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State changes law on sourcing and taxing corporate income

TAXING MATTERS
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New York has overhauled its corporate tax law.

The changes are the most significant in more than 30 years and will have far-reaching implications for how taxes are computed for New York corporations and corporations in other states that do business here.

This article will review the key changes and analyze their practical implications for in-state and out-of-state companies. The changes can be divided into five categories:

Apportionment: New York tax is imposed only on New York receipts. To the extent income is earned in another state, it is not subject to tax here. But how do you determine whether income is earned in New York or elsewhere? There are very complex rules that address the issue.

Historically, income from selling goods has been treated as earned in New York to the extent the goods are delivered here. Income from services was sourced to New York if the services were performed here, and "other" income was sourced to New York to the extent it was "earned" here.

This approach has become increasingly difficult to implement, especially with the provision of services over the Internet. Under the revised law, New York has moved to a "market-based" sourcing regime in which sales of services are sourced to the state where they are received or delivered. This changes the state to which many services are sourced.

In addition, the revised law establishes many specific categories for sourcing items that were previously in the "other" category. This makes the sourcing rules much more precise. It also eliminates the separate sourcing regime that previously applied to banks, treating banks in the same manner as all other corporations.

Combined reporting: When does a corporation need to report its income together with its affiliates? The answer to this question can have a substantial impact on the corporate tax liability of the group.

The rules about combined reporting in prior New York law led to many disputes. Corporations were required to report together if they were engaged in an integrated, "unitary" business and met certain ownership thresholds—but only if (1) there were substantial intercorporate transactions between the group members or (2) failure to report together would distort the income of the group members. Because these two factors were subjective, they created compliance headaches.

The revised law has eliminated these factors. Organizations are required to file a combined return if they are engaged in a unitary business and meet ownership thresholds. If the corporations meet the ownership thresholds but are not engaged in a unitary business, they can elect to file on a combined basis. This expands the number of corporations required to file together and greatly simplifies the rules.

Tax base: New York tax for corporations is not strictly based on income. Instead, New York imposes tax on the highest of four factors. The tax reform eliminates one of these factors immediately and phases out a second over time. It also reduces the tax rate on income to 6.5 percent, the lowest level since the 1960s.

The new law also makes a number of important technical changes to how corporations pay tax on the capital of their subsidiaries and their investment income, and to how expenses are attributed. It creates and continues a variety of incentives for qualified manufacturers in the state.

Net operating losses: If a company loses money, how does it compute the losses that it can carry over for state tax purposes and use in future years? New York law previously computed these based on the federal losses. The revised law makes significant changes to the applicable technical rules. Losses for New York purposes are now computed based on the income apportioned to New York without reference to federal rules.

Because of the substantial changes to how these losses are calculated, New York is changing the rules for using existing losses. Instead of allowing corporations to continue to use these losses, they are required to convert them into a special transition amount that they may take against their income over a prescribed period of time.

Economic nexus: The final major change will affect out-of-state companies only.

For a company to be required to pay tax in a state, it must have a certain type of close connection with the state, known as "nexus."

Out-of-state firms will have "nexus" if they have more than $1 million in New York receipts.

In the past, New York's nexus law has focused on physical presence. Under constitutional principles, a company generally must have a physical presence in New York to be required to collect tax here.

The revised state law implements a new concept known as economic nexus, which has been gaining traction in a number of states. Under this concept, a company is treated as having nexus with New York State if it has more than $1 million of receipts from the state.

The constitutional issues associated with economic nexus are still being explored. However, under principles of the new law, companies that do not have a physical presence are subject to New York's taxing jurisdiction for the first time if they have sufficient sales here. This is an important change that may subject out-of-state companies to New York's taxing jurisdiction for the first time.

Generally the changes are effective on Jan. 1, 2015. Corporations subject to New York taxes should consult with their New York tax advisers about how the revisions will apply in their specific situations.

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