## New York State's Taxation of Banking Corporations and Other Financial Companies

On April 14, 2008, New York State participated in the Multistate Tax Commission's (MTC) definitions working group for the revision of the model financial institutions regulations. A key topic of this call was the taxation of non-bank businesses that are undertaking traditional banking activities, as well as banks that are doing non-banking activities. One objective of the group is to devise a definition of a *financial institution*, and one alternative suggested on the conference call was whether the income streams from a corporation's financial and non-financial activities should be subject to different tax structures and apportionment methods.

New York taxes banks and non-bank financial services companies under two separate, but similar, tax structures. Because of this, we have had to deal with a number of issues that may inform the current discussion. A brief explanation of New York's current tax structure is given below, followed by a discussion of issues that can arise.

### *General Business Corporations*

Non-bank financial services companies are taxed in the same manner as other general business corporations. New York State imposes a franchise tax under Article 9-A of the Tax Law which equals the highest of four bases: a tax on allocated entire net income (ENI), a tax on allocated capital, a tax on allocated minimum taxable income (AMT), or a fixed dollar minimum tax.

Taxpayers must segregate their income and capital into business and investment income and capital, respectively. Investment income and capital are typically allocated to New York using a much lower allocation percentage than business income and capital. Expenses attributable to investment income or capital are deductible against investment income, not business income. The classification of income and capital as investment can also confer other advantages, such as the exclusion of cash from the investment allocation percentage. A corporation must also pay a separate tax on its subsidiary capital. However, income from subsidiary capital is fully deductible in computing the ENI, capital, and AMT bases.

New York has moved from a three factor apportionment formula (property, payroll, receipts) to a single receipts factor for tax years 2007 and after. The receipts factor has special sourcing rules for specific industries, such as securities and commodities brokers. Special apportionment formulas apply to aviation, trucking, and railroad corporations.

New York is a separate filing state, but may require or permit taxpayers which are related corporations to file on a combined basis under circumstances where separate filing would result in a distortion of tax liability, or in the presence of substantial intercorporate transactions. However, for tax years beginning on or after January 1, 2007 an Article 9-A taxpayer is required to file a combined return with a related corporation where there are substantial intercorporate transactions among the related corporations.

### *Banking Corporations*

New York State imposes a franchise tax, under Article 32 of the Tax Law on banking corporations. The definition of banking corporation includes banks chartered under the laws of New York, another state or country, national banks, and, subject to certain ownership and business requirements, a corporation owned by a bank or bank holding company.

Banks pay tax on the highest of four bases: a tax on allocated entire net income, a tax on allocated alternative entire net income, a tax on allocated taxable assets, or a fixed dollar minimum tax. The income and asset tax bases are similar to the analogous bases under Article 9-A, but are tailored more toward the banking industry. Banks are not allowed to segregate their income and capital into business and investment varieties. Because of this, banks do not receive the favorable treatment of investment income that Article 9-A taxpayers do. Banks are not subject to a separate tax on subsidiary capital. They are, however, allowed to deduct 17 percent of interest and 60 percent of dividends and net gains from subsidiaries in computing the ENI base.

Generally, banking corporations must allocate their income using a three factor apportionment formula that includes receipts, deposits, and wages, with receipts and deposits both double-weighted. However, certain subsidiaries that are 65 percent or more owned by banks or bank holding companies that substantially provide management, administrative, or distribution services to an investment company are required to use a single receipts factor apportionment formula.

New York has not adopted the MTC model for apportionment in its entirety; however, New York's statute uses a solicitation, investigation, negotiation, approval, and administration (SINAA) method to source interest income from loans to the state.

A banking corporation may be required or permitted to file a combined return with other banking corporations under certain circumstances. Although similar to the combination rules under Article 9-A, there are distinct differences. A corporation may be included in a combined return under Article 32 when it meets a 65 percent ownership test, while under Article 9-A a corporation must meet an 80 percent ownership test to be included. Most importantly, cross-article combination is prohibited. That is, a banking corporation taxable under Article 32 cannot be included in a combined report with a corporation taxable under Article 9-A.

### *Discussion*

The taxation of banks in Article 32 under a separate but similar tax structure as non-bank financial services companies in Article 9-A presents a great deal of complexity. There is often uncertainty on the part of taxpayers as to their appropriate tax article, leading to numerous inquiries with the Tax Department. Often a firm taxed under Article 9-A and a bank taxed under Article 32 will be affiliates owned by the same parent company. The affiliation of banks and other financial companies has become a major issue in the years since the passage of the federal Gramm-Leach-Bliley Act (GLBA), leading New York to enact transitional provisions to clarify filing requirements for taxpayers. Still, tax article classification remains an issue that arises on a regular basis.

The fact that banks and Article 9-A corporations cannot be combined creates additional complexity. Banks must be taxed under Article 32, but their business may include activities that a non-bank financial services company could do. An Article 9-A taxpayer may have both non-financial services income and income from activities might also be conducted by a bank.

In certain circumstances, the definition of a bank can result in a financial company that is not organized as a banking corporation being taxed under Article 32 if it is owned by a bank or bank holding company. However, historically New York also allowed certain corporations owned by banks to elect to continue to be taxed under Article 9-A when the current bank tax was enacted in 1985. Many of these "grandfathered 9-A" corporations still exist today. In addition, New York has historically taxed real estate investment trusts (REITs) under Article 9-A, giving them preferential tax treatment which allows them to typically pay only the fixed dollar minimum tax. Until 2007, this treatment applied to REITs owned as captives (subsidiaries) of other corporations, allowing a REIT to be taxed under Article 9-A while its parent could be a bank taxed under Article 32.

Prior to law changes in 2007, the dual tax structure provided ways for banks to use captive REITs and grandfathered 9-A corporations to reduce their tax due to New York through careful tax planning. A significant number of banks created captive REITs to hold their loan and mortgage assets. Because REITs were generally not taxed on income or capital under Article 9-A, the income generated by these assets escaped taxation. In some cases, the REIT was formed in another state, or owned by a holding company, and was not a New York taxpayer at all.

Interest income generated on the transferred assets could be funneled back to the parent bank in the form of a dividend, sixty percent of which was deductible in computing ENI. A structure could also be set up that allowed the REIT or a holding company to accumulate dividends without passing them to the parent Article 32 taxpayer, resulting in no taxable income being realized by the parent on the assets. Captive regulated investment companies (RICs) could be used for tax planning in the same manner as captive REITs, although they have not been as much of an issue for New York.

Banks that have grandfathered 9-A subsidiaries have also used these companies to hold their financial investments. Grandfathered 9-A companies used in this manner were typically inactive and had little substance. The grandfathered 9-A earned interest on the investments and received the favorable treatment provided by investment income under Article 9-A. The transitional provisions enacted by New York in response to the GLBA allowed for a similar arrangement. As with captive REITs, interest income generated on the assets of the 9-A company was passed up to the Article 32 parent as a dividend, sixty percent of which was deductible.

New York enacted legislation in 2007 and 2008 to curb the use of these entities as vehicles for tax planning, although some of the provisions affecting captive REITs and RICs sunset after 2010. Captive REITs and RICs are now required to be included in a combined return, and grandfathered 9-A corporations may have their 9-A status revoked under certain circumstances. However, as long as the present tax structure remains in place, opportunities may continually arise for banks and other financial corporations to segregate their assets and income streams between the two articles in order to gain favorable tax treatment.

Article 9-A Tax Law changes enacted in 2007 that amended the combined filing requirements and switched to a single receipts factor put further distance between the two articles. Combined filing is now mandatory for related corporations under Article 9-A in the presence of substantial intercorporate transactions. Under Article 32, the presence of substantial intercorporate transactions may lead New York to permit or require combination, but does not mandate it. The Article 32 apportionment scheme has always been different than Article 9-A because the factors were tailored to apply to banks. Now, the separation is greater because the receipts factor is the only common factor, and receipts are defined differently for the two taxes.

The difficulties inherent with the split taxation of banks and non-bank financial services companies have led both taxing authorities and the financial services industry in New York to consider the possibility of creating a single tax structure. However, no proposal has been put forward, and there is no clear consensus as to what form such a tax should take.