

NEW YORK BANKERS ASSOCIATION
TAX COMMITTEE

NEW YORK STATE – CORPORATE TAX REFORM
OBSERVATIONS AND QUESTIONS

In response to the outline of a proposal to merge Articles 9-A and 32 of the Tax Law, as described in the document headed Corporate Tax Reform, the Tax Committee of the New York Bankers Association offers the following preliminary observations and related questions:

Broad Principles

1. Revenue Neutrality – The Department intends to broaden the base of taxable income with an offsetting reduction in the tax rate.
 - a. How is the State going to get sufficient comfort that the revised tax rate will not result in a higher tax than anticipated jeopardizing the financial health of all New York industries, including the banking industry, which does not currently have large margins of capital cushion to absorb even a temporary excessive tax structure?
 - b. As a condition precedent to proceeding with this proposal, the Department should consider producing a report of the revenue changes caused by each component of its proposal together with an initial baseline of how revenue neutrality will be accurately achieved.
 - c. Even assuming that revenue neutrality might result at a macro level for New York State, it seems certain that there will be “winners and losers” in this process.
 - i. Has the state anticipated the potential impact of severe redistributions of tax among industry groups or among individual taxpayers within industry groups?
2. Retention of New York as Financial Center – Past efforts by the department to engage in corporate tax reform have always been accompanied by an affirmation of the intention to maintain New York’s place as the world’s financial capital. No such principle is included in the Corporate Tax Reform outline.
 - a. Is this omission intended?
 - b. In a related vein, a number of provisions of the current banking law are intended to incentivize institutions to maintain their headquarters in New York.
 - i. Does the Department intend to continue to support tax incentives to maintain New York as a headquarters State?

1. If so, please provide specifics.
3. Job Growth – The recent recession has cost New York tens of thousands of jobs in the commercial banking and thrift industries alone.
 - a. Should not one of the principles of corporate tax reform be to encourage the re-establishment of those jobs in New York when the economic recovery begins? If so, what specific feature will the Department support to achieve such a principle?
4. Economic Competitiveness – The principle described as “Economic Competitiveness” contains no reference to competing with the international businesses that compete for loans, deposits, and investments against many money center and regional banks as well as thrifts.
 - a. Is that omission intended?
5. Bank Incentives – In 1985 Article 32 was rewritten to deliver an effective tax rate to banks that struck a balance between maintaining the banking industry’s contribution to the tax base and supporting a strong NYS-based banking network. This was done largely through targeted modifications that for the last 24 years largely accomplished those goals.
 - a. Has the Tax Department given due consideration to the impact of the potential elimination of all bank specific modifications on the continued existence of a vibrant, healthy NYS-based banking industry?
 - b. Will the Department publish a policy paper on the anticipated effect that enactment of these proposals would have on New York banking customers (e.g., capital levels, service delivery, credit access, and other important operational matters)?

Specific Components

Corporations Subject to Tax

1. In addition to credit card banks and REITs, what **additional** specific types of corporate taxpayers does the Department anticipate would be subjected to the New York Corporation Franchise Tax without a physical presence solely because economic nexus is present?

Entire Net Income Base and Rate

1. Federal Taxable Income as Starting point
 - a. Under current law, entire net income of a foreign banking corporation is on income that is effectively connected with the conduct of a United States trade or business (Federal Form 1120-F).

- i. Will New York State continue this methodology?
 - b. Will the proposal incorporate dynamic conformity with the Internal Revenue Code, as has long been the case in New York?
- 2. Investment income
 - a. Would interest expense (direct and indirect) be attributed to investment income using the current rules existing under Article 9-A?
 - b. Will the amount of interest expense attributed to investment capital be limited to the amount of gross income generated by such investment capital?
 - c. The outline provides that "Investment income would be exempt from tax".
 - i. Please confirm that this the investment allocation percentage utilized under current law (Article 9-A) would be discontinued.
 - d. Dividends
 - i. Will New York State still have a 50% dividend received deduction as presently exists under Article 9A?
 - ii. There is considerable confusion about the treatment of dividend income, particularly from unitary subsidiaries.
 - 1. How would dividends, gains and losses from investments in unitary subsidiaries held for more than 6 months be treated?
 - 2. How would dividends, gains and losses from investments in non-unitary subsidiaries held for more than 6 months be treated?
 - e. What definition of "unitary" does the Department propose for categorizing investments (stock and partnerships) as being either "business capital" or "investment capital"?
 - f. Grandfathered 9-A investment subsidiaries of Article 32 corporations will apparently lose the favorable tax treatment of income from investment capital (e.g., interest income on fixed income securities).
 - i. Most banks believe these incentives remain necessary to allow banks to effectively compete with other Article 9-A investment companies and Broker-Dealers.
 - ii. The outline provides that "*Interest income, gains, and losses from debt instruments would be presumed to be business income unless the income cannot be apportioned as such under the U.S. constitution.*"

1. It would be helpful if the Department were to provide guidance as to under what circumstances a bank's fixed income portfolio (e.g., U.S. government securities and mortgaged backed securities) would qualify as "investment income".

Special Provisions

1. Interest on Government Obligations – What is the policy reason for repealing the favorable taxation of interest earned by banks on government obligations?
2. Bad Debt Expense
 - a. Will banks and thrifts be forced to follow the direct charge-off method of computing bad debt deductions under § 166 of the Internal Revenue Code?
 - i. Since the bad debt reserve method is merely a timing difference as to when bad debt deductions are taken into account (as contrasted with a permanent difference like the international banking facility provisions) will the Department support continued use of the reserve method of accounting for bad debts?
 1. If not, why not?
 - ii. If the Department intends to require banks to apply the direct charge-off method of computing bad debt deductions under § 166 of the Internal Revenue Code, what transition rules are contemplated by the Department?
 - b. Savings Institutions ('thrifts')
 - i. Current New York tax law intentionally reflects a social incentive of supporting residential lending in New York State. NYTL § 1453(h) effectively provides a permanent favorable tax rate adjustment to thrift institutions that maintain a high level of residential loans on their balance sheets.
 1. Policy question: In this lending environment, is this an appropriate time to alter this long-standing tax policy position?
 - a. When repeal of the thrift bad debt rules are combined with adoption of customer-based sourcing for mortgage loans, thrifts will pay a much higher New York Corporate Franchise Tax when making mortgage loans to New York residents.
 - i. Has the Tax Department determined that such an incentive is no longer appropriate?

- ii. Has the Department considered the fact that these rules could result in banks selling off New York loans to investors disinterested in any banking service relationship with New York customers, which could change the dynamics of the loan servicing relationship and adversely impact how loans in default are worked out?

c. GAAP Accounting and Regulatory Capital Implications

- i. Unlike commercial banks, thrifts generally do not carry a deferred tax liability for the potential recapture of the New York bad debt reserve maintained under Section 1453(h) into New York entire net income.
- ii. Bank "Safety & Soundness" Issue – Any decision to repeal the thrift bad debt reserve method must **not** result in a recapture of the existing reserve. Even if recapture were to be spread over a number of years, thrifts would suffer an immediate reduction in regulatory and GAAP capital equal to the full amount of the reserve subject to recapture. Upon enactment, a thrift would be compelled to record a deferred tax liability for the full amount of New York Corporation Franchise Tax that would be owed as a result of recapture. No discount would be permitted for the discounted present value of actual tax payments.

3. Tax Credits

- a. No specific mention is made regarding tax credits, which might be characterized as "special provisions".
 - i. Is this an indication that the Department intends to support continued use of tax credits that have previously existed under Article 9-A and/or Article 32?
 - ii. Will tax credit carry forwards created under current law (e.g., Mortgage Recording Tax Credit, Financial Services Investment Tax Credit, Empire Zone Credits, etc.) and carried forward to a unitary combined tax return be available for use?
- b. Observation – These tax credits incentivize community banks in New York to engage in specific activity (mortgage lending, investment in property, job creation, etc.). These activities are part of banks' rolling three-to-five year plans.
 - i. It is critically important for the banking community to understand the role tax credits will play in the new tax law and any limitations that might be imposed on carry forward of existing credits.

Apportionment of Business Income

1. If fixed income investments are eliminated from investment capital, there would likely be a large volume of receipts sourced to New York that had previously been excluded from the factor because of classification as income from "investment capital", which could trigger a substantial shift in the apportionment ratio.
 - a. Does the Department anticipate that there would be adjustments to the receipts factor to minimize unfavorable shifts in the apportionment factor?
2. It may be difficult for some banks to design and implement systems to capture customer-based sourcing data for a law that is effective January 1, 2010.
 - a. If systems are not put in place to correctly identify customers on a timely basis, will there be a presumption or default rule that banks could use to apportion income until such time as systems are fully developed?
3. There is no guidance on how to source receipts from a bank's investment in fixed income securities (e.g., government securities and mortgaged backed securities).
 - a. What sourcing rules (e.g. - Location of management activities of the investment portfolio, location of issuer, other) does the Department envision for receipts from such investments?

Combined Reporting

1. Can the Department elaborate on the specific features of the "*unitary business test*" referred to in the outline?
2. If a water's-edge election is made, will New York allow domestic and alien corporations to join in the filing of a combined return, similar to California?
3. Operating Losses
 - a. Observations:
 - i. Under current law, combined group net operating losses ("NOL") are carried over and used against future entire net income of the combined group regardless of which affiliate generated the NOL in the original year or generated the income in the subsequent year.
 - ii. Under the Department's proposal as set forth in the outline, operating losses of one unitary group member are not offset against operating income of other members of the unitary group in the year such losses and income is recognized for tax purposes.
 - iii. This separate taxpayer tracking of NOL carry forwards would appear to undermine the principle of "Simplicity" set forth on the first page of the Department's outline.

b. Questions:

- i. In light of the observations set forth above, why is it considered to be necessary to assign unitary NOL carry forwards to each specific New York taxpayer and then limit utilization of such NOLs to future income assigned to that specific taxpayer?
- ii. Is the policy objective behind the separate taxpayer NOL tracking rule so compelling as to possibly compromise the broad principle of "Simplicity"?
- iii. Why is the separate taxpayer NOL tracking rule a better tax policy than current rules which permit cross-utilization of attributes?
- iv. In year 1, if a unitary group comprised of 50 corporations reflects a unitary NOL, the unitary group will be required to assign the NY source NOL to each New York "taxpayer" corporation. How would such assignment be accomplished?
 1. California uses a method known as intrastate apportionment to determine the amount of income and/or losses for each taxpayer. Does New York State envision using this methodology?
- v. The corporate reform principles suggest very different results based on whether a loss is incurred by a group member that has nexus and is a New York taxpayer (that loss is not usable as an offset to gains of other members) and a loss incurred by a unitary member that is not a New York taxpayer (that loss is allocated and reduces pro rata the net positive taxable income of the New York taxpayers in the unitary group.) What is the rationale for this disparate treatment?

c. Transition Rules:

- i. We urge that the Department provide some guidance as to how utilization of pre-law change NOLs from different groups will be used in a unitary combined group under the proposed new tax law. It would be helpful if the Department included examples.

d. Deferred Income Tax and Regulatory Capital Implications

i. Observations:

1. Banks record deferred tax assets reflecting the anticipated tax benefit of claiming an NOL deduction in the future. The proposal to limit NOL deductions to the income of the corporate taxpayer that was assigned the original NOL introduces uncertainty in the ability of a corporation to use the NOL before expiration. Enactment of such a rule may result in greater tax expense to corporations reporting operating losses, which may adversely

impact regulatory capital ratios and increase stress on banks' balance sheets.

2. A proposal that does not allow NOLs to be cross-utilized is biased toward corporations that operate in a single corporation, which is legally impossible for bank holding company groups. For example, a bank with overseas subsidiary operations must generally hold such operations in an edge act corporation, which is legally separate from the parent bank.

a. Thus, tax policies that favor single corporation structures inherently discriminate against complex bank holding company groups that are compelled by federal banking law to operate in multiple separate corporations. As such, this provision does not appear to adequately consider the multi-entity operations currently utilized throughout the financial services industry business.

ii. Given the collateral deferred tax and capital ratio implications associated with the proposed NOL carry forward provisions, does the Department believe that these proposals remain balanced and equitable to the regulated financial services industry?

4. Eliminations

a. Some of our banks are concerned that the Department may intend to tax dividends from wholly-owned subsidiaries now in a combined group. Currently, such dividends are eliminated in combined reporting. The Corporate Tax Reform will eliminate the exemption for income from subsidiary capital. Under the Corporate Tax Reform, *"income of the entire unitary business would be apportioned among NY Taxpayers in a unitary group, each of whom would file a separate NY return."*

i. Are dividends from unitary affiliates that are included in the unitary combined return fully eliminated or fully taxable?

1. Under California's rules of combination such dividends are eliminated prior to apportionment, which avoids this problem.

a. Does NY intend to follow California's regime in this regard?

b. Please clarify.

5. In the outline, the Department stated *"the income of the entire unitary business would be apportioned among the New York taxpayers in the unitary group, each of whom would file a separate New York tax return"* but went on to state "an election to file a group return would be available as an accounting and billing convenience".

- a. The implications of these statements are not clear and it would be helpful if the Department would provide further clarity with examples.
6. Capital Gains and Losses
- a. Is there intent to measure capital loss carryovers on a post-apportionment basis?
 - i. If so, how?
 - ii. Why?
 - b. Is there intent to limit utilization of capital loss carry forwards to the specific corporation that generated the capital loss or will it be permitted to be utilized by any member of the unitary group?
 - i. If so, how?
 - ii. Why?
 - c. Have you considered the potentially damaging impact on regulatory capital of a rule that prohibits the capital losses of one legal entity from offsetting the capital gains of another legal entity in the unitary group? (See item #3d above.)
 - d. It will be important to develop transitional rules for the treatment of capital losses:
 - i. Realized in pre-unitary years and carried over to unitary years, and
 - ii. Realized in unitary years and carried back to non-unitary years.
 - 1. Has the Department considered transition rules?

Alternative Tax Bases

1. Tax credits created under current law (e.g., Mortgage Recording Tax Credit, Investment Tax Credit and Empire Zone credits) can reduce the alternative taxes to the fixed dollar minimum tax. The outline states that "*the tax liability under both the fixed dollar minimum and the alternative tax could not be reduced by most credits*".
 - a. What is the reason for this shift in tax policy?
 - i. New York banks would like the treatment under current law to continue.
 1. Is there a barrier to retaining the current rules?
2. The current alternative tax structure is very burdensome.
 - a. Are you considering tax policy ideas to reduce the burden of the alternative tax?
 - b. An alternative tax based on gross receipts could be quite burdensome for those financial services corporations that transact in high volume/low margin positions.
 - c. What ideas are under consideration to ensure that the alternative tax does not become the principal tax?
 - d. Without careful consideration, this type of alternative tax base could easily violate your "Broad Principal" of "Economic Efficiency" by triggering an alternative tax that is distortive.
3. AMT Credit – For several years the financial services industry has advocated for a credit mechanism for the alternative taxes under current law. Specifically, a credit should be available under which taxes paid under the alternative tax structure are carried over as a credit against future tax based on unitary combined ENI. Of course, it would be reasonable to limit consumption of such credits to an amount which reduces the current

tax on unitary combined ENI to the alternative tax amount in the carry forward year. An unlimited carryforward would be essential to ensure that the alternative tax never adversely impacts the capital ratios of financial services firms.

- a. Will the Tax Department support such a crediting mechanism?

Rate Reduction

1. What tax rate will be applied to allocated unitary entire net income?
2. Would the same tax rate apply regardless of whether a water's edge election is made or not?

Other Issues

1. If this proposal is not adopted, does the Department plan to extend the Gramm-Leach-Bliley provisions?
2. At this time, our banks are unable to calculate the impact of these changes on their tax provisions. How is the Department doing its calculations on State (and City) revenue?

Economic Incentives

1. Customer based sourcing of loans may increase dramatically the marginal cost of making a loan to a New York customer for some taxpayers.
 - a. Does the Department plan to offset this disincentive to make New York loans with a tax credit or other benefit?
2. There is no tax incentive to place or maintain employees in the tax jurisdiction. The loss of incentives to keep employees in New York may reduce payroll, sales and use, excise and other tax revenues.
 - a. Has the Department factored these impacts into its forecasts?
3. Will the Department be advancing new principles to encourage job creation in New York in general and New York City in particular?
 - a. CT has no wage or property factor and has a lower statutory rate than the combined New York State/City.
 - b. NJ still has a wage factor so NY might attract jobs from NJ. However, NJ has proposed a single sales factor.
4. NY needs incentives built into the tax law and the outline does not reflect any details in this area.