MULTISTATE TAX COMMISSION

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Testimony

To: Senator Liz Krueger, Chair, and Members of the Select Committee on Budget and Tax Reform

From: Joe Huddleston
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Subject: Examining New York State's Business and Banking Tax Structures

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Chairperson Krueger and members of the Select Committee, thank you very much for the opportunity to submit this testimony. We would like to address two of the questions you've raised.

- ***Are there any aspects of the Corporate Franchise Tax or Bank Tax that create inequitable advantages between large and small businesses or businesses in related industries? How can a better balance between these businesses be achieved?***

The one aspect of New York's tax structure that is most likely to produce inequities between businesses in related industries is the fact that banks and non-bank financial institutions are subject to two overlapping and conflicting taxes. Non-bank financial services companies, such as brokers, are subject to the general business franchise tax imposed under Article 9-A of the New York Tax Law applicable to general business corporations doing business in New York. However, banking corporations doing business in New York are exempted from Article 9-A, and are instead subject to the franchise tax imposed under Article 32 of the New York Tax Law.

As a preliminary manner, it should be noted that the deregulation of the banking industry under the Gramm-Leach-Bliley Act allows banks and non-bank financial services companies to do business as affiliates of a common parent. This has resulted in complex issues of tax administration under New York's dual tax structure. These complexities can and often do, lead to taxpayer uncertainty as to the appropriate tax article for their business. Deregulation of the banking sector has reduced the need for sharp regulatory distinctions between banks and other types of financial services. Thus, it

has become less clear whether an entity is a "banking corporation" within the meaning of Article 32, and therefore exempt from the general tax and subject to the bank tax.]

Furthermore, deregulation has allowed Article 32 banks and Article 9A corporations to compete in providing similar services. Taxing the income from the provision of these services differently, depending on whether the entity is a bank or another type of financial service provider, can create undesirable competitive advantages and disadvantages. Both taxpayers and the state may benefit from a uniform tax structure applicable to all financial services whether provided by a bank or otherwise.

Among the more important differences between the two tax structures are (1) the treatment of investment income and capital (2) the rules for combination, and (3) the applicable apportionment factors. These important differences can produce inequities among similar financial services companies and allow for manipulation of investment portfolios so as to obtain favorable tax treatment

A. Different Treatment of Investment Income and Capital

Article 9-A imposes a franchise tax on the highest of four alternative tax bases: allocated entire net income (ENI), allocated capital, allocated minimum taxable income (AMT) or a fixed dollar minimum tax. Taxpayers must segregate their income and capital into business or investment income and capital in order to calculate both the tax base and the applicable allocation percentage.

Investment income and capital receive favorable tax treatment under Article 9-A. First, investment income and capital allocated to New York are subject to a much lower allocation percentage than business income and capital. Cash is excluded from the investment income allocation. Expenses attributable to investment income or capital are deductible against investment income. While non-bank financial services companies must pay a separate tax on subsidiary capital, income from subsidiary capital is fully deductible in computing the corporation's ENI, capital and AMT bases.

Banking companies subject to tax under Article 32 may not segregate their capital and income into investment and business capital and income and therefore do not receive the favorable tax treatment afforded their non-bank competitors in the financial services industry.[1] Furthermore, because of the favorable tax treatment of investment income and capital, Article 9-A encourages manipulation of investment portfolios to maximize investment capital and income and minimize business capital and income

B. Different Combination Rules

For tax years beginning on or after January 1, 2007, combined reporting is now mandatory under Article 9-A when there are substantial intercorporate transactions between related corporations. Banking corporations filing under Article 32 may be required or permitted to file a combined return with other banking corporations under

[1] Banks are, however, allowed to deduct 17 percent of interest and 60 percent of dividends and net gains from subsidiaries in computing the ENI base.

certain circumstances; combination is not mandatory. There are significant differences in the rules for determining the members of the combined group. Article 32 corporations may be included in a combined return when they meet a 65% ownership test, whereas the ownership test under Article 9-A is 80%. More significantly, cross-article combination is prohibited. It is quite common for a company taxed under Article 9-A and a bank taxed under Article 32 to be affiliates of the same parent company. As a result, New York's prohibition on cross-article combination raises difficult tax compliance issues for both taxpayers and the Tax Department. The prohibition causes related companies engaged in similar activities to be taxed differently depending on which side of the statutory line they fall. This can produce manipulation of the corporate structure for tax purposes or can result in inequitable tax treatment of similarly situated taxpayers.

C. Different Apportionment Formulae

Beginning in tax years 2007, corporations that are required to file under Article 9-A apportion their income using a single receipts factor. But Article 32 filers must use a three-factor apportionment formula that includes receipts, deposits and wages, with receipts and wages both being double-weighted. This difference in apportionment formulae can cause taxpayers competing in similar markets to have very different amounts of income apportioned to the state. It also adds additional complexity to the proper determination of tax among the members of a related corporate group, some of which are subject to tax under Article 9-A and others under Article 32.

A possible solution would be for New York to adopt a uniform system of taxing all financial institutions, whether they are banks or otherwise. The difficulty, of course, is in designing such a system. A reasonable starting point for such a system would be the formulation of a uniform definition of a "financial institution" that is broad enough to encompass both "banking corporations" currently taxable under Article 32 and non-bank financial services companies currently taxable under Article 9-A. The Multistate Tax Commission has formulated a recommended definition of a "financial institution", which is contained in Appendix A to the MTC Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions (adopted November 17, 1994). A copy of Appendix A is attached hereto.[2]

- ***Are the business and banking taxes structured in a way that allows companies to move tax liabilities out of state, or prevents them from doing so?***

Article 32 specifically prohibits the combination of foreign and domestic banks. Foreign affiliates of domestic banks are taxed separately in New York, as long as they have nexus with the state. Non-nexus affiliates are not required to file in New York. A number of banks have expressed concern about the inability to combine foreign and domestic affiliates, because the statutory bar precludes their ability to offset foreign losses against domestic gains. On the other hand, the fact that foreign, non-nexus affiliates are not required to file in New York could result in income otherwise taxable in

[2] The Commission's recommended formula is advisory only, unless adopted into law or regulation by the member states. New York is an associate member of the Commission.

the state being isolated in non-nexus foreign affiliates.[3] One possible solution is for the state to require that all bank affiliates be required to combine, whether they are foreign or domestic corporations. Furthermore, in order to fairly reflect foreign-source income that is attributable to New York, the law could require taxpayers to file using the worldwide method of formulary apportionment.[4] However, no state other than Alaska currently requires taxpayers to use worldwide formulary apportionment, and Alaska limits it to the oil industry. Instead, the combination states require "water's edge" apportionment, which limits the apportionable income to domestic-source income. An alternative to mandatory worldwide formulary apportionment is to allow taxpayers an election to file on a worldwide basis. A number of states, including California, provide for such an election. This would address any inequities resulting from the inability to domesticate losses incurred by foreign non-nexus affiliates, but of course would not address any loss of revenue resulting from entity isolation.[5]

[3] Since non-nexus affiliates are not required to file in New York, the state lacks data to determine whether the isolation of income in non-nexus affiliates is a significant issue.

[4] Worldwide formulary apportionment requires that all members of the unitary group be combined, whether foreign or domestic and further requires that foreign-source income of any of the affiliates be included in the apportionable tax base. While non-nexus affiliates are not taxed, the income and factors of the non-nexus affiliates are used to determine the tax liability of the unitary nexus affiliates. The United States Supreme Court has twice affirmed the constitutionality of worldwide formulary apportionment. *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159 (1983) (foreign-source income of domestic affiliates); *Barclay's Bank PLC, et al., v. Franchise Tax Board,* 512 U.S. 298 (1994) (foreign-source income of foreign affiliate).

[5] The Multistate Tax Commission's Proposed Model Statute for Combined Reporting (approved August 17, 2006) in effect allows taxpayers to elect to file on a worldwide basis. Although the model statute is drafted so as to require worldwide apportionment, Section 5 allows the taxpayer to elect to file on a water's-edge basis. *Model Statute,* Section 5.