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Tax Policy

New York Gov. Andrew Cuomo (D) has proposed sweeping corporate and bank tax changes during this legislative session. In this interview, Kendall Houghton and Matthew Hedstrom of Alston & Bird LLP and Jeffrey Reed of Mayer Brown offer their insight on the bill, discussing New York's potential move to an economic nexus standard, its potential overhaul of the old combined reporting system and corresponding move to mandatory unitary combined reporting, and the elimination of the bank tax, among other proposals.

New York's Proposed Budget Bill: Lawmakers Consider Complete Restructuring of Corporation Franchise, Bank Taxes

Kendall L. Houghton, Matthew P. Hedstrom and Jeffrey S. Reed, interviewed by Melissa Fernley

BLOOMBERG BNA: What is the historic significance of this proposal?

REED: New York has a unique corporate tax system and bank tax system. The corporate tax system has been in place for almost 100 years now and the bank tax system has been in place for nearly as long. The current versions of Article 9-A (the corporation franchise tax) and Article 32 (the bank tax) are over 30 years old. Just because something is old does not necessarily mean that it is flawed, but there are a number of issues that have been identified with respect to both taxes that have provided some of the impetus for a total restructure of the present system.

Kendall L. Houghton is a partner with Alston & Bird LLP in Washington, D.C., Matthew P. Hedstrom is a senior associate with Alston & Bird LLP in New York, and Jeffrey S. Reed is an associate at Mayer Brown in New York. All of them focus their practices on state and local tax planning and controversy matters. Melissa Fernley is a state tax law editor at Bloomberg BNA.

BLOOMBERG BNA: Are there any aspects of these laws that you believe are ripe for reform?

REED: The bank tax and the corporation franchise tax have different apportionment rules. So you could have similarly situated taxpayers that are taxed differently, depending on whether they fall under the bank tax, or the corporation franchise tax. And in practice that actually happens, for example, you could have a broker dealer or you could have an investment company and it may have to pay the bank tax or the regular corporation franchise tax depending on who its parents are. Supporters of the reform are arguing that this is problematic and that similar businesses should be taxed the same way.

Another point is you can't file combined returns across articles. If you have a big group of companies and some of them are banks, and some of them just pay the regular general business corporation tax, they cannot file combined returns, so many companies have a bank tax group and a corporate tax group.

The terms under the New York corporation franchise tax are unfamiliar, even to state tax specialists familiar with UDITPA. For instance, in New York important terms include subsidiary capital and investment capital, and what's really apportionment is called, ''allocation'' under the New York rules. There is a unique combination system which a lot of people don't like, which is based on distortion and substantial intercorporate transactions. It's leading to uncertainty and protracted audits.

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There are tough NOL rules in New York that are resulting in trapped losses. And the sourcing rules under the general business tax are creating lots of audit issues. One example is the distinction between services and other receipts. Services are sourced based on where they are performed. There are many ongoing audits in which services are being performed outside of New York, the associated receipts are being sourced out of New York, and auditors are attempting to reclassify the receipts as ''other receipts'' that are sourced to New York.

There is also the perception within the New York Department of Taxation and Finance that a lot of states have adopted economic nexus and New York should follow suit. So those are some of the things people are seeing and are pointing to and arguing that the system should be modernized.

BLOOMBERG BNA: Is New York's current tax system causing problems for business taxpayers?

HEDSTROM: At a minimum, the current system has created protracted audits on issues that probably could have been simplified, which has also created unnecessary litigation or ''too much'' litigation and is a drain on company resources.

''At a minimum, the current system has created protracted audits on issues that probably could have been simplified, which has also created unnecessary litigation or 'too much' litigation . . .''

MATTHEW HEDSTROM, ALSTON & BIRD LLP

If you talk to our clients, a lot of effort is dedicated to New York; not just because it's an important state, but because the tax system is so complex. The changes are intended to provide simplification and improve compliance, and also cut down on some of the lengthy audits and some of the litigation.

BLOOMBERG BNA: Haven't some of these proposals been considered, but not adopted in the past? What do you think the difference might be this time around?

REED: Many of the proposals in the current budget bill date back to 2010. At that time, the department worked on advancing corporate tax reform. Gov. Cuomo was new, he wanted to study the issue, so he wanted to spend some time before moving forward with any kind of large scale reform. So what's happened over the last couple of years is there have been a few blue ribbon commissions that have been appointed and they've been composed of former tax commissioners, business leaders, etc. And they have studied corporate tax reform, they have issued a couple of reports and the reports that have come out are largely consistent with the 2010 proposals. The difference this time around is that the issue has now been studied and has the support of the governor and for the first time is being included in the governor's proposed budget.

HEDSTROM: In particular, you have economic nexus, the unification of Article 32 and Article 9-A, taxation of alien corporations to the extent of effectively connected income, elimination of subsidiary capital and some of the market/customer-based sourcing rules, and also mandatory unitary combined reporting. So while the state has been kicking it around, as Jeff said, since 2010, this is really the first time there's been pen to paper.

HOUGHTON: Certainly there are elements in the bill as we've looked at it, which represent efforts to either close perceived tax loopholes that render the system less subject to alleged abuses on the part of taxpayers. And/or to take advantage of the opportunity to ''reach out and touch'' as many taxpayers as possible.

If you consider all those different motivations, they are going to impact different taxpayers in different ways. Hopefully, taxpayers will benefit from the proposed reforms on an aggregate basis. But this is clearly a serious effort, it's an effort that (Matt, Jeff and I) decided we have to look at in a clear-eyed fashion and not be cynical about it. And to really try and get a grasp on what this bill may mean because if this advances, taxpayers are going to need to deal with it immediately.

BLOOMBERG BNA: You mentioned one of the reform proposals is aimed at New York's tax treatment of alien corporations or non-U.S. entities. What are some of the issues that these types of businesses are facing in New York?

HEDSTROM: New York, under this proposed budget bill, would generally tax those alien corporations to the extent of their effectively connected income as defined under the I.R.C., rather than taxing the apportioned share of worldwide income. This would be an important change because under the present system an alien corporation could have no federal income tax liability, but nonetheless have liability under New York's income tax.

The federal tax lawyers, or the in-house lawyers at our clients will say, ''Well look, we don't have any federal taxable income because of the application of the Internal Revenue Code or a treaty, and therefore we shouldn't have any New York taxable income, correct?'' And it is nearly always phrased as a rhetorical question, but that wasn't always the answer; case law in New York—through the application of statutes and regulations—essentially taxes foreign alien corporations on their entire worldwide income if they were doing business in New York for purposes of computing entire net income. Granted the companies would typically have a very small New York apportionment percentage, so the tax hit wasn't always large. But as a practical matter, they would have a filing responsibility.

What this budget bill proposes to do, which is actually, as we view it, a taxpayer favorable change, would tax alien corporations to the extent of their effectively connected income—''effectively connected income'' is a federal term and it essentially means income that's affiliated with a trade or business being conducted in the United States.

BLOOMBERG BNA: In that situation, if they don't owe federal tax, how does an alien corporation compute its income tax liability in New York? Must it fill out a pro forma federal return to determine what its New York tax liability is going to be?

HEDSTROM: Yes. In essence, they would have to recompute their New York income using their worldwide figures, whether done on sort of a pro forma basis or to your point, using a pro forma federal return. And it is difficult to get clients comfortable with that approach

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because it struck them as a little bit odd that they didn't have any ''income'' for federal tax purposes, but nonetheless for New York purposes they did.

BLOOMBERG BNA: What are some of the provisions in the bill that are going to affect business taxpayers the most?

HOUGHTON: Changing the definition of ''doing business'' and effectively moving to an economic nexus standard is to me one of the top three or four game changers in this bill. And the overhaul, of the old combined reporting system and moving to mandatory unitary combined reporting, constitutes a very significant change. Also, the elimination of the bank tax and bringing a broader array of taxpayers under the same set of rules seems to be quite significant.

BLOOMBERG BNA: What impact would the proposal's economic nexus provision have on business taxpayers?

HEDSTROM: Certainly there has been a trend toward states adopting economic nexus provisions. California and other states have gone that way by statute, and certainly others by case law, at least insofar as intangible holding companies are concerned, credit card issuing banks, and in one state, franchisees.

But what I think is important is that a lot of states now take the position that very little ''presence'' constitutes physical presence/substantial presence, for example, the presence of data on a server or the ''use'' of software in the state. And when we're talking about economic nexus in the context of what New York is essentially proposing, because it's based on receipts, if you look at how economic nexus intersects with their sourcing rules, you really could have a type of situation where taxpayers will raise Due Process and/or Commerce Clause challenges.

REED: In 2010, when much of what is in the current bill was initially developed, economic nexus made a lot more sense. If you look at the world in 2010, taxpayers were losing all the economic nexus cases. However, more recently taxpayers have won economic nexus cases on due process grounds. Despite that, New York is still looking to go forward with economic nexus, but I would expect that there will be challenges.

BLOOMBERG BNA: So is the economic nexus provision modeled after a factor presence standard, which actually puts a number on what constitutes nexus?

HEDSTROM: That's correct and then subject to a $1 million receipt threshold. You're absolutely right, that's a factor presence standard, not a qualitative standard like some of the other states have done.

REED: In other states that adopt a factor presence standard, what often happens in an audit is, the auditor is hesitant to just hang his or her hat on economic nexus. So the auditor will look for other connections to the state. It will be interesting to see how they administer this in New York. Are auditors really just going to impose tax based on over a million in New York receipts, or will auditors continue to look for other bases for asserting nexus?

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JEFFREY REED, MAYER BROWN

HEDSTROM: Again, if you think about it in the context of the ''new economy'' where there is a significant number of internet-based cloud service businesses, you really can envision a scenario where you've got a company that is deriving easily over $1 million of receipts from New York, but would have very little ''presence'' otherwise. Nonetheless, that company would be subject to tax and it would be doing business under the statute based on the fact that they are largely a service provider with receipts that are sourced under New York's new apportionment regime.

If you have an economic nexus standard that is based on solely receipts, you really could have strange situations where a business has no real purposeful activity/direction in the state, yet is nonetheless deemed to be ''doing business'' under the statute.

Nexus could be triggered by a company that does less than what would be protected under Pub.L. No. 86-272, and I think that raises the question in those instances: how bullish will a state like New York be about asserting nexus over such an internet-based provider?

BLOOMBERG BNA: How do you think the proposed economic nexus standard in New York would fare against a constitutional challenge?

HOUGHTON: The interface between the nexus standard that is being proposed here and due process minimum contacts is really interesting. Because I think that saying you are deriving receipts from activity in New York if you have $1 million or more from a sale to an in-state purchaser or purchasers is trying to boot strap your due process minimum contacts. You're saying the receipts are evidence of a purposeful market penetration.

It seems to me that the state is probably going to be taking that position in certain audits, especially those where it doesn't have alternative contacts that it can rely on to build its case for nexus.

So the question I have is: if you're a taxpayer who cannot claim federal Pub.L. No. 86-272 protections because you are deriving your income from the sales of services or intangibles and you have $1 million in receipts that are associated with New York customers, are you comfortable taking and defending a non-filing position based on your interpretation of the due process case law? Or, are you going to say, ''Well, I would be better served by seeking to broaden the scope of federal Pub. L. No. 86-272?''

“[I]f a state like New York is going to premise nexus on $1 million of sales and potentially no other contacts, will that invigorate the interest in securing federal preemptive legislation to restrain the state from some of these extreme applications of its proposed statutory standard?”

KENDALL HOUGHTON, ALSTON & BIRD LLP

In that regard, we’ve seen the BATSA bill percolating in Congress over the past number of years. But if a state like New York is going to premise nexus on $1 million of sales and potentially no other contacts, will that invigorate the interest in securing federal preemptive legislation to restrain the state from some of these extreme applications of its proposed statutory standard?

BLOOMBERG BNA: Isn’t part of this how New York’s proposed economic nexus threshold compares with other states? It would be higher than California’s which has a receipts threshold of $500,000.

HEDSTROM: From New York’s perspective when they look around and they may say, ‘Look, California has it.’

But I think in practice, the states are wary of taking on some of those fringe cases where you are a notch above the threshold without a lot of purposeful direction in or activity within a state. The issue becomes how many multistate businesses can say that they don’t have the requisite minimum contacts (fairness notion) that’s required for due process? A lot of companies can’t argue that.

Similar to California, another big market, where it gets interesting I think is the web-based world where a lot of companies don’t need to penetrate any particular market, and they can do as much as they need to with advertising and solicitation through the internet.

REED: New York’s threshold is a million, but a million does not seem like a very high number. What if a California-based company is providing an online service to a single New York customer and its monthly fee adds up to over $1 million a year?

If they have just one customer in New York that’s receiving the service, is that going to be enough for them to have due process nexus? I think going beyond the $1 million receipts threshold number, you’re going to have to look at other factors such as: are they advertising there? Are they really directing activity at the state? What’s their connection to the state? How many customers do they have? Ultimately the analysis will have to go there, rather than simply looking at the receipts number, which is what the proposed economic nexus statute does.

BLOOMBERG BNA: The proposed budget would also overhaul New York’s combined reporting rules. What are some of the problems with the current system?

HEDSTROM: Historically combination in New York was based on a determination of whether there was, or was not, distortion.

In 2007 the state changed the regime to apply a ‘‘substantial intercorporate transactions’’ test, with the additional element of distortion; but in essence, New York would combine companies if there were substantial intercorporate transactions and/or distortion. There was much ado about this change from just a simple distortion inquiry.

The department published guidance, which made everybody laugh because it looked like spaghetti, with lines going this way, lines going that way, all to determine whether you were combined, whereas other states would look to whether you met an ownership requirement and whether you were unitary—that was pretty much the analysis.

Historically, on audit the entities that were combined most often were the result of unwinding ‘‘planning,’’ whether it was factoring entities or intangible holding companies.

Recently the department’s approach has morphed into a more aggressive distortion analysis, and morphed in a way such that the department is asserting that certain entities should be decombined where a company was filing a combined return. For that reason, I think a lot of companies have felt as though the combined reporting regime is both unpredictable and slightly ‘‘unfair’’ on how it’s been administered historically and currently.

BLOOMBERG BNA: How does this compare with other states?

REED: In most states that have adopted combined reporting, the analysis is relatively simple. You look to see if a company is related, and you look to see if the company is unitary, and if so it can be a member of the combined return unless there is an exception. New York has traditionally viewed itself as a separate reporting state, so the default is separate entity reporting unless there are substantial intercorporate transactions between the companies, or there’s distortion between the companies.

The trouble is that it is very difficult to figure out if there is distortion. It’s not a clear concept. The same goes for substantial intercorporate transactions. When you try to apply the tests, you find that they are difficult to apply to real world fact patterns and there’s no guidance to turn to. And you can’t get an advisory opinion with respect to combination. So many taxpayers are not sure who should be in their combined group and who should be out. And this has been a hot audit issue for a long time.

So there has been lots of audit activity in the combined reporting area. But a lot of this would go away if the budget bill in its current form passes. New York would then move more toward a California-style combined reporting where you just look to see if entities are related and unitary.

I should mention there still can be some controversy about whether entities are unitary. In states like Illinois and California, for example, there’s plenty of case law addressing whether companies in different fact patterns are unitary or not. But the unitary analysis is a little more straightforward to apply than a distortion analysis. So hopefully this will make combined reporting compliance easier if the budget bill passes.

HOUGHTON: And isn’t it ironic that we can be saying that a ‘‘pure’’ unitary regime is it going to be easier to live with and function within, given that there has been a fair amount of litigation over what constitutes a uni-

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tary relationship? And of course the extensions of the unitary principle, to establish whether or not gains are business or non-business in nature.

"[I]sn't it ironic that we can be saying that a 'pure' unitary regime is it going to be easier to live with and function within, given that there has been a fair amount of litigation over what constitutes a unitary relationship?"

KENDALL HOUGHTON, ALSTON & BIRD LLP

But as you say Jeff and Matt, it's going to be a significant change. Given the relative absence of case law on this question in New York, I would presume to the extent a taxpayer finds itself subject to a unitary audit, assuming this proposal is implemented, that it will be looking to the precedents that have been created in the state courts of California, Illinois or similar states. Would you agree?

REED: Yes, I think there's a little case law in New York on unitary and they generally tend to look at *Container* and some of the U.S. Supreme Court cases and I think they would do that and also look to cases in other states that are applying the same concept.

HEDSTROM: What is interesting about New York is that their case law on unitary is not as vast as other states. Because a lot of the historic analysis was focused on distortion or substantial intercorporate transactions, often the unitary issue was either stipulated or folded into the distortion analysis. So there wasn't a whole lot to fight about because, at the end of the day, everyone knew that the battle was going to be over the distortion analysis. And it was more subjective and, to Jeff's point, less clear, so if you were either arguing for combination or against combination you'd spend your time arguing about distortion and rather than whether entities were unitary.

BLOOMBERG BNA: What are some of the changes that are being proposed regarding New York's tax treatment of net operating losses?

REED: New York's current system is generally unfavorable when it comes to NOLs. There's lots of trapped losses that cannot be utilized. You'll start with your federal income, which let's just say is a loss, and then you apply New York modifications and you get some number. But if the resulting New York loss is more than your federal loss, you're limited to the amount of the federal loss.

Another limitation is, when you carry forward your NOL to use it in another year, you can't use any more loss than the loss you use for federal tax purposes. So for example, if you have a $1 million New York loss and you're carrying it forward to the next year and at the federal level you only have a $500,000 loss, then you'll lose the benefit of the extra $500,000.

The current NOL system in New York I think a lot of people don't like that the federal NOL limits result in a lot of trapped losses. Also, the NOL system applies on a pre-apportionment basis. So just at a high level a change that will be made is to move away from the tie to the federal limit.

BLOOMBERG BNA: Do you believe the proposed bank tax overhaul is important?

REED: I think the Article 32 repeal is very important. Right now some companies are paying the bank tax, some companies are paying the corporate tax and the thought is everyone should pay the same tax. So banks would move over and they would pay the regular corporation franchise tax (Article 9-A) that other companies are paying. So that's an extremely important change because banks for so long have been under a separate regime, but now they're going to be under the same regime as other companies.

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BLOOMBERG BNA: One of the criticisms was that so many changes are being made to the bank tax, but the banking industry isn't really going anywhere. Do you think that's a valid concern?

HEDSTROM: I think the rate decrease for banks is what's driving some of the concern about the budget bill generally. The notion is that the banks have done quite well over the past X amount of years and may do better here (depending on the bank's facts).

On the flip side, I would imagine your point is well taken. The banks aren't going to go anywhere. To relocate outside of New York City—the head of the financial world—would be quite unlikely. I think it becomes balancing the elimination of Article 32 to the point that some may lose and some win and trying to get New York to a modernized tax system.

BLOOMBERG BNA: Are there any components of this bill that would be enacting practices that are already currently in place?

HEDSTROM: I think that, to some extent, that market-based sourcing could be an example of a current practice in certain situations. On audit, the department has tried to take the position that certain services fall into the "other business receipts" category and tried to move the receipt from where it was "performed" to where it was "earned." That can result in sort of a re-characterization of the service, such that the state would be able to move from what would effectively could be thought of as a cost of performance type analysis where these services were performed to one where they're earned and push it toward market.

I think to some degree the sourcing regime in the budget bill, which seeks to essentially employ a market-based approach across the board for most things except financial transactions, which have a whole set of other rules. Somewhat a move towards where the department was trying to be and probably where they want to be, is that a fair statement?

HOUGHTON: That sounds right to me based on the fact gathering that we have seen. Jeff how do you feel about that?

REED: I agree. I think, just use the example of economic nexus, I think really the auditors in New York have been pretty good about applying a physical presence rule historically. They may want economic nexus, but they have been following physical presence. So I think it is right, there are changes in here that are wanted by people at the department. I think a lot of this stuff is new and does not reflect what they are doing on audits, other than using market-based sourcing for services companies, which some auditors are doing on audits, despite the current ''where performed'' sourcing rule.

HOUGHTON: In my view, it certainly reflects the general rush toward market-based sourcing that has tended to accompany a shift in focus on sales factor formulary apportionment. It will be interesting to see how New York's version of market-based sourcing matches up or departs from what other states are doing in that regard. New York historically has not been a leading player in the Multistate Tax Commission, but we are all familiar with Professor Pomp's hearing officer's report relating to the MTC's proposed revisions to UDITPA. One of the most significant proposed revisions of which relates to market-based sourcing. I think that Pomp's report did a good job at identifying that what 'market' means in Illinois may be something very different from what it means in Alabama, California or now New York. I think time will tell whether or not what New York's doing feels familiar and is easily applicable by taxpayers that have to utilize market sourcing regimes elsewhere.

BLOOMBERG BNA: What are the likely fiscal effects of the budget proposal?

REED: The figure I saw was that they are projecting a $350 million dollar loss based on all these changes together. I think that there's just so many moving parts here that it does not seem that it would be possible to arrive at any number with a high degree of certainty. I mean, with economic nexus you would think that presumably they're going to be at least some new taxpayers on the rolls. Some banks are going to come out net winners switching to the regular corporate tax. Some are going to be net losers; some will pay more tax, some will pay less tax. How that'll play out across all banks I am not sure and it seems difficult to arrive at anything other than an educated guess when making fiscal estimates.

HEDSTROM: It's going to come down to whether the powers that be value the sort of principles that were outlined when this budget bill was announced, which include simplification, encouraging compliance and reducing complexity, notwithstanding some revenue loss.

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MATTHEW HEDSTROM, ALSTON & BIRD LLP

I think to Jeff's point if you use that number as a real figure it's going to raise some eyebrows, but it is hard to predict with certainty. Even how companies would look on a mandatory unitary combined basis could be quite different than how they're currently filing on a distortion type of basis or substantial intercorporate transactions for that matter.

REED: Many people who are strongly behind this are viewing it as a modernization effort that will make New York more competitive. I think that the thinking in some quarters is that this is going to make New York more business friendly. In other words, aside from the immediate fiscal impact, the hope is that in the long run it should result in even more business here and more companies are going to want to set up in New York rather than put their operations in a neighboring state.

BLOOMBERG BNA: If the tax changes we've discussed in the New York budget bill are enacted, do you believe New York City would follow suit?

REED: If this passes at the state level, I'd think there'd be tremendous pressure for New York City to follow suit, because no one would want a situation where you have a very different system at the state level than you have at the city level. I would think worse case, if the state legislation passes there would be a gap, hopefully just a short period of time between when the state level legislation is passed and when equivalent city legislation passes. But this is a big open question.

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