McDermott
Will & Emery

On the Subject

State & Local Tax

March 13, 2014

This is the fourth installment of a series that takes an inside look at the corporate tax reform proposals in Governor Andrew Cuomo's 2014–15 New York Budget Bill. This proposed reform is sweeping and, if enacted, is likely to result in major changes for many New York corporate taxpayers. This installment of Inside the New York Budget Bill examines the Budget Bill's nexus provisions, which may have limited impact on current New York taxpayers but will significantly affect corporations that do not currently pay Franchise Tax but have customers in New York. The next installment of this series will address net operating losses and credits.

Inside the New York Budget Bill

Part Four: Nexus

By: Maria P. Eberle, Lindsay M. LaCava and Leah Robinson

This installment of Inside the New York Budget Bill examines the Budget Bill's nexus provisions. Although these provisions may have limited impact on current New York taxpayers, they will significantly affect corporations that do not currently pay Franchise Tax but have customers in New York.

The New Economic Nexus Standard

It is well established under current law that a corporation must have a physical presence in New York to be subject to tax under Article 9-A or Article 32, with just a few exceptions. The Budget Bill proposes to significantly expand the number of corporations that are subject to tax in New York by adopting an economic nexus standard (in addition to the current physical presence nexus standard). For purposes of Article 9-A, a corporation would be subject to tax if it is "deriving receipts from activity in [New York]." As discussed in prior installments, the Budget Bill would repeal Article 32.

A corporation is deemed to be "deriving receipts from activity in [New York]" if it has $1 million or more of receipts included in the numerator of its apportionment factor, as determined under the Budget Bill's apportionment sourcing rules (New York receipts). See part three of this series for a discussion of sourcing changes and a summary chart of the Budget Bill's significant sourcing rules. For example, a corporation selling digital products will be taxable in New York (regardless of where it is physically present) if it has at least $1 million in sales to customers with IP addresses in New York; a corporation selling services may be taxable in New York (regardless of where it is physically present) if it has at least $1 million in sales to customers with billing addresses in New York, even if the service was performed in another state; and a corporation receiving interest on loans secured by real property will be taxable in New York (regardless of where it is physically present) if it has at least $1 million in interest receipts from loans secured by real property in New York even if the solicitation, investigation, negotiation, final approval and administration of the loans occurs elsewhere.

The Budget Bill retains the current economic nexus standards for certain credit card corporations, subjecting such corporations to tax if they (1) have issued credit cards (including bank, credit, travel and entertainment cards) to 1,000 or more customers with a mailing address within New York (New York customers); (2) have 1,000 or more locations in the state covered by merchant customer contracts to which the corporation remitted payments for credit card transactions (New York merchant locations); or (3) have New York customers plus New York merchant locations totaling 1,000 or more.

The Budget Bill also has special rules for corporations included in combined reporting groups. (For a discussion of the Budget Bill's combined reporting rules, see part one of this series.) Under those rules, if a corporation does not meet the $1 million threshold itself, but has at least $10,000 of New York receipts, the $1 million test would be applied to that corporation by aggregating the New York receipts of all members of its combined reporting group having at least $10,000 of New York receipts. Similarly, a credit card corporation that has at least 10 New York customers, at least 10 New York merchant locations, or at least 10 New York customers plus merchant locations would be subject to tax in New York if the total number of New York customers and/or New York merchant locations for all members of its combined reporting group that have at least 10 New York customers, New York merchant locations, or New York customers plus merchant locations is 1,000 or more.

If the Budget Bill is adopted, many out-of-state corporations may, for the first time, find themselves subject to New York's taxing jurisdiction solely by reason of meeting the Budget Bill's bright-line economic nexus thresholds. For example, the Budget Bill provides an 8 percent rule for sourcing receipts from certain financial transactions (discussed in part three of this series). As a result, a corporation that has $1 million or more of New York receipts based on the requirement to assign 8 percent of, say, net interest from reverse repurchase agreements to New York will now have New York nexus even if the corporation does not have any other contacts with New York.

Out-of-state corporations should carefully consider the economic nexus implications of certain receipts sourcing elections available in the Budget Bill. For example, the Budget Bill provides taxpayers the option of sourcing receipts from "qualified financial instruments" (generally, financial instruments that are marked to market under section 475 of the Internal Revenue Code) either using a fixed percentage (8 percent, which reflects New York's relative gross domestic product) or based on customer location (billing addresses in the case of individuals or commercial domicile in the case of business entities).

The Inevitable Constitutional Challenges

Although states have wide latitude in imposing their tax jurisdiction, that jurisdiction to tax is limited by the Due Process and Commerce Clauses of the U.S. Constitution. There is an open question as to whether having economic nexus with a state—with no physical presence whatsoever—is sufficient for a state to impose tax. The Due Process Clause requires some "minimum connection" between the state and the person it seeks to tax. The Due Process nexus requirement will be satisfied if a person has purposefully directed its activities at the taxing state. The Commerce Clause, on the other hand, is more restrictive and requires a "substantial nexus" between the state and the person it seeks to tax. Although it is clear that a person must have a physical presence in a state to have substantial nexus there for sales and use tax purposes, the degree of contact that a person must have with a state to meet the substantial nexus standard for net income (or other business activity tax) purposes is not so clear. While this issue has not been litigated in New York, it has been litigated in a number of state courts and tribunals, and the results have been divided, with some courts concluding that a physical presence is necessary to create substantial nexus for net income tax (or other business activity tax) purposes and others concluding that an economic presence is sufficient to create substantial nexus for income and other business activity tax purposes. The Supreme Court of the United States has yet to weigh in on this issue and may never do so. However, federal legislation (the Business Activity Tax Simplification Act of 2013) has been introduced that would establish a physical presence nexus standard for net income and other business activity tax purposes.

Absent Supreme Court of the United States or congressional action, questions may arise regarding the extent to which (if at all) New York can constitutionally tax corporations pursuant to this new economic nexus standard. Can New York constitutionally tax an out-of-state corporation that generates more than $1 million of New York receipts from the licensing of intangible property if that property is used by its customers' customers in New York? At least one state court has concluded that such tangential revenue-raising activity is not sufficient to give rise to taxable nexus. Similarly, can New York constitutionally tax an out-of-state corporation that generates more than $1 million of New York receipts from selling tangible personal property over the Internet to customers in New York? At least one federal court has found that merely having customers in a state does not satisfy the Due Process nexus requirement. Those and other similarly situated taxpayers may want to consider challenging the Budget Bill's proposed economic nexus thresholds on Due Process and/or Commerce Clause grounds if enacted.

Members of a combined reporting group should also consider whether the economic nexus aggregation rules are unconstitutional to the extent they create nexus for certain members of a combined reporting group based on the New York contacts of other members of the combined reporting group. The aggregation rules appear to extend the concept of "attributional nexus" beyond the limits of what has been sanctioned by the Supreme Court of the United States, which has approved attributional nexus only in situations where a person conducted in-state activities that were significantly associated with the out-of-state corporation's ability to establish and maintain a market in the state.

Corporate Partner Nexus

Based on a current regulation, an out-of-state corporation is subject to tax in New York if it is a general partner in a partnership doing business in New York, or if it is a limited partner in a partnership (other than a portfolio investment partnership) doing business in New York and meets one of 10 enumerated circumstances, including ownership of more than a 1 percent limited partnership interest, the basis of which is more than $1 million.

The Budget Bill grants the New York State Department of Taxation and Finance (the Department) the authority to adopt regulations that provide that a corporation is subject to tax in New York if it is any type of partner in a partnership that is doing business in New York or that has economic nexus with New York, thereby providing the Department with authority to expand the scope of its existing corporate partner nexus regulation.

This proposed change closely mirrors (with the exception of the economic nexus aspect discussed below) New York City's corporate partner nexus rule, which does not contain an exception similar to New York State's for corporate limited partners that hold less than a 1 percent limited partnership interest with a basis of not more than $1 million.

As with economic nexus, the potential expansion of New York State's corporate partner nexus provisions may subject many additional out-of-state taxpayers to New York State's taxing jurisdiction. Although the New York Tax Appeals Tribunal has affirmed the constitutionality of New York's corporate partner nexus provisions (and applied those provisions to a passive member of a limited liability company), New York's highest court has not yet ruled on this issue. Thus, out-of-state corporations whose only connection with New York is ownership of a limited partnership or a limited liability company doing business in New York may want to consider challenging the Budget Bill's proposed expansion of New York's taxing authority by asserting that the mere ownership of a limited partnership or limited liability company—particularly in a situation where the partnership's or limited liability company's only connection with New York is economic nexus—does not create sufficient nexus with the state as required by the Due Process and Commerce Clauses based on the principles discussed above.

Fulfillment Services Exception

Under current law, a corporation is not taxable in New York solely by reason of using fulfillment services provided by an unrelated person (a person with whom the corporation has 5 percent or less common ownership) and storing inventory at the fulfillment provider's premises. For this purpose, fulfillment services are (1) the acceptance of orders electronically or by mail, telephone, telefax or Internet; (2) responses to consumer correspondence or inquiries electronically or by mail, telephone, telefax or Internet; (3) billing and collection activities; or (4) the shipment of orders from an inventory of products offered for sale by the out-of-state corporation.

The Budget Bill would eliminate the fulfillment services exception, meaning that out-of-state corporations using unrelated New York fulfillment service providers could become taxable in New York if the corporation stores inventory on the premises of the fulfillment provider or otherwise meets the economic nexus thresholds. The current fulfillment services exception encourages out-of-state corporations to use the services of New York companies; repeal of this exception may cause some out-of-state corporations to reconsider their operations and use fulfillment centers in neighboring states instead.

Economic Nexus for Groups with P.L. 86-272-Protected Members

Out-of-state corporations whose activities fall within those described in 15 U.S.C. §§ 381-384 (P.L. 86-272) are not subject to a state's income tax, regardless of whether the state employs a physical presence standard or an economic nexus standard. However, P.L. 86-272-protected companies should carefully consider the combined effect of the Budget Bill's economic nexus provisions, combined reporting regime and apportionment provisions (which reflect a "Finnigan" approach).

Imagine a unitary group consisting of three corporations that have 100 percent common ownership: (1) a retailer of tangible personal property that itself is protected from New York taxation by P.L. 86-272 (Vendor); (2) an intangibles holding company that owns and licenses copyrights and trademarks (IHC); and (3) an entity that performs cash management functions for the group (Internal Bank). If either the IHC or the Internal Bank have economic nexus with New York under the new provisions (for example, if the Internal Bank is required to assign 8 percent of certain receipts to New York; see discussion in part three of this series) then each member of the group will be included in the combined report and the Vendor's attributes (including its income and receipts) will be included in the computations regardless of its P.L. 86-272 protection.

Alien Corporations

Under Article 9-A, alien corporations (corporations organized in a jurisdiction outside of the United States) are currently subject to tax on their worldwide income. In a departure from current law, the Budget Bill provides that an alien corporation that has no "effectively connected income" under the Internal Revenue Code is not subject to tax.

New York City

Currently, New York City's nexus provisions are substantially similar to the State's current regime (with the exception of the corporate partner nexus provisions discussed above). The Budget Bill's nexus provisions would not automatically affect New York City's regime, resulting in certain taxpayers being subject to tax at the New York State but not the New York City level. Of course, even without these provisions, there are many corporations subject to New York State taxation that do not conduct activities in New York City and are not subject to tax there.

For more information, please contact your regular McDermott lawyer, or:

Maria P. Eberle: +1 212 547 5702 meberle@mwe.com

Lindsay M. LaCava: +1 212 547 5344 llacava@mwe.com

Leah Robinson: +1 212 547 5342 lmrobinson@mwe.com

For more information about McDermott Will & Emery visit: www.mwe.com