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2007 Budget Targets State Tax "Loopholes"

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Governor Spitzer signed has legislation that, along with setting the State's budget for the new fiscal year, made several important amendments to the tax law.[1] Certain elements of the Budget Bill, negotiated late in the process and with traditional Albany opacity, reduce corporate taxes. Other amendments, proposed as "loophole closers," alter or eliminate certain planning and structures businesses and individuals have used to reduce New York taxes.

Tax Reductions

Looking first at the tax reductions, the 2007 legislation lowers the top state corporate tax rate from 7.5% to 7.1%.[2] This new rate applies to the entire net income base,[3] in tax years beginning on or after January 1, 2007. For "manufacturers" the top tax rate has been cut even further -- to 6.5% -- for tax years beginning on or after January 31, 2007.[4] To qualify for the lower rate, manufacturers must maintain at least $1 million of assets[5] in New York; for small manufacturers with less than $1 million total assets, the lower rate applies if "all" real and personal property is located in New York. Qualified corporations "principally engaged in the production of goods by manufacturing [etc.]" thus enjoy a significant benefit, even with respect to income that is not derived from manufacturing, and even when the manufacturing, and associated jobs, are located outside New York. It will however be interesting to see whether the New York property requirement sparks any constitutional challenge, particularly in respect of small enterprises with less than "all" of their property in New York, who are now taxed at a higher rate by virtue of engaging in interstate commerce.

Also intended as a benefit to corporations, single-factor, receipts-based apportionment of net income has now been fully phased in, for tax years beginning in 2007.[6] Receipts-based apportionment benefits corporations that have plant and payroll in New York but sell property to customers elsewhere. It is, however, of little benefit to service or financial sector businesses, as their receipts tend to be sourced where the workers, rather than the customers, are located.[7]

"Loophole Closers"

Turning to the "loophole closers," perhaps the most far-reaching of the 2007 amendments is a fundamental change in corporate combined reporting under the corporate franchise tax (Article 9-A).[8] Combined reporting essentially works by disregarding the different corporate boxes into which a unitary business may be legally subdivided, and instead calculating tax on the overall profits of the business. Where corporate business is conducted in multiple jurisdictions, combined reporting can produce significantly different results than entity-based separate reporting. It can lower taxes in some cases, by allowing affiliates to net profits and losses, or to reflect out-of-state factors in apportioning income. It can increase taxes in other cases, by bringing new taxpayers, and their profits and factors, into the combined report.

New York had historically required (and permitted) combined reporting where necessary to eliminate distortion, *i.e.*, the underreporting of New York income as a result of non-arm's length transactions among affiliates. This "distortion" standard permitted groups to avoid New York combination by demonstrating that their dealings were always on arm's-length terms. That exercise, in turn, generated considerable controversy, with dueling transfer pricing experts an increasingly common feature of corporate audits.

To eliminate this source of controversy, and eliminate as well corporations' ability to avoid unwanted combination by correctly pricing intercompany transactions, the 2007 amendments adopt a new standard under Article 9-A for requiring combined reporting. Effective for tax years beginning on or after January 1, 2007, affiliated corporations will be required to file combined State reports "if there are substantial intercorporate transactions among the related corporations, regardless of the transfer price . . . ."[9]

The statute further provides that it is not necessary for any one corporation to have substantial transactions with every other related corporation; it is sufficient that such transactions occur "between the taxpayer and a related corporation or collectively, a group of such related corporations."[10] Accordingly, if there is, for example, a financing affiliate located in New York, and that corporation derives 50% or more of its revenues or expenses[11] from transactions with affiliates, it appears that all of the affiliates dealing with the finance subsidiary will now be included in a New York State report.

Individual Taxpayers

For individual taxpayers two other "loophole closers," both effective in 2007, merit attention. The first relates to employee-owned personal service corporations ("PSCs") and S corporations.

Nonresidents of New York are taxed on their New York source income. In the case of income from a service business, that can be measured in one of two ways. Owners of a business source income based on the extent to which the business is conducted in New York. Employees, by contrast, source income based on the days the individual actually works[12] in New York. Where a partner perform services primarily outside New York, the employee sourcing rule can be more advantageous than the partner rule. As a result, structures were developed in which the partner in the firm was a corporation (not the individual), and the corporation then paid wages to the individual as its employee; the individual then would source that wage income based on his or her physical location, not the firm's factors.

The Budget Bill adds a new provision authorizing the Commissioner "to allocate all income, deductions, credits, exclusions and other allowances"[13] between a PSC or S corporation and its employee-owner.[14] This authority is available where "substantially all of the services" of the corporation are performed for another entity, and the "effect" of the structure is the "avoidance or evasion of New York income tax" by reducing New York source income, or by securing any tax benefit not otherwise available, "provided such allocation is necessary to prevent avoidance or evasion of New York State income tax or to clearly reflect the source and the amount of the income of the . . . corporation or any of its employee-owners."[15]

This provision is to be invoked on audit, meaning it is not self enforcing. Moreover, it incorporates a variety of conditions and standards, and permits a variety of remedies. Given the historic willingness of New York lawyers to challenge unfavorable tax audits,[16] the State may find this loophole closer more grist for the controversy mill.

Hybrid S Corporations

The second change affecting individual taxpayers relates to "hybrid" S corporations. In New York, S corporation treatment requires a separate S election. Where shareholders do not make the New York election, corporations that are S corporations for federal purposes will be taxable as C corporations in New York. Because that status can produce favorable State taxation of investment income, or relieve nonresident shareholders of New York filing obligations, hybrid S corporations can be useful planning vehicles.

Reacting to the use of hybrid S corporations to defer or eliminate New York tax on investment income, the Budget Bill prescribes a new standard under which a New York S election will be deemed to have been made.[17] Specifically, if in any corporate tax year more than 50% of gross income is "investment income," the shareholders will be deemed to have made a New York S election. "Investment income" for this purpose means "interest, dividends, royalties, annuities, rents and gains derived from dealings in property,"[18] including such items derived from pass-through entities. Hybrid S corporations now must monitor their gross income to determine whether the corporation or its shareholders will be filing in New York. Also, since income classified as "investment" in this new provision may not, in fact, qualify for the favored "investment income" treatment allowed to New York C corporations (rent, for instance), the new provision may force S elections even where there was no particular State tax engineering going on.

Special Status Entities

On a more arcane plane, the Budget Bill made a number of "loophole closing" changes aimed at State tax planning that employed certain special status entities to mitigate corporate tax. Wal-Mart and others[19] have been in the news of late for their use of captive real estate investment trusts (or "REITs") to reduce state income taxes.

The Budget Bill seeks to foreclose that planning, adopting two different forms of deterrents. Under the new law, REITs that are 80% owned or controlled by an Article 9-A taxpayer (or by a member of a New York Article 9-A combined group) will be required to file a combined report with such affiliates, and will lose the dividends paid deduction that is allowed to REITs federally. In the case of banks and insurance companies, they will be allowed no subsidiary capital exclusion for dividends or gain from REITs, including that derived indirectly through REIT holding companies. The bank rules are phased in, and do not apply at all to certain smaller banks. The Budget Bill includes analogous provisions targeting RICs as well.

Unfortunately the REIT amendments impinge in certain unanticipated respects on classic REITs, and create multiple taxation for certain banks, problems in need of corrective technical action.

The other special status legislation relates to banks that own Article 9-A subsidiaries. A 1985 grandfathering rule permits certain bank subsidiaries to continue to be taxed under Article 9-A; and 2000 transition rules, responding to the federal Gramm-Leach-Bliley ("GLB") law, permit certain existing corporations to freeze their status as Article 9-A or Article 32 taxpayers, and allow newly-formed corporations to choose Article 9-A or Article 32 status.

Under the Budget Bill,[20] banks will find it more difficult to maintain subsidiaries that are eligible to be taxed under Article 9-A. The Budget Bill specifies events that will cause grandfathered or transitional rule status to be terminated, resulting in taxation under Article 32.

The legislation also broadened the definition of banking corporations to include investment subsidiaries, even where their activities are outside the realm of those lawfully conducted by banks or closely related thereto.[21]

While the use of grandfathered and transitional rules entities was substantially curtailed by the Budget Bill, the GLB transitional rules were also reenacted once again, through 2009, keeping some elements of this planning alive. Whether the extension of transitional rules signals a commitment to actually rationalize Articles 9-A and 32 in the near future remains to be seen.

Finally, and in case the message is not yet clear, New York's statute requiring disclosure of federal and state tax shelters has been extended from its initial July 1, 2007, expiry to July 1, 2009. New York has not yet designated any State tax plan or structure as a reportable transaction, but again the extended effective date may signal some action on that front.

City's Corporate Tax Laws

In reflecting on the Budget Bill amendment, it is very important to note that, with the exception of the extended bank tax and GLB transition rules, the Budget Bill did not directly amend the City's corporate tax laws. The Bloomberg administration objected to certain of the Governor's originally proposed amendments as harmful to economic development. The response seems to have been to amend only the State's corporate taxes, leaving the City's in place. Of course corporations taxable in the City also pay State tax, so whatever harm there may be, in terms of State taxes, has been done. It now falls to the City to consider conforming, and to taxpayers to deal with whatever nonconformity remains.

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1 S. 2110-C, A.4310-C (hereinafter the "Budget Bill" or "A.4310-C"). The legislation constitutes Chapter 60 of the Laws of 2007.

2 A. 4310-C, Part N, amending Article 9-A (applicable to general business corporations) Article 32 (applicable to banks), and Article 33 (applicable to insurance companies).

3 New York also imposes alternative taxes, if greater, on alternative minimum income, capital (or assets), and payroll. The alternative tax on the minimum taxable income base under Article 9-A has also been reduced, from 2.5% to 1.5%. *Id*., amending §210(1)(c)(ii).

4 A. 4310-C, Para. N, adding Tax Law §210(1)(a)(vi).

5 "Assets" here means tangible personal property and other tangible property, including buildings, which are acquired by purchase and are principally used in the production of goods by manufacturing, etc. The $1 million is measured by adjusted basis. See Tax Law §210(12)(b)(i)(A).

6 A. 4310-C, Part B, amending Tax Law §210(3)(a)(10)(iii).

7 There are some customer-based sourcing rules for taxpayers performing management services for RICs, and for registered broker/dealers. Tax Law §210(3)(a)(2)(B).

8 The New York corporate franchise tax is applicable to general business corporations. Combined reporting for banks (taxed under Article 32) and insurance companies (taxed under Article 33) was not affected by the Budget Bill.

9 A.4310-C, Part J, amending Tax Law §211(4)(a).

10 *Id*.

11 See N.Y.C.R.R. §6-2.3(c).

12 Or is deemed to work in New York under the "convenience of the "employer" rule. See *Zelinsky v. Tax Appeals Tribunal*, 1 N.Y. 3d 85 (N.Y. 2003).

13 A. 4310-C, Part K, adding Tax Law §632-a.

14 This is defined as an employee owning, directly or by attribution, more than 10% of the outstanding stock. Tax Law §632-a(3).

15 *Id*.

16 See, *e.g.*, *Lunding v, NY Tax Appeals Tribunal*, 522 U.S. 287 (1998) (deductibility of alimony paid by nonresident); *Zelinsky v. Tax Appeals Tribunal*, *supra* (allocation of wage income tax to New York); *Montgomerie v. NYS Tax Appeals Tribunal*, 291 AD 129 (3d Dept. 2002) (treatment of partnership income in year of change of residence); *McDermott*, DTA #820099, NYS Div. of Tax Appeals, February 2, 2006 (taxability of retirement income).

17 A. 4310-C, Part L, adding Tax Law §660(i), effective for tax years beginning on or after January 1, 2007.

18 Tax Law §660(i)(3).

19 See *e.g.*, *Bridges v. Autozone Properties, Inc.*, La. Sup. Ct. No. 2004-C-814, March 24, 2005.

20 A. 4310-C, Part G, adding Tax Law §1452(n) and §1452(a)(9)(iii).

21 Tax Law §1452(a)((9)(iii).