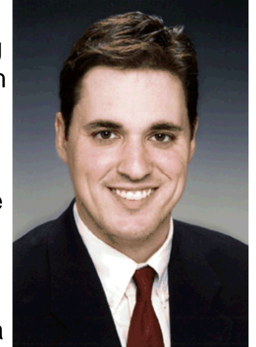
Noonan's Notes on Tax Practice
State Tax Notes, May 7, 2007, p. 423
44 State Tax Notes 423 (May 7, 2007)

New York Budget Increases Taxes by $300 Million

by Timothy P. Noonan and Christopher L. Doyle



On April 9 New York Gov. Eliot Spitzer (D) signed into law 2007 New York Laws Chapter 60 (the Budget Act), which enacted some revenue provisions necessary to address the governor's spending plan. The Budget Act includes aspects that will please some taxpayers and distress others. Although generalizations are difficult, one might observe that banking corporations bore the brunt of the tax increases. Overall, the bill is scored to raise the state's revenue by $300 million. However, it accomplishes that by enacting $450 million in tax increases and other revenue raisers and $150 million in tax decreases resulting from targeted rate reductions. Given the "black box" nature of state revenue forecasting, one should not be surprised if both estimates are lower than what will actually be experienced.

Consistent with other revenue budget bills in recent years, Spitzer and the Legislature put together a single bill containing 15 separate revenue and tax initiatives, which are identified as parts A through O in the Budget Act. Each part constitutes, in effect, a separate tax or revenue bill. The separate parts are used to ease the eleventh-hour mixing and matching that occurs at the end of the budget process. The governor's original budget proposal released in January contained 22 parts. Based on the number of changes alone, it would appear that the final revenue package represents a significant retreat from the governor's original proposal.

Single-Factor Apportionment Accelerated (Part B)

With the stroke of his pen, Spitzer moved the implementation of single-factor receipts-based apportionment forward a year. As a result, most business corporations subject to tax under article 9-A of New York's Tax Law will be subject to receipts-based apportionment for all years beginning on and after January 1, 2007. Because nonresident shareholders of New York S corporations source income to New York "consistent with the . . . rules for allocation under article nine-a" (Tax Law section 632(a)(2)), they also will be using single-factor receipts-based apportionment for sourcing the business income flowed through to them from their S corporations. However, the New York City general corporation tax, which has historically diverged from the article 9-A tax only accidentally, continues to allocate business income based on the three-factor formula (with the receipts factor double-weighted only for manufacturing corporations).

If you are reading this, you are probably already aware of the tax policy arguments in favor of single-factor apportionment: Focusing on the receipts factor removes the in-state employment and capital investment disincentives inherent in the old three-factor regime. So generally, that is a very positive development, and Spitzer and the Legislature should be applauded for that effort. That said, questions remain about whether single-factor regimes may be subject to constitutional challenge. Further, although New York's rules for sourcing receipts work well in specific areas, for example, sales of tangible property, New York has struggled to establish a comprehensive rule that may be easily applied to the sourcing to New York of service receipts and "other business" receipts. Until clear and easily applied rules are adopted, it is anticipated that this will become an even greater area of controversy.

Corporate Owners of REITs and RICs (Part F)

According to the release explaining Spitzer's January budget proposals, this part of the Budget Act is intended to close a so-called loophole. Under federal law, some entities formed to hold real estate assets are considered real estate investment trusts if they comply with specific statutory requirements. REITs are a construct of federal tax law and were initially intended to permit widely held and easily transferable investment in real property assets; thus, one of the requirements in the federal law is that each REIT should have at least 100 members.

A REIT is not subject to federal income tax as long as it distributes substantially all of its income at least annually. Instead, the owners of the REIT are taxed on their dividends from the REIT. In states like New York, corporations have formed

closely held REITs to hold their real estate assets. Before the Budget Act, if a REIT distributed substantially all of its income, it was not subject to federal, state, or local income tax. And as long as the New York corporate owners held an interest in the REIT large enough (generally 50 percent or more) for the REIT to be considered a subsidiary, the dividends received by the corporate owners from the REIT may not have been subject to state or local tax. That is because states like New York have dividends received deductions that exclude part or all of the dividends the corporate owner receives from a subsidiary.

Under the Budget Act, New York article 9-A business corporations with closely held REIT subsidiaries are now required to include the REITs in the parent corporation's combined return.

Under the article 32 franchise tax on banking corporations, banks have been permitted only a 60 percent deduction for subsidiary dividends. So one would think that the value of the REIT strategy to banks would be significantly less than the value to business corporations. Banks operating in New York state are, however, subject to the harshest franchise tax regime that any New York business faces. That has the effect of magnifying the benefits available from the REIT strategy. And unfortunately for banks, the Budget Act also addresses REITs owned predominantly by article 32 banking corporations. While business corporations will be forced to include their controlled REITs in their business's combined report, banking corporations will instead be required to include in computing their entire net income a larger portion (and eventually all) of REIT and regulated investment company dividends and sale gains. For banks, the elimination of the deduction for dividends received from subsidiaries that are REITs or REIT holding companies is phased out over a period of years. Instead of the 60 percent dividends received deduction previously enjoyed, banks are limited to a 30 percent dividend received deduction for the 2007-2008 tax years and a 15 percent dividends received deduction for the 2009 and 2010 tax years. After 2010 no deduction for REIT or REIT holding company dividends will be available to banks, and similar rules will apply to gains banks recognize on their sale of interests in REITs or REIT holding companies.

The REIT benefit is also phased out under the article 33 franchise tax on insurance companies on a schedule similar to that applicable to banks. Further, under the Budget Act, regulated investment companies and their owners are treated in a manner similar to REITs and their owners.

Spitzer's original budget proposal included the same REIT strategy nullification rules for the New York City general corporation and bank taxes. New York City, however, let the Legislature and governor know that it did not want to kill the banking golden goose by having those rules included in its law. Therefore, for New York City purposes, the REIT strategy should continue to provide benefits.

Grandfathered Subsidiaries and Electing Affiliates (Part G)

The Budget Act reins in article 32 banks' use of so-called grandfathered and electing article 9-A subsidiaries.

The investment income of business corporations taxed under article 9-A is subject to very favorable apportionment. Because the article 9-A investment income apportionment method treats as income taxable in New York only the investment income that is apportioned to New York based on the security *issuer's* presence in New York (and not the *taxpayer's* presence in New York), typically only a small portion of that income gets taxed in New York. Article 32 banking corporations (including the corporations required to file with a bank on a combined article 32 return), however, are required to apportion to New York their business *and* investment incomes, using a formula that takes into account the relative presence in New York of the banks' payroll, receipts, and deposits. For banks with a strong New York presence, that results in a significantly greater portion of their investment income being taxed in New York than if they were business corporations subject to the article 9-A tax.

In the past there have been two techniques to ease the harshness of New York's rules for taxing investment income earned by banks. Under a 1985 law, corporations that were subsidiaries of banking corporations could continue being taxed under the article 9-A rules if the corporations were business corporations under pre-1985 laws. Those so-called grandfathered article 9-A subsidiaries have, over the years, been marketed among banks. After a bank purchases a grandfathered article 9-A subsidiary, it could capitalize the subsidiary with investment assets and other assets that are not required to be held directly by the parent banking corporation. That elective treatment permits tax on investment income to be paid at a significantly lower effective rate than if the banks held the investment assets directly. In a recent case, the Department of Taxation and Finance unsuccessfully argued that the use of that elective structure by a New York bank was improper based on principles of economic substance and business purpose.[1] The case is on appeal to the Tax Appeals Tribunal, but clearly this legislation, described below, is in response to the tax department's general displeasure with the use of that structure by New York banks and the department's inability to shut down the structure under existing law.

Similarly, under the tax law rules conforming New York laws to the federal Gramm-Leach-Bliley Act, some banking corporations are permitted to have affiliates that are subject to tax under article 9-A -- so-called electing article 9-A affiliates. As has been the case with the grandfathered article 9-A subsidiaries, electing article 9-A affiliates have sometimes been used to reduce the effective tax rate on income from investment assets that would otherwise apply if the assets were held directly by a bank.

Under the Budget Act, it is intended that grandfathered article 9-A subsidiaries and electing article 9-A affiliates should lose their favored status and should become taxable under the article 32 bank franchise tax if any of the following conditions exist or occur in a tax year beginning on or after January 1, 2007; that is, if the subsidiary or affiliate:

- becomes subject to the fixed-dollar minimum tax;
- has no wages or receipts allocable to New York state (unless the corporation is operating as a holding company for other affiliates that are engaged in the active conduct of a trade or business);
- is acquired by an unrelated corporation; or
- acquires assets in excess of 40 percent of its immediately preceding average asset value and, as a result of that asset acquisition, it changes the nature of the business in which it is principally engaged.

Required Combined Reporting (Part J)

Under pre-2007 laws, related business corporations were permitted or required by the commissioner to file combined reports if they satisfied three requirements: the corporations had to be under common control; the corporations had to be engaged in a unitary business; and something about the intercorporate relationship distorted the income or assets of a New York corporate taxpayer that was a member of the related group of corporations. Under New York's regulations, distortion is presumed to exist (but could be disproved) if "substantial intercorporate transactions" were present.

Under the Budget Act, the Tax Law is amended to *require* related corporations to file a combined report if there are substantial intercorporate transactions. If substantial intercorporate transactions are present, it will not be possible for taxpayers to avoid combination by proving that distortion does not exist to avoid combination.

A similar forced-combination rule is added by the Budget Act for insurance corporations subject to tax under article 33.

Discretionary Allocations Between Corporations and Employee-Owners (Part K)

The Budget Act permits the commissioner to reallocate income and expenses between personal service corporations and their employee-owners if the existence of a personal service corporation and the employment relationship results in the avoidance or evasion of New York income tax by reducing the income (or in the case of a nonresident, reducing the New York-source income) of the employee-owner. That new discretion should be exercised only if substantially all the services of a personal service corporation are performed on behalf of another New York business.

When services are provided directly by nonresident employees to a New York employer, all the wages paid to the employee might be viewed as New York-source income under the so-called convenience rule. To avoid that result, nonresident individuals have in the past formed closely held corporations to perform services for New York businesses. By interposing the corporation between the individual and the New York business, the individual could avoid treatment of any of the service fees paid by the New York business to the corporation (and then to the individual) as having a New York source, as long as those services were performed outside the state by the individual. Although the closely held corporation would have a filing obligation in New York state, it would be anticipated that the wages paid to the individual would, for the most part, negate the income earned by the service corporation.

Nonresident partners or partnerships doing business in New York could likewise limit their New York tax using a similar technique (for example, a personal service corporation acting as a partner of the New York partnership).

The new provisions are not mandatory, but are discretionary. Further, it is not clear at this time how the commissioner will exercise the discretion and under what circumstances the discretion will be exercised.

Mandated New York S Election (Part L)

Under prior law, a federal S corporation doing business in New York could be *either* a C corporation or an S corporation for New York tax purposes, at the election of the taxpayer. Because C corporations are required to pay tax to New York

only on income apportioned to New York by formula, many New York resident shareholders have refrained from making New York S elections for the corporations they own. That resulted in a tax at the corporate level on apportioned income but no tax at the individual level until the income was distributed.

Under the Budget Act, a New York S election will be *deemed* made for any year in which more than 50 percent of the corporation's federal gross income is from the following items: interest, dividends, royalties, annuities, rents, and gains derived from dealings in property. Although the law is intended to reach only those corporations principally engaged in investment activities, the inclusion of "rents and gains derived from dealings in property" may result in the application of the deemed S election to a much broader category of corporations.

That provision is effective for all tax years beginning on and after January 1, 2007. Because shareholders may not know whether a mandatory S election will be required until the end of the S corporation's tax year, estimated tax rules are relaxed for affected S corporation shareholders.

And Now for Something Completely Different (Part N)

As mentioned earlier in this article, the Budget Act includes some benefits for taxpayers; most of those provisions are in Part N.

The entire net income tax rate for business corporations is reduced from 7.5 percent to 7.1 percent. For small-business taxpayers and manufacturers, the rate is reduced even further, to 6.5 percent.

The rate applicable to a business corporation's minimum taxable income base is also reduced from 2.5 percent to 1.5 percent.

Banks also enjoy an entire net income rate reduction from 7.5 percent to 7.1 percent.

All of the rate reductions take effect for tax years beginning on or after January 1, 2007. It should be noted that the metropolitan commuter transportation district surcharge for business corporations is required to be calculated based on the rates that were in effect before July 1, 1998.

Conclusion

This year's budget provides a mixed bag for taxpayers, with positive developments such as the rate reductions and single-factor apportionment coupled with alleged loophole closures and other provisions that arguably limit tax planning opportunities. Banks, in particular, appear to suffer most under the new rules. And as with any new legislation, time will tell how the provisions will play out in day-to-day practice and in new or ongoing audits.

* * * * *

This column is by Timothy P. Noonan and Christopher L. Doyle, partners with Hodgson Russ LLP, Buffalo, N.Y.

FOOTNOTE

[1] *Matter of Premier National Bancorp, Inc.*, administrative law judge (2006). The authors represent the taxpayer in this case. (For the decision, see *Doc 2006-9487* [**PDF**] or *2006 STT 99-13*.)

© Hodgson Russ LLP 2007