its original return for the year of acquisition, the presumption does not apply and the actual holding period is used for purposes of determining if the stock should be classified as investment capital. As a result, taxpayers will have to monitor the holding period for newly acquired stock right up until the date the return is filed for the tax year the stock was acquired.

The Budget Bill also repeals the requirement that offsetting positions in the same or similar stock be taken into account when determining whether stock has been owned for the requisite holding period. It would have been extremely burdensome and limiting for some taxpayers to comply with this requirement, so its removal is beneficial.

2. Investment Income

The Budget Bill imposes a "cap" on the amount of income that a taxpayer can treat as investment income. If a taxpayer's investment income (before the deduction of interest expenses that are directly or indirectly attributable to investment income) comprises more than 8 percent of the taxpayer's entire net income, the taxpayer's investment income (before interest expense attribution) will be limited to 8 percent of the taxpayer's entire net income. For taxpayers that elect to reduce their investment income by 40 percent in lieu of attributing interest expenses to investment income, the 40 percent election is applied *after* the 8 percent cap. This means that any "excess" investment income (income in excess of the 8 percent cap) will be included in the taxpayer's taxable business income base.

Taxpayers that have income from investment capital in excess of the 8 percent cap should consider whether that income can be excluded from their taxable business income base on constitutional grounds. Under the Due Process and Commerce Clauses of the U.S. Constitution, income can constitutionally be included in a taxpayer's apportionable tax base only if the income is derived from a business operation or asset that is unitary with the taxpayer's in-state business (*e.g.*, unitary stock). The New York Department of Taxation and Finance historically argued that these constitutional limitations did not apply for New York corporate franchise tax purposes because of New York's unique investment income allocation regime (which apportioned investment income based on the issuer's contacts with New York instead of the taxpayer's contacts). However, that unique investment income allocation regime was repealed as part of last year's corporate income tax reform, leaving the door open for constitutional fair apportionment challenges with respect to income from non-unitary business operations or assets (such as dividends or gains from the sale of non-unitary stock) that is included in a taxpayer's apportionable business income base.

Last year's budget bill commendably attempted to deal with the potential constitutional issues that could arise as a result of the repeal of the investment income allocation regime by providing that "when income or gain from a debt obligation or other security cannot be apportioned to the state . . . as a result of constitutional principles [('non-unitary debts and securities')], the debt obligation or other security will be included in investment capital." However, because that statutory protection operates to reclassify non-unitary debts and securities as "investment capital," the income from which is treated as nontaxable "investment income," the 8 percent cap may undo this statutory protection to the extent investment income exceeds 8 percent of entire net income. Thus, taxpayers may need to rely on constitutional principles to challenge the inclusion of such income in the apportionable business income base.

3. Expense Attribution

The Budget Bill repeals the requirement that taxpayers deduct hedging expenses when computing investment income (*i.e.*, taxpayers are no longer required to attribute hedging expenses to investment income). Thus, the only expenses that taxpayers are required to attribute to and deduct from investment income are interest expenses.

The Budget Bill also clarifies that the election to reduce investment income by 40 percent in lieu of attributing and deducting interest expenses is revocable. As with making the election, any revocation of the election for investment income will also apply to exempt CFC income and exempt unitary corporation dividends and vice versa.

C. Tax Rates and Qualified New York Manufacturers

1. Qualified New York Manufacturers

Effective for tax years beginning on or after January 1, 2014, qualified New York manufacturers are subject to a 0 percent business income tax rate and to beneficial rates for purposes of the tax on business capital and the fixed dollar minimum tax. A "qualified New York manufacturer" is a manufacturer (either a single taxpayer or a combined group) that meets two qualifications. First, it has property in New York that is described in section 210-B.1 of the Tax Law (*i.e.*, property that is eligible for the investment tax credit), and either (1) the adjusted basis of such property for federal income tax purposes at the close of the taxable year is at least $1 million, or (2) all of its real and personal property is located in New York. Second, it is principally engaged in qualifying activities (*e.g.*, manufacturing, processing or assembling) (the "principally engaged" test). A taxpayer—or, in the case of a combined report, a combined group—that does not satisfy the principally engaged test may still be a qualified New York manufacturer if the taxpayer or the combined group employs during the taxable year at least 2,500 employees in manufacturing in New York and has property in the state used in manufacturing, the adjusted basis of which for federal income tax purposes at the close of the taxable year is at least $100 million.

The Budget Bill's technical corrections restrict the types of property eligible for consideration in the principally engaged test to property mentioned in Tax Law section 210-B.1(b)(i)(A) (property that is principally used by the taxpayer in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture or commercial fishing), rather than property described in the entirety of section 210-B.1. This correction mirrors the definition of eligible property before the 2014 law changes.

The technical corrections also contain an important clarification with respect to the application of the qualified New York manufacturer test in the context of combined reporting groups. The Budget Bill makes it clear that the qualified New York manufacturer test must be applied at the combined group level, meaning that even if a corporation, on its own, is a qualified New York manufacturer, if that corporation is part of a combined reporting group that does not meet the test on a combined basis, no member (including that corporation) can qualify.

The technical corrections also clarify that the rate of tax applicable to the capital base for a qualified New York manufacturer for tax years beginning on or after January 1,

2015, and before January 1, 2016, is 0.132 percent, rather than 0.15 percent.

2. Other Tax Rate Changes

The Budget Bill makes a few additional clarifying amendments to the tax rate provisions:

- Clarifications to the language regarding the tax rates applicable to the business income base for qualified emerging technology companies;
- New fixed dollar minimum tax tables for S corporations that are qualified New York manufacturers or qualified emerging technology companies; and
- A reduction of New York receipts for part-year taxpayers for purposes of applying the fixed dollar minimum rate tables (taxpayers that are subject to tax for more than six months but not more than nine are permitted to reduce their fixed dollar minimum tax by 25 percent; taxpayers that are subject to tax for no more than six months are permitted to reduce their fixed dollar minimum tax by 50 percent).

D. Apportionment

1. Treatment of Excess Investment Income

As discussed above (Section I.B.2), the Budget Bill includes a "cap" whereby investment income cannot exceed 8 percent of a corporation's (or a combined group's) entire net income. A resulting issue is the impact of that cap and the "excess" investment income that it creates on the apportionment factor that will be applied to a taxpayer's business income, assuming that inclusion of the excess investment income is constitutional.

As a preliminary matter, the excess investment income will not be eligible for the Tax Law's 8 percent fixed sourcing election (*i.e.*, a taxpayer may elect to include 8 percent of receipts from qualified financial instruments (QFI) in the numerator of its apportionment fraction in lieu of using a more specific sourcing provision) because such income cannot be considered income from QFIs; a financial instrument that qualifies as investment capital cannot also qualify as a QFI (for a discussion of changes to the definition of a QFI see section I.D.2 below). Even though, through operation of the cap, excess investment income will be treated as business income and not investment income, there is no corresponding provision in the statute specifying that the character of the investment that gave rise to such excess investment income will switch from investment capital to business capital. Thus, a taxpayer's election to use the 8 percent fixed sourcing method will not apply to any excess investment income.

Instead, the excess investment income will need to be sourced under the general customer sourcing rules for financial instruments. Under those general rules, dividends and net gains from sales of stock are not included in either the numerator or denominator of the apportionment formula, unless the Commissioner determines that inclusion is necessary to properly reflect the business income or capital of the taxpayer. The Commissioner's determination is governed by the Tax Law's general provision on alternative apportionment, meaning that the Commissioner can require or taxpayers can request factor representation to the extent necessary to properly reflect the taxpayer's business income or capital. Interestingly, in those cases where the excess investment income is properly included in business income, inclusion in the apportionment formula should be required on constitutional grounds (factors used in an apportionment formula must reasonably reflect how income is earned).

2. Description of QFI

The rule concerning what will qualify as a QFI for purposes of the 8 percent fixed sourcing percentage election has now been broadened. Under last year's corporate income tax reform, only financial instruments that were actually marked to market under sections 475 or 1256 could be treated as QFIs. That definition has been broadened to include certain types of instruments that are of a type referenced in certain of the financial transactions sourcing rules, as long as the taxpayer (or, if it files as part of a combined report, any member of its combined report) has marked to market a financial instrument of that same type in the relevant taxable year. The types of instruments that are specifically referenced in the financial transactions sourcing rules are

loans; federal, state and municipal debt; asset-backed securities and other government agency debt; corporate bonds; dividends and net gains from sale of stock or partnership interests; other financial instruments; and physical commodities. Under last year's corporate income tax reform, a loan secured by real property cannot be a QFI; as a result, even though all "loans" are considered one type of instrument for purposes of the financial transactions sourcing rules, if the only loans that a taxpayer has marked to market are loans secured by real property, then none of the taxpayer's loans shall be considered QFIs. (The Budget Bill offers clarification as to when a loan is considered to be secured by real property; thus, under the new rule, a loan will be considered to be secured by real property if, at the inception of the loan, 50 percent or more of the value of the loan collateral consists of real property.)

3. Marked to Market Income

The Budget Bill has also made certain changes that are applicable when a taxpayer elects the 8 percent fixed sourcing method for its income from QFIs. While it is clear from last year's corporate income tax reform that all income, gain or loss from QFIs is business income once a taxpayer elects the 8 percent fixed sourcing method, the Budget Bill clarifies that the phrase, "all income, gain or loss," includes marked to market net gains. Thus, when sourcing the net income from QFIs, 8 percent of all marked to market net gains should be included in the numerator of the apportionment fraction and all marked to market net gains should be included in the denominator of the apportionment fraction.

Furthermore, some of the apportionment changes reflect the potential mismatch in application of the customer sourcing rules to marked to market income. As part of the general switch to customer sourcing in last year's corporate income tax reform, income from financial instruments also became subject to customer sourcing rules. When a financial instrument is subject to Internal Revenue Code section 475 or 1256, marked to market income and loss – or the change in value of the financial instrument – is included by such taxpayer in computing its federal taxable income, and thus in computing its New York business income tax base. Customer sourcing rules would then require sourcing of such income based on where the purchaser of the financial instrument is located. In the case of a financial instrument that has not been sold by the end of a tax year, it would be impossible to source the marked to market income from that financial instrument to the purchaser's location since there would not have been a purchaser. The Budget Bill adds some sourcing rules that address this problem.

Under the new rules, the amount of marked to market net gains included in the numerator of the apportionment fraction for each type of financial instrument is determined by multiplying the marked to market net gains from that type of financial instrument by a fraction, the numerator of which is equal to the net gains (usually interest and net gains from sales) included in the numerator of the apportionment formula under the customer sourcing rules for that type of financial instrument, and the denominator of which is equal to all of the net gains (again, usually interest and net gains from sales) included in the denominator from that same type of financial instrument. All marked to market net gains from such financial instruments would then be included in the denominator of the apportionment formula.

If, however, the taxpayer has a net loss from that type of financial instrument or if the financial instrument is of a type that is not otherwise sourced by the taxpayer under the financial instrument customer sourcing rules, then the amount of such otherwise unsourced marked to market income will be included in the numerator of the apportionment fraction by multiplying such unsourced marked to market net gains by a fraction, the numerator of which will include all of the receipts included in the numerator of the business apportionment formula from the customer sourcing rules applicable to financial instruments plus all previously sourced marked to market income that is in the numerator, and the denominator of which will consist of all receipts included in the denominator under the customer sourcing rules applicable to financial instruments and previously sourced marked to market income included in the denominator.

4. Sourcing Hierarchy

In determining the location of a business customer under the financial instrument sourcing rules, a hierarchy of methods is used. Before passage of the Budget Bill, the first method for determining such location was the location of the treasury function for the business entity. That method has now been removed due to taxpayers' complaints that location of a customer's treasury function was not a method that was used by any other state and was not information that a taxpayer would usually have for its customers.

5. Treatment of Physical Commodities

Under last year's corporate income tax reform, receipts from sales of tangible personal property and electricity that are traded as commodities, as such term is defined under IRC section 475, will be sourced, not according to the general apportionment rules for receipts from sales of tangible personal property, but according to the special physical commodities rules that are contained in the section of the sourcing rules dealing with income from financial instruments (the "Physical Commodities Sourcing Rule"). The Budget Bill clarifies that such physical commodities can also be treated as QFIs for purposes of the 8 percent fixed sourcing method election. In describing what instruments can qualify as QFIs, the Budget Bill specifically provides that a QFI includes a financial instrument that "is of a type described" in the Physical Commodities Sourcing Rule. Prior to this reference, it was not clear whether physical commodities could be treated as QFIs because it was not clear whether (a) they could be considered "financial instruments" and (b) the direction to use the Physical Commodities Sourcing Rule overruled the possibility that they could qualify for QFI treatment. Since there is now a specific reference that the items that qualify for the Physical Commodities Sourcing Rule can be treated as QFIs, any uncertainty in this area is resolved.

Furthermore, with respect to the Physical Commodities Sourcing Rule, a revision was made to clarify that the denominator would include both receipts from the sale of physical commodities actually delivered within and without New York plus, in the case of those commodities for which no actual delivery occurred, from sales to purchasers located within and without New York. Prior to the clarification, the statute could have been interpreted so that the denominator would have included only those receipts from sales of physical commodities actually delivered to points within and without New York State *or* receipts from sales to purchasers located within and without New York.

The Budget Bill also contains certain clarifications and technical corrections to the apportionment sourcing rules applicable to receipts derived from the operation of vessels and receipts derived from aviation services.

E. Combined Reporting

1. Investment Income

Last year's corporate income tax reform provisions provided that (1) the election to reduce investment income or other exempt income by 40 percent in lieu of attributing interest expenses to that income and (2) the election to apportion income and gains from qualifying financial instruments using the 8 percent rule (discussed in Section I.D.2. above) apply to all members of a combined group. The Budget Bill provides that the following elections also apply to all members of the combined group: (1) the election to waive the net operating loss carryback period and (2) the election to deduct up to one-half of the prior year net operating loss conversion subtraction pool over a two-year period starting with the tax year beginning on or after January 1, 2015.

As discussed above, the Budget Bill also provides that the new 8 percent cap on investment income applies by comparing the investment income of the combined group (before the deduction of attributable interest expenses) to the entire net income of the combined group.

2. Designated Agent

Under last year's corporate income tax reform, each combined group must have one designated agent, and that designated agent must be a New York taxpayer (*i.e.*, must have nexus with New York). The Budget Bill eliminates the requirement that the designated agent be the parent corporation of the combined group (under last year's corporate income tax reform taxpayers were permitted to

choose another designated agent only if there was no parent corporation included in the combined group or the parent was not a taxpayer). This change gives combined groups greater flexibility in selecting the designated agent for the combined group.

The Budget Bill makes a few additional clarifying amendments to the combined reporting provisions:

- When computing the combined business income base, the apportioned business income of the group is reduced by any prior net operating loss conversion subtraction as well as any net operating loss deduction (last year's corporate income tax reform provisions referred to only the net operating loss deduction).
- A combined net operating loss is composed of net operating losses that are carried back or carried forward to the taxable year (last year's corporate income tax reform provisions referred only to net operating losses carried forward to the income year).
- The timeliness of the commonly owned group election that must be made on an original return will be determined with regard to extensions.

F. Net Operating Losses and Investment Tax Credit

1. Net Operating Losses – Prior NOL Conversion Subtraction

For tax years beginning on or after January 1, 2015, the calculation of the New York NOL Deduction has changed dramatically. As a result, the Tax Law provides for a transition calculation, a "prior NOL conversion subtraction" ("Conversion Subtraction"), for purposes of computing the allowable deduction for NOLs incurred under the old law.

To calculate the Conversion Subtraction, the taxpayer first must determine the amount of NOL carryforwards it would have had available for carryover 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 new law—using the former (*i.e.*, 2014) Tax Law, including all limitations applicable under the former law. This amount is referred to as the "unabsorbed NOL." Second, the taxpayer must determine its apportionment percentage (*i.e.*, its BAP) for that base year (base year BAP), again using the former (*i.e.*, 2014) Tax Law; this is the BAP reported on the taxpayer's tax report for the base year. Third, the taxpayer must multiply the amount of its unabsorbed NOL by its base year BAP, then multiply that amount by the tax rate that would have applied to the taxpayer in the base year (base year tax rate). The resulting amount is divided by 6.5 percent (qualified New York manufacturers use 5.7 percent). The result of these computations is the "prior NOL conversion subtraction pool" ("Conversion Subtraction pool").

A taxpayer's Conversion Subtraction will equal a portion of its Conversion Subtraction pool computed as outlined above. The standard rule provides that one-tenth of the Conversion Subtraction pool, plus, in subsequent years, any amount of unused Conversion Subtraction from prior years, may be deducted as the Conversion Subtraction. Last year's corporate income tax reform provided that any unused Conversion Subtraction could be carried forward until tax years beginning on or after January 1, 2036 (tax year 2035 for calendar year filers). The Budget Bill includes slight changes to that carryforward provision. Now, any unused Conversion Subtraction may be carried forward for no longer than 20 years *or* until the taxable year beginning on or after January 1, 2035, but before January 1, 2036, whichever comes first. This language corrected an error in the original law that allowed for the carryforward beyond a 20-year period.

Last year's budget bill also provided taxpayers with an alternative one-time election to deduct up to one-half of the Conversion Subtraction pool over a two-year period starting with the tax year beginning on or after January 1, 2015. However, if a taxpayer makes this election, that taxpayer cannot carry forward any unused Conversion Subtraction beyond that two-year period. The technical corrections clarify that this election is (1) revocable and (2) must be made on a taxpayer's *first* return (not an amended return) for the tax year beginning on or after January 1, 2015, and before January 1, 2016 (with regard to extensions). The technical corrections also clearly provide

(as previously assumed) that any unused portion of the Conversion Subtraction pool will be forfeited at the end of the two-year period. Since the election is revocable, taxpayers should consider making the election if there is any chance that the taxpayer may be able to use the Conversion Subtraction pool within the first two years.

2. Net Operating Losses – Current Year

Under current law, a taxpayer can deduct an NOL Deduction from its apportioned business income base. The NOL Deduction for a particular tax year is the amount of NOL from one or more taxable years that is carried forward or back to that tax year. An NOL is the amount of "business loss" incurred in a tax year multiplied by the taxpayer's apportionment percentage for that year (*i.e.*, NOLs are computed and carried forward on a post-apportionment basis). The maximum amount of NOL Deduction allowed in a taxable year is the amount that reduces the taxpayer's tax on apportioned business income to the higher of the tax on capital or the fixed dollar minimum tax.

The technical corrections provide new ordering rules for purposes of applying NOL Deductions. Taxpayers are now required to first carry an NOL back to the three taxable years preceding the loss year (with the exception that no loss can be carried back to taxable years beginning before January 1, 2015). The NOL must first be carried back to the earliest of the three taxable years. If the NOL is not entirely used in that year, it must be carried to the second taxable year preceding the loss year, and any then-remaining NOL must be carried to the year immediately preceding the loss year. After application of the carryback rules, any unused NOL may be carried forward (until entirely used) for up to 20 taxable years following the loss year. NOLs carried forward must also be carried in order, first to the taxable year immediately following the loss year, and so on.

Taxpayers can irrevocably elect to waive the entire carryback period. Such an election must be made on an original (not amended) timely filed return (determined with regard to extensions) for the year of the NOL for which the election is to be in effect. A separate election is required for each loss year, and an election made by a combined group will apply to all group members.

3. Investment Tax Credit

As with last year's corporate tax reform in New York, earlier budget bill proposals involving credits, including changes to the investment tax credit calculation for masters of films, television shows or commercials, were not adopted.

With respect to the financial services investment tax credit, the technical corrections provide that the investment tax credit may not be taken for property first placed in service on or after October 1, 2015, thus effectively ending the investment tax credit for financial services companies as of that date. For property placed in service before that date, language from prior law was restored that permits the aggregation of use by certain affiliates to meet the statutory qualifying use requirement.

Amendments were also made to provide that certain credits may be applied to reduce tax to the fixed dollar minimum rather than to the greater of the tax on capital or the fixed dollar minimum (*e.g.*, the investment tax credit).

II. Sales Tax Provisions

A. Dodd-Frank Act Relief Provisions

The Budget Bill includes provisions that provide relief from potential sales and use tax implications arising from compliance with certain requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (commonly referred to as Dodd-Frank). Under Dodd-Frank, large financial services organizations must develop and implement resolution plans allowing for an orderly wind-down of their banking and broker/dealer operations in the event of an adverse financial event, such as another financial crisis. The affected financial services organizations and their regulators have agreed in principle to plans where front-office and back-office assets and operations would be segregated into separate legal entities. As a result, many affected financial services organizations are implementing plans whereby back-office functions are being placed into separate bankruptcy remote legal entities

as a way to ensure that an orderly wind-down of the affected entities could occur, with the back-office functions remaining available to all potentially affected entities.

Without the relief provided by the Budget Bill, the Dodd-Frank-mandated reorganizations could have resulted in increased New York sales tax compliance burdens and increased New York sales tax liabilities, both upon the reorganization itself and on an ongoing basis. Many transactions that formerly occurred between different units within the same legal entity (and hence were not subject to sales tax) will have to occur between different legal entities after the restructurings and thus will be taxable. To prevent this increase in sales and use tax burdens and liabilities, an exemption was included in the Budget Bill that will apply to sales of property or services that are entered into or conducted as a result of the resolution planning required by Dodd-Frank, so that the affected companies are not subject to sales or use tax on transactions that occur solely as a result of their compliance with a federal law that has been put in place to make the global financial systems safer.

The exemption provided by the Budget Bill is tied to the status of the buyer and the seller as a “covered company” or “material company” as defined in section 243.2(l) of the Code of Federal Regulations, which is one of the sections implementing Dodd-Frank. Under the exemption, sales of tangible personal property or services among related parties are exempt from the New York sales and use tax if the vendor and the purchaser are referenced as either a “covered company” or a “material entity” in a resolution plan (or the vendor and the purchaser are separate legal entities pursuant to a divestiture authorized by Dodd-Frank), and the sale would not have occurred between such related entities were it not for the resolution plan or divestiture. (For purposes of this provision, parties are considered to be related if they bear a relationship described in IRC section 267.) Furthermore, the exemption is only available to the extent that the related-party vendor did not claim a resale exclusion upon its original purchase of the property. This exemption provision will apply only to sales made, services rendered or uses occurring on or before June 30, 2019 (or sales made, services rendered or uses occurring pursuant to a binding contract entered into on or before June 30, 2019). However, in no event will this exemption apply after June 30, 2024.

B. New Sales and Use Tax Provisions for Boats and Aircraft

The Budget Bill also provides sales and use tax benefits for the purchase and use in New York of expensive boats and general aviation aircraft. These changes were enacted in an effort to make New York’s aviation and boating sales and use tax policies more competitive with the policies of neighboring jurisdictions.

Under the new rules, boats, including yachts, will be subject to sales and use tax in New York on only the first $230,000 of the sales price. In addition, use tax will not be owed on the use of a boat within New York State unless (1) the boat is registered, or is required to be registered, under New York’s vehicle and traffic laws, or (2) the boat is used in New York State for more than 90 days.

With respect to aircraft, the Budget Bill provides an exemption from the sales and use tax for “general aviation aircraft,” plus machinery or equipment installed on such aircraft. Changes also have been made with respect to small non-commercial aircraft. Previously, leases of certain small non-commercial aircraft were subject to acceleration of sales or use tax on the lease payments, whereby all sales or use tax was required to be paid on all lease payments up-front at the time of inception of the lease. Under the Budget Bill provisions, however, sales or use tax on lease payments for such aircraft would no longer need to be accelerated.

Furthermore, the provision for tax-free transfers of tangible personal property due to a merger, contribution or distribution between related parties formerly did not apply to aircraft. (Instead, the purchaser of the aircraft in such a related-party transaction was entitled to a refund or credit against the sales or use tax due in the amount of sales or use tax paid by the seller upon its purchase or use of the aircraft.) The Budget Bill broadens the application of this exemption so that the transfer of certain aircraft pursuant to a merger, contribution or distribution between related parties will now qualify as a tax-free transfer.

C. Additional Sales and Use Tax Provisions

The Budget Bill included various other sales and use tax provisions, including the following:

- In recognition that breweries, distilleries, cideries and wineries are a growing part of New York's economy, and to encourage more tastings throughout the state, the Budget Bill (1) expands the current sales and use tax exemption for wine furnished for consumption at a wine tasting to also apply to the bottles, corks, caps and labels used to package the wine, and (2) adopts a similar exemption for other alcoholic beverages furnished to customers for consumption at no charge at a tasting held by a licensed brewery, farm brewery, cider producer, distillery or farm distillery in accordance with New York's Alcoholic Beverage Control Law.
- Incentives for solar power purchase agreements by providing an exemption from the sales and compensating use tax for receipts from the sale of electricity by a person primarily engaged in the sale of solar energy system equipment and, in certain circumstances, electricity generated by a residential or commercial solar energy system.
- The definition of taxable prepaid telephone calling services has been amended to include certain prepaid mobile calling services. In addition, the sourcing rules for prepaid telephone calling services have been amended to provide that in certain circumstances (*i.e.*, when the sale does not take place at the vendor's place of business, there is no item shipped in connection with the sale, or the vendor doesn't have the address associated with the customer's mobile telephone number) the vendor of the prepaid telephone calling service can source a sale to an address that reasonably reflects the customer's location at the time of the sale or recharge, as approved by the Commissioner.

D. Sales and Use Tax Provisions Not Included

A large part of the story concerning the sales and use tax provisions in the Budget Bill concerns the provisions that did not make it into the version that was passed by the Legislature. The Governor's initial draft of the Budget Bill contained provisions that were designed to address what were referred to as "tax avoidance" structures. One of those provisions would have required the acceleration of sales and use tax on lease payments for all related-party leases of tangible personal property, and another would have limited the exemption for certain transfers between related parties as part of a contribution, distribution or merger. (Technically, the exemption was removed, and a corresponding credit was provided that was meant to put taxpayers in the same position as if the original exemption existed, but in theory there were many gaps in coverage under the corresponding credit, and many taxpayers may have been harmed by such provision in a manner never intended by the legislature.) In addition, the Budget Bill did not include the provisions that would have significantly affected e-commerce companies by imposing a sales and use tax collection responsibility on marketplace providers.

III. New York City Corporate Tax Reform

A. Background

As discussed above, in 2014 New York State enacted sweeping reforms with respect to its taxation of corporations. New York City's tax structure, however, was not changed at that time, resulting in concern among taxpayers about having to comply with two completely different sets of rules for New York State and New York City, and concern from representatives of the New York City Department of Finance, who would have lost the benefit of the joint audits that they currently conduct with New York State and the automatic conformity to any New York State audit changes resulting from separately conducted New York State audits.

Although it came down to the wire, the Budget Bill did make the necessary changes to largely conform the New York City corporate franchise tax provisions to those in place for New York State. These changes will be effective as of January 1, 2015, which is the same general effective date for the New York State corporate tax reform.

B. Differences Between New York State and City Tax Laws

Even after passage of the Budget Bill, there remain some differences in the tax structures of New York State and New York City. Some examples include the following:

- New York State has economic nexus provisions, but New York City does not (except for credit card banks).
- New York State will phase out its alternative tax on capital (with rate reductions implemented until the rate is 0 percent in 2021; different, lower rates apply for qualified New York State manufacturers), and the maximum amount of such tax is capped at $5 million (for corporations that are not qualified New York manufacturers). Not only will New York City not phase out such alternative tax, it has increased the cap to $10 million, less a $10,000 deduction. Also, New York City will not have a lower cap for manufacturers.
- Under New York State's corporate tax reform, a single tax rate is imposed on the business income base for all taxpayers (except for favorable rates for certain taxpayers, such as qualified New York manufacturers), with the amount of such rate being decreased from 7.1 percent to 6.5 percent in 2016. Qualified New York manufacturers are subject to a 0 percent tax rate on the business income base. In the Budget Bill implementing New York City's tax reform, there is no similar rate reduction. Furthermore, instead of using a single rate for all taxpayers (except for the favorable rates adopted for certain taxpayers, such as qualified New York manufacturers), New York City will impose a *higher* tax rate (9 percent) on the business income base for certain large financial corporations than will be imposed on other corporations (8.85 percent). In addition, New York City will not impose a 0 percent tax rate on qualified New York manufacturers; instead, there will be a potential reduction in the tax rate, with the amount of such deduction dependent upon the amount of the manufacturer's income, with the reduced rate reaching as low as 4.425 percent. Additionally, the New York City definition of "qualified New York manufacturer" is slightly different from the State's definition.
- New York City will continue its phase-in of a single sales factor business allocation percentage, but the Budget Bill also provides for an election for certain taxpayers to have a modified three-factor formula apportionment even after the phase-in of a single sales factor is complete.
- New York City has traditionally taxed S corporations in a manner similar to the taxation of C corporations and has imposed an entity level tax on partnerships. The taxation of partnerships and S corporations will not change as a result of the Budget Bill (S corporations will continue to be subject to the former General Corporation Tax, and unincorporated entities will continue to be subject to the Unincorporated Business Tax, which has not been amended by the Budget Bill), so in addition to many other differences, those entities will remain subject to the costs of performance sourcing rules instead of the new customer-based sourcing rules. New York City has organized a working group to study and determine the proper treatment of such entities.

For more information, please contact your regular McDermott lawyer, or:

Maria P. Eberle
+1 212 547 5702 | meberle@mwe.com

Lindsay M. LaCava
+1 212 547 5344 | llacava@mwe.com

Alysse McLoughlin
+1 212 547 5307 | amcloughlin@mwe.com

For more information about McDermott Will & Emery visit www.mwe.com

The material in this publication may not be reproduced, in whole or part without acknowledgement of its source and copyright. *"Inside the New York Budget Bill: 2015 – 2016 Budget Legislation"* is intended to provide information of general interest in a summary manner and should not be construed as individual legal advice. Readers should consult with their McDermott Will & Emery lawyer or other professional counsel before acting on the information contained in this publication.
©2015 McDermott Will & Emery. The following legal entities are collectively referred to as "McDermott Will & Emery," "McDermott" or "the Firm": McDermott Will & Emery LLP, McDermott Will & Emery AARPI, McDermott Will & Emery Belgium LLP, McDermott Will & Emery Rechtsanwälte Steuerberater LLP, McDermott Will & Emery Studio Legale Associato and McDermott Will & Emery UK LLP. These entities coordinate their activities through service agreements. McDermott has a strategic alliance with MWE China Law Offices, a separate law firm. This communication may be considered attorney advertising. Previous results are not a guarantee of future outcome.

Boston Brussels Chicago Dallas
Düsseldorf Frankfurt Houston London
Los Angeles Miami Milan Munich
New York Orange County Paris Rome
Seoul Silicon Valley Washington, D.C.

Strategic alliance with MWE China Law Offices (Shanghai)