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# REPORT ON LEGISLATION BY THE COMMITTEE ON STATE AND LOCAL TAXATION

## 2015-16 ARTICLE VII BUDGET BILL A.3009 / S.2009 COMMENTS ON THE CITY CORPORATE INCOME TAX REFORM PROVISIONS OF THE NEW YORK STATE 2015-2016 EXECUTIVE BUDGET[1]

## INTRODUCTION

This report on the proposed New York City corporate tax reform embedded within the New York State 2015-2016 Executive Budget Bill ("Proposed City Reform Legislation") was prepared by the New York City Bar Association's Committee on State and Local Taxation. The primary focus of this report is to evaluate the level of conformity between the Proposed City Reform Legislation with the New York State corporate tax law changes enacted on March 31, 2014 and the technical corrections contained in the Budget Bill ("State Reform Legislation").

Historically, the City general corporation tax has substantially conformed to the State's corporate franchise tax law. Nevertheless, the City has a history of decoupling from the State in specific areas either by statute or through policy with respect to the administration of the corporate tax law. For example, in 2007 when New York State implemented a single sales factor for apportionment purposes, the City declined to follow suit. Rather it enacted a provision to phase in the sales factor over a nine-year period.

Although we recognize that a uniform system of corporate taxation is easier for taxpayers to navigate and is ultimately more predictable, we also understand that the City and the State have different constituencies, budgetary concerns and other factors that drive their tax administration. Nevertheless, we believe that conformity should be the norm and that the city corporate statutes should decouple from the state corporate tax statutes only where there is a compelling reason for doing so.

[1] The principal drafters of this report were: Raymond J. Freda, Amy F. Nogid, Jeffrey S. Reed, Leah Robinson and Laurie J. Stoeckmann. Helpful editorial and substantive comments were received by: Arthur Rosen. Although members of the Committee on State and Local Taxation, both David W. Bunning and Glenn Newman recused themselves from participation in this report.

**EXECUTIVE SUMMARY**

This report covers the following areas: effective date, nexus, tax base, tax rates, apportionment, combined filing, tax attributes, tax credits and other miscellaneous provisions. The Committee's comments regarding each of these areas are summarized as follows:

Effective Date and Applicability. While we support uniformity between the City and State corporate tax laws, the Committee believes that making the Proposed City Reform Legislation effective retroactively to January 1, 2015 will make it difficult, if not impossible, for calendar year corporate taxpayers to compute their March 15, 2015 extension payments properly. Accordingly, we recommend that the Budget Bill be revised to include a provision granting statutory penalty relief to all calendar year corporate taxpayers with respect to their first quarter tax payments.

Nexus. The Committee acknowledges the movement by states to an economic nexus standard; however, we believe that this provision would invite constitutional challenges.

Tax Bases. While significant conformity would be achieved by enactment of the Proposed City Reform Legislation, it does not provide for a phase out of the tax on Capital as does the State Reform Legislation. The Committee believes the City should consider adopting the State phase out of the tax on capital as it presents a hardship on taxpayers when they are not generating positive net income and are thus financially vulnerable.

Tax Rates. The Proposed City Reform Legislation provides for reduced corporate tax rates. The Committee notes that there a number of inconsistencies between the City and State with regard to the provisions affecting qualified New York City manufacturers.

Apportionment. Apart from the City's continued phasing in of the single sales factor, the Proposed City Reform Legislation mirrors most of the State Reform Legislation's apportionment provisions. The Committee raises concerns with the failure of the Proposed City Reform Legislation to conform to the provisions impacting corporate partners and would like to see guidance on how to apply the new apportionment provisions.

Combined Report. The Committee supports the elimination of the current substantial intercorporate transactions test that is applied in determining member of a combined filing group. Likewise the Committee is supportive of the Proposed City Reform Legislation's adoption of the unitary standard enacted within the State Reform Legislation.

Net Operating Losses. The Committee supports the Proposed City Reform Legislation's full adoption of the State Reform Legislation's net operating loss provisions. We note one discrepancy that arises in the mathematical computation of the prior net operating loss subtraction that ultimately lowers the amount of City net operating losses that can be carried forward.

Other Provisions. Although the Proposed City Reform Legislation contains a few revisions to administrative and procedural provisions, the Committee believes that a

comprehensive review of all administrative and procedural provision is long overdue and that any changes contained in the Proposed City Reform Legislation should be deferred until such a comprehensive review is completed.

**DISCUSSION**

## I. Effective Date and Applicability

### A. Proposed City Reform Legislation

Subdivision 1 of Section 11-651[2] provides that the corporate tax law changes will become effective for tax years beginning on or after January 1, 2015. The provisions apply to all corporate taxpayers but specifically exclude S corporations and qualified subchapter S subsidiaries.

### B. Comments

While we applaud the City's effort to conform the effective date so as reduce the impact that could result from two disparate taxing regimes, concerns have arisen. For corporate taxpayers that report on a calendar year end basis, estimated tax payments and extensions will be due on March 15. If the legislation is not enacted before March 15, there could be errors in determining the proper members that should be included in the filing group and in calculating the quarter estimated tax payments. As discussed further below, proposed Section 11-654.3 will drastically alter the analysis for determining which related entities in an affiliated group will be required to join in the New York City combined filing. The Proposed City Reform Legislation requires a unitary test whereas the current regime utilizes a substantial intercorporate transactions test. The differences between the two tests are material and may result in very different filing group. Without knowing the exact composition of the combined filing group, taxpayers will have a difficult time computing the group's proper estimated tax.

Similarly, the "economic nexus" provisions contained within Section 11-653, discussed below, could result in companies that had not been subject to tax becoming taxpayers with an obligation to file corporation tax returns. Again, if the law does not pass before March 15, then those taxpayers will be late in making their first quarter estimated tax payments and thus subject to penalties.

Finally, as discussed further below, proposed Section 11-654 significantly alters the method for computing the net income tax base. The proposal for computing the net income tax by reducing entire net income by investment income and other exempt income is a significant departure from the current entire net income approach. If the law is not enacted prior to March 15, taxpayers will be bound to compute their estimated tax liability under the current entire net income method which could result in significant shortfalls and thus penalty imposition.

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[2] References to "Section" are to sections of the New York City Administrative Code.

In sum, we note that the Proposed City Reform Legislation does not take into account these timing issues for taxpayers required to file March 15 estimated tax and thus does not provide any statutory penalty relief. Accordingly, we recommend that an amendment be made to the existing proposed legislation to provide full penalty abatement for deficiencies in estimated tax payments impacted by the retroactivity of the taxing statutes.

## II. Nexus

### A. Proposed City Reform Legislation

Section 11-653 of the Proposed City Reform Legislation, in addition to imposing the tax on corporations that employ capital, own or lease property, or maintain an office within the City also imposes the tax on any corporation that derives more than one million dollars in receipts from the City. Receipts is defined to include those receipts that are subject to apportionment as described in Section 11-654.2 and are included in the numerator of the sales apportionment factor. The Proposed City Reform Legislation also provides that any corporation that 1) issues a credit card to one thousand or more New York City customers (by mailing address); 2) has merchant customer contracts with merchants such that the total number of locations covered by those contracts is one thousand or more; or 3) the sum of the number of City credit card customers plus the number of merchant customer contracts with locations in New York City equals one thousand or more, will have nexus with the City and thus be subject to the tax.

Further, the proposed legislation provides where a corporation has less than one million dollars in New York City receipts, but does have at least ten thousand dollars of New York City receipts and is part of a unitary group as defined under Section 11-654.3, then all the New York City receipts of the unitary filing group members with more than ten thousand dollars in New York City receipts will be aggregated to determine whether they collectively meet the one-million-dollar-receipts threshold.

Similarly the proposed legislation provides for aggregation for purposes of determining whether a taxpayer that issues credit cards meets the one-thousand filing threshold. That is, where a credit card issuer has more than ten customers or merchant locations within the City, then its customers or merchant locations are aggregated with its other unitary group members, as determined under Section 11-654.3 with more than ten City customers or merchant locations to determine whether they collectively meet the one-thousand-customers or customer-locations threshold.

The proposed legislation provides that the Commissioner of Finance will annually review the one-million-dollar-receipts and one-thousand-customers-or-merchant-locations thresholds. The Commissioner e will adjust the receipt thresholds if the consumer price index has changed by ten percent or more since January 1, 2015, or the date of the last change to the threshold.
The proposed legislation imposes the corporate income tax on all corporate partners who own an interest in a partnership that is doing business, employing capital, owning or leasing property, maintaining an office or deriving receipts in or from the City.

B. Comments

Although we applaud the efforts to conform the State and City nexus provisions, we are concerned that asserting nexus on an out-of-state company solely on the basis that it generates more than $1 million dollars in revenue runs afoul of the Commerce Clause of the U.S. Constitution and, perhaps, the U.S. Constitution's Due Process Clause. Under prevailing law, a state can only impose an income tax on an out of state corporation to the extent it has "substantial nexus" with the state.[3] While the Supreme Court has determined that physical presence is required for a state to impose a sales tax collection responsibility on an out of state corporation,[4] it has yet to do so specifically with regard to the imposition of a corporate income tax. As a result, states have been divided on the question.

For example, in *J.C. Penney National Bank v. Johnson*,[5] the Tennessee Court of Appeals held that J.C. Penney, an issuer of consumer credit cards with no physical presence in Tennessee, was not subject to the State's corporate income tax as it did not have the requisite physical presence to satisfy the substantial nexus requirement under the Commerce Clause.

In contrast, in a case with very similar facts, the West Virginia Court of Appeal held in *Commissioner v. MBNA America Bank*,[6] that MBNA's systematic and continuous direct-mail, solicitation and promotion of its products in West Virginia, albeit performed from outside the State did satisfy the substantial nexus requirement under the Commerce Clause.

In our opinion this lack of clarity will certainly invite litigation with regard to the $1million filing threshold proposed in the Proposed City Reform Legislation.

## III. Tax Bases

A. Proposed City Reform Legislation

Under the new proposal, taxpayers will compute a tax on business income, business capital and a fixed dollar minimum basis and pay on the highest amount computed. The Proposed City Reform Legislation eliminates the computation of the alternative tax and the tax on subsidiary capital.

*Tax on Business Income*

Under the proposed legislation, a tax will be imposed on business income attributable to the City. Proposed Section 11-652.7 defines business income as entire net income minus investment income and other exempt income. In turn, entire net income is defined as total

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[3] *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977).

[4] *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).

[5] 19 S.W. 3rd 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000). *See also*, *Scioto Insurance Company v. Oklahoma Tax Commission*, 279 P.3d 782 (2012).

[6] *Tax Comm'r of W. Va. v. MBNA America Bank*, 220 W. Va. 163 (2006), *cert. denied*, 551 U.S. 1141 (2007).

income from all sources and presumably shall be equivalent to net income reported to the United States Treasury. For alien corporations, entire net income will be that which is effectively connected as determined under Section 882 of the Internal Revenue Code.

Investment Income is all income including capital gains in excess of capital losses derived from investment capital less interest deductions allowable in computing entire net income which are directly or indirectly attributable investment income or investment capital.

Investment capital is defined as investments in stocks that are held by the taxpayer for more than six consecutive months but are and have never been used by the taxpayer in the regular course of business. Stock in unitary affiliates is not included in investment capital and there is a presumption that corporations are not unitary to the extent ownership is less than twenty-percent.

Investment capital will be reduced by liabilities that are directly or indirectly attributable to investment capital. To the extent liabilities attributable to investment capital exceed investment capital then investment capital will be zero.

To the extent interest expenses directly or indirectly attributable exceed investment income the taxpayers are required to add such excess back to entire net income. In lieu of performing interest expense attribution, the new law permits taxpayers to elect to reduce their investment income by forty-percent.

Other exempt income is the sum of a taxpayer's exempt CFC income and exempt unitary corporate dividends.

Exempt CFC income is income included in federal gross income pursuant to Section 951(a) of the Internal Revenue Code received from a corporation that is conducting a unitary business with the taxpayer but is not included in a combined report. Exempt CFC income is reduced by interest deductions directly or indirectly attributable to that income. In lieu of performing interest expense attribution, the new law permits taxpayers to elect to reduce their Exempt CFC income by forty-percent.

Exempt unitary corporate dividends means dividends received from a unitary affiliate wherein such affiliate is not included in the unitary report, reduced by interest deductions directly or indirectly attributable to such income. The proposed law provides that taxpayers may, in lieu attributing interest deductions, reduce exempt unitary corporate dividends by forty-percent.

To the extent interest expense attributed exceeds other exempt income such excess is added back to entire net income.

*Tax on Business Capital*

Under the proposed legislation, a tax will be imposed on a taxpayer's business capital attributable to the City. Business capital is defined to mean all assets, other than investment

capital and stock issued by the taxpayer, less liabilities not deducted from investment capital. Business capital will only include those assets that generate income, loss or expense in the computation of entire net income. The tax on business capital is capped $10 million for any one taxpayer in a taxable year.

*Fixed Dollar Minimum Tax*

The proposed legislation imposes a fixed dollar minimum tax on corporations based on their New York City receipts as determined under the apportionment provision embodied in Section 11-654.2. The tax is imposed on sliding scale and ranges from $25 for taxpayers with receipts not more than one-hundred thousand to two-hundred thousand for taxpayer with receipts in excess of one-billion dollars. The proposed legislation provides for proration of the fixed dollar minimum tax for taxpayers with a taxable year that is shorter than 12 months.

B. Comments

The Proposed City Reform Legislation substantially conforms to the State Tax Reform provisions particularly with respect to the tax imposed on business income. It does so by aligning the City and the State's definitions, elections and the overall computation of the tax on business income. This level of conformity will certainly make it easier for taxpayers who are subject to both tax regimes.

With regard to the tax on capital we note that while the State Tax Reform tax on capital is capped at $5 million per taxpayer and ultimately phases out the tax, the Proposed City Reform cap is set at $10 million with no phase out of the tax. While budgetary concerns may be behind the City's decoupling, we are concerned that the additional tax on capital will further burden companies that are struggling financially. This additional strain on the taxpayer could ultimately have serious negative consequences to the City economy and to those who are employed by such taxpayers.

Although the Proposed City Reform Legislation's provisions for the fixed dollar minimum tax conform in full to the State Tax Reform, we note our concern for the dramatic increase in this tax. Currently, the highest fixed dollar minimum tax is $5,000. Under the Proposed City Reform Legislation, the highest fixed dollar minimum tax is $200,000. This is a significant increase in the tax and could be imposed at a time when the taxpayer is financially vulnerable and may have difficulties in absorbing such a cost.

Accordingly, we recommend that both the $10 million cap and the top fixed dollar minimum tax of $200,000 be reduced.

## IV. Tax Rates

A. Proposed City Reform Legislation

The chart below lays out the new rates that will become effective with passage of the City Tax Reform.

| **Tax Rates** | **Pre-Reform** | **Proposed Reform** |
|---|---|---|
| Income Tax Rate | 8.85% entire net income | 8.85% business income |
| Reduced Income Tax Rate for Qualified NYC manufacturers | N/A | 4.425% |
| Capital Tax Rate | 0.15% | 0.15% |
| Cap on Capital Tax | $1 Million<br>($350K for 2008 or before) | $10 Million<br>No phase out |
| Alternative Tax Rate | 8.85% | Eliminated |
| Fixed Dollar Minimum Tax | $25 to $5,000 ($300 for tax years in or before 2008) | $25 to $200,000 |
| Subsidiary Capital Tax Rate | 0.075% | Eliminated |

| Taxpayer | Pre-Reform | Income Level | Post-Reform |
|---|---|---|---|
| **Small non-manufacturers** | 8.85% | 6.5% to 8.85% | 6.5% |
| Allocated business income | <$1 M | $1 M ≤ x < $1.5 M | ≥$1.5 M |
| Unallocated business income | <$2 M | $2 M ≤ x < $3 M | ≥$3 M |
| **Qualified NYC manufacturers** | 8.85% | 4.425% to 8.85% | 4.425% |
| Allocated business income | <$10 M | $10 M ≤ x < $20 M | ≥$20 M |
| Unallocated business income | <$20 M | $20 M ≤ x < $40 M | ≥$40 M |

B. Comments

The proposed legislation provides a reduced tax rate to qualifying New York City manufacturing corporations. The reduced tax rate is 4.425%, but the rate is higher if the manufacturer has allocated business income of more than $10,000,000. Additionally, if a manufacturer has over $40,000,000 of business income it is taxed at the regular New York City corporate tax rate of 8.85% and cannot claim the benefit of the incentive.

A corporation is a "qualifying New York City manufacturing corporation" if it has property in the city used for manufacturing purposes and either: (1) the adjusted basis of such property for federal income tax purposes at the close of the taxable year is at least one million dollars; or (2) more than 50% of its real and personal property is located in the City.

The term "manufacturing" includes the process, including the assembly process, of working raw materials into wares suitable for use or giving new shape, new qualities or new combinations to matter that already has gone through some artificial process, by the use of machinery, tools, appliances and other similar equipment. For a taxpayer to be a manufacturing

corporation, more than 50% of the taxpayer's gross receipts are derived from the sale of goods produced by manufacturing.

In the context of a combined group, the combined group is considered a manufacturer if more than 50% of the combined group's receipts in the aggregate derive from receipts from the sale of goods produced by manufacturing.

The Proposed City Reform Legislation uses different criteria to determine what constitutes manufacturing than that provided for under the State's Tax Law. The criteria under the proposed legislation appears to be consistent with the criteria set forth in 19 § RCNY 11-63(c)(4), but differs with that contained in N.Y. Tax Law § 210.1(a)(vi), which includes a broader variety of activities under its definition of manufacturing ("manufacturing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture or commercial fishing"). The State Reform Legislation does not address whether preproduction activities, which explicitly constitute "manufacturing" under 19 RCNY § 11-63(c)(4)(ii)(A)(8) and (c)(4)(v) Ex. 14, are qualified manufacturing activities.

Additionally, the Proposed City Reform Legislation provides for a different alternative test than under the New York Tax Law. The alternative test under the New York Tax Law requires that all of the manufacturer's real and personal property be located in New York. Under the Proposed City Reform Legislation, the manufacturer need have more than 50% of its real and personal property located in the City to qualify under the alternative test.

## V. Apportionment

### A. Proposed City Reform Legislation

The Proposed City Reform Legislation's revisions to the New York City General Corporate Tax ("GCT"), including the portion related to the apportionment of business income, is included in Part QQ of the 2015-2016 Budget Bill. The portion related to the apportionment of business income ("Apportionment") is included in paragraph 3 and paragraph 4 of Section 11-654 [Computation of Tax] and Section 11-654.2 [Receipts apportionment] contained in a new Subchapter of 3-A [Corporation Tax of 2015] to Chapter 6 of Title 11 of the New York City ("City") Administrative Code ("Code").

The Proposed City Reform Legislation closely conforms to the State Reform Legislation and the newly proposed technical and clarifying legislation. The principal difference is that the Proposed City Reform Legislation continues the phase-in of a single sales factor rather than immediately conforming to a single sales factor to be effective for tax years beginning on and after January 1, 2015.

Under the Proposed City Reform Legislation, like the State Reform Legislation, receipts from sales of electricity are sourced to the delivery location. Net gains (not less than zero) from the sales of real property are sourced to the location of the property. Royalties from the use of patents, copyrights, trademarks, and similar intangibles are sourced to New York City if such intangibles are used within the City. Receipts from digital products are generally sourced to the customer's primary use location of the product.

Sourcing rules are created for apportioning income from financial instruments. Qualified financial instruments (QFIs) are defined as financial instruments that are eligible or required to be marked to market under I.R.C. §§ 475 or 1256, excluding loans secured by real property. Taxpayers can use one either customer-based sourcing for each income stream that does not constitute tax exempt income; or elect to treat all income from QFIs as taxable business income and apportion 8% of the net income (dividend income, interest income, and net gains), not less than zero, from QFIs to New York City. The 8% QFI election must be made on an annual basis, is irrevocable, and applies to all the QFI income of all members of a combined group. Non-qualified financial instruments (non-QFIs) are all financial instruments that do not meet the definition of QFI and the related income is subject to customer-based sourcing. I n cases where sourcing rules for financial transactions rely on commercial domicile, taxpayers are required to use the following hierarchy:

- seat of management and control; and
- billing address of the customer.

Receipts constituting the primary spread of selling concessions from underwritten securities are sourced to the customer's location. Receipts from credit card authorization processing and clearing and settling processing are sourced to the location where the credit card processor's customer accesses the processor's network. All other credit card processing receipts are sourced to New York City using the average of 8% and the percentage of New York City access points. Receipts from services are generally sourced to New York City if the customer receives the benefit of the service in the City.

There are, in addition, special apportionment rules for trucking, railroad, transportation of gas through pipes, and aviation. Current sourcing rules continue generally for:

- sales of tangible personal property;
- rentals of real and tangible personal property;
- broker/dealer activities, except as noted above;
- interest, fees, penalties, service charges, merchant discounts, and credit card fees;
- services provided to a Regulated Investment Company (RIC); and
- advertising

B. Comments

In various places terminology Proposed City Reform Legislation varies from the State Reform Legislation. For example, where the State Reform Legislation uses "is" or "are" in certain contexts, the Proposed City Reform Legislation uses "shall." It is my understanding that the New York City Law Department, in its review of the Proposed City Reform Legislation, made certain style or grammatical changes consistent with the existing City Code style. Such differences are ignored in this review as the intent in the Proposed City Reform Legislation affecting apportionment appears to be consistent with the intent of the State Reform Legislation although it is worth noting that such differences could give rise to uncertainty and controversy.

Another difference is that where the State Reform Legislation uniformly refers to the portion of business income to be subject to tax as an amount "apportioned to the state by the apportionment factor" the Proposed City Reform Legislation continues the use of "allocation," as in the existing GCT, rather than uniformly using apportionment and thus refers to a "business allocation factor." In most applications where taxable income is determined by a percentage it is referred to as apportionment. No significance is attached to this difference between State Reform Legislation and Proposed City Reform Legislation.

Finally, the State Reform Legislation provides a title describing the type receipt for which a specific computation methodology is provided. The Proposed City Reform Legislation generally does not provide an introductory title. It is suggested that the City conform to this formulation as it makes it easier to pinpoint the rules for specific receipt type.

To accommodate the continued phase-in of a single sales factor, this portion of the Proposed City Reform Legislation does not fully conform to the State Reform Legislation. A definition of property and payroll factor is included in the subdivision explaining the computation of the business allocation for tax years beginning prior to 2018. Ideally, immediate conformity to the State Reform Legislation would be desirable from a compliance perspective.

The Proposed City Reform Legislation does not specifically address the treatment of corporate partners. State Reform Legislation, however specifically addressed the treatment of corporate partners as follows:

> The current approach to partnership items of receipts, income, gain, loss, and deduction that flow through a partnership to a corporate partner as well as gains or losses from the sale of a partnership interest itself (i.e., the current regulations) is retained.[7]

Although the City had indicated a desire to conform to the State, it is unclear how the City will treat corporate partners until such regulations are adopted. It would be helpful to have clearer guidance at the outset.

In addition to the discretionary authority described in Subdivision 9 of Section 11-654, the Proposed City Reform Legislation also provides a revised discretionary authority in Subdivision 11 of Section 11-654.2 and these two separate provisions may cause some confusion as they are not identical and both appear to be effective as of January 1, 2015. Subdivision 9 of Section 654 closely conforms to the discretionary provision in the existing GCT currently in effect, while Subdivision 11 of Section 11-654.2 closely conforms to the discretionary authority included in the State Reform Legislation.

Subdivision 9 of Section 11-654 and Subdivision 11 of Section 11-654.2 differ in important respects. For example, Subdivision 11 of Section 11-654.2 refers to the inclusion or exclusion in the calculation of "other items" in authorizing possible discretionary adjustments to the normal calculation of the business allocation percentage while Subdivision 9 of Section 11-

[7] New York State Corporate Tax Reform Outline (April 2014)

654 refers to the inclusion or exclusion of “factors” rather than "other items.” “Items” may be interpreted to refer to types of receipts while “factors” may be interpreted as allowing factors in addition to or other than the receipts factor. In addition, as drafted, Subdivision 9 of Section 11-654, unlike the Subdivision 11 of Section 11-654.2, does not specifically state that the taxpayer may seek a discretionary adjustment. Additionally, it does not state that the burden of proof is on the party seeking the discretionary adjustment. It would be best to craft a provision that conforms as closely as possible to the State Reform Legislation while recognizing that the payroll and property factors remain until 2018. In any event, once the single sales factor is phased in, it is suggested that authority contained in Subdivision 9 of Section 11-654 sunset for tax years beginning on and after 2018.

The Proposed City Reform Legislation is mirroring the State Reform Legislation QFI election that allows taxpayers to elect a fixed 8% of the net income from QFIs for inclusion in the numerator. It is understood that 8% approximates New York State’s contribution to United States gross domestic product (“GDP”). If 8% approximates New York State's contribution to GDP it is logical to assume that the City’s contribution to GDP is less than 8 The Proposed City Reform Legislation should reflect the actual percentage of City GDP.

The provision for sourcing receipts from aviation services including air freight forwarders and other aviation service providers is generally comparable to State Reform Legislation; however the State Reform Legislation, in determining the receipts to be included in the numerator the apportionment factor from other aviation services, provides for the computation of a percentage determined by aggregating three fractions, the numerators of which include 60% of the following: aircraft arrivals and departures in New York, revenue tons handled at New York airports and originating revenue in New York. The denominators of the fractions included all such items within and outside the State. The Proposed City Reform Legislation, however, includes 100% of New York City items in the numerator of the fraction. Currently the City includes 100% of the New York City items in the numerator. Without a compelling reason to decouple on this provision, we recommend that the Proposed City Reform Legislation conform to the State. That is, the numerator should include only 60% of aircraft arrivals and departures in New York City, revenue tons handled at New York City airports and originating revenue in New York City.

## VI. Combined Reporting

### A. Proposed City Reform Legislation

Section 11-654.3 substantially overhauls New York City’s combined reporting regime. The current regime provides for mandatory combination if the following three requirements are met: (1) control; (2) unitary; and (3) substantial intercorporate transactions. Under the Proposed City Reform Legislation, the substantial intercorporate transactions requirement is eliminated. Corporations will be required to file combined reports if they are unitary and are over 50% owned or controlled by each other or by the same interests.

Other corporations required to be included in a combined report include: captive REITs, captive RICs and combinable captive insurance companies.

The Proposed City Reform Legislation provides for a commonly owned group election. Under the election, a taxpayer may elect to treat as its combined group all commonly owned companies. The election is to be made on an original, timely filed return of the combined group. The election is irrevocable and is binding for the year it is made and for the next taxable years; it is automatically renewed for the next seven years unless it is affirmatively revoked.
The Proposed City Reform Legislation also clarifies how tax should be computed in a combined report by providing for intercompany eliminations and stating that credits should first be computed on an individual company basis and then can be shared amongst group members.

B. Comments

We applaud the Proposed City Reform Legislation's conformity to the New York Tax Law. Additionally, we note that the substantial intercorporate transactions test is difficult for auditors and taxpayers to apply in practice and sometimes in the past has been a source of contention among taxpayers and auditors, both at the State and City level. In eliminating the substantial intercorporate transactions test, the Proposed City Reform Legislation makes corporate tax compliance much easier and more predictable although there will certainly be, from time to time, controversies as to whether one or more particular corporations are part of a unitary enterprise.

We note that there is some lack of clarity in the Proposed City Reform Legislation. For example, how would an election to file a combined return be affected, if, subsequent to making the election, the sole nexus member of the group no longer has nexus?

## VII. Net Operating Losses

A. Proposed City Reform Legislation

Section 11-654.1 of the Proposed City Reform Legislation radically changes the New York City treatment of net operating losses ("NOLs"). If enacted, taxpayers will no longer be allowed to carryforward any net operating losses incurred in years beginning after January 1, 2015. Instead, taxpayers will be required to convert their existing unabsorbed NOLs carryforward amounts into a "prior NOL conversion subtraction" that can be used to reduce the taxpayer's business income. The mechanics involve: (1) multiplying the amount of unabsorbed NOL by the taxpayer's 2014 business allocation percentage; and then (2) multiplying that amount by the taxpayer's base year tax rate. That product is then divided by 8.85% to determine the taxpayer's NOL subtraction pool amount available for use. For any given year, a taxpayer can use 10% each year for 10 years of the pool plus any unused amount from preceding tax years. Alternatively, taxpayers can elect to use 50% of their prior NOL conversion subtraction over two years. However, to the extent the taxpayer does not exhaust all of their prior NOL conversion subtraction over the two years as elected, then any unused amount will be forfeited.
For all NOLs generated in tax years on or after January 1, 2015, taxpayers will carryforward their NOLs on a post apportioned basis and prior NOL limitations (e.g. New York City NOL cannot exceed the Federal NOL) are eliminated.

B. Comments

The Proposed City Reform Legislation largely achieves conformity with the New York State Tax Law's treatment of NOLs. One technical difference relates to determining the NOL conversion subtraction pool. In computing the pool under the New York State Tax Law, the taxpayer divides the pool by 6.5% or, in the case of a qualifying manufacturer, 5.7%. N.Y. Tax Law § 210.1(a)(viii)(2)(II). However, in computing the pool for New York City purposes under the proposed legislation the taxpayer would divide the pool by 8.85%. Since the taxpayer is dividing by a larger number, the taxpayer will reach a lower quotient and therefore will be permitted to carry forward a lower net operating loss for New York City tax purposes.

## VIII. Tax Credits

A. Proposed City Reform Legislation

The Proposed City Reform Legislation adopts or carries over all the credits that were previously available under the prior law.

B. Comments

The Committee supports retention of the City's current tax credits. The City's current tax credits provide valuable tax benefits and any reduction thereto would negatively impact taxpayers. Further, in many instances taxpayers have altered their activities or business practices to take advantage of certain credits and it would be unfair to take away those benefits.

## IX. Other Provisions

A. Proposed City Reform Legislation

*City Assessments based upon State Changes under the extended Statute of Limitations*

Section 10 and Section 16 of Part QQ of the NYS Budget Legislation amends parts of Section 11-674 and 11-678 of City Code. Section 11-674 imposes limitations on assessment of additional tax by the City Department of Finance ("Department") and Section 11-678 imposes limitations on claims for credit or refund by taxpayers. While most of the amendments in the proposed amendments to these sections deal with updating references to the new Subchapter of 3-A, a substantive change is included that concerns when assessments may be made or refunds claimed after the expiration on the normal three-year statute of limitations has expired.

One of the exceptions to the normal three-year statute applies when the federal government or the State makes audit changes affecting a taxpayer's taxable income or capital. Under current law, notwithstanding the expiration of the three-year statute of limitations, the Department may assess additional tax related solely to federal or State changes within two years of the reporting of the changes by the taxpayer and the taxpayer similarly may claim a refund within the same two year period based solely upon the federal or State changes. That is true for

all federal or State adjustments related to the change in taxable income or capital other than changes to the allocation of income or capital.

B. Comments

Under the proposed amendments to these two sections of the Code, effective for taxable years beginning on and after January 1, 2015, the Department would now be able to assess even for State (but not federal) changes to the allocation of income or capital and taxpayer would be able to make a claim for refund even for State (but not federal) changes to the allocation of income or capital.

This particular amendment appears to be unrelated to conforming the City's taxation of corporations to the State Reform Legislation. This prohibition on assessments or refunds related to federal and State changes affecting the allocation of income or capital has been in the City law since the GCT was enacted effective for taxable years beginning on and after 1967. Moreover, the State and City taxation of corporations has been generally comparable since 1967.

Clearly, the Department has the authority to audit taxpayers within the normal statute of limitations period and assess based upon changes it deems required under the law including adjustments in the allocation of income. Taxpayers, particularly large taxpayers are usually subject to duplicative State and City audits within the normal three-year statute of limitations and some taxpayers under existing law may even be subject to a third audit when the City conducts a second City examination solely based on State changes. The limitation on assessment based upon allocation changes has lessened the burden of multiple audits of the taxpayer after the City had its own opportunity to audit the taxpayer within the normal statute of limitations period. While the it is true that the current law also limits the ability of taxpayer's to claim refunds based upon State allocation changes, in practice, the State rarely reduces a taxpayer's taxable income or capital based on allocation adjustments and taxpayers usually file refund claims simultaneously with the State and the City within the normal three-year statute. Thus, the change is clearly intended to enhance the Department's ability to audit and assess additional tax even after the normal three-year statute of limitations period has expired.

These particular amendments ought to be considered as part of a broader review of administrative and procedural provision and on their own merits and not enacted as part of tax reform.

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