New York State Tax Reform Commission Issues Final Report

New York State Tax Reform and Fairness Commission Recommends Merging Bank Tax into Corporate Franchise Tax, Streamlining Corporate Audit Process, Increasing Estate Tax Exemption, Eliminating GST Tax, Reinstating Gift Tax and Closing “DING” Trust Loophole

SUMMARY
On November 11, 2013, the New York State Tax Reform and Fairness Commission issued its final report (the “Commission” and the “Report”, respectively) recommending changes to New York’s tax system, including changes to its franchise, sales, estate and personal income taxes. The Commission was charged by Governor Andrew Cuomo with developing revenue-neutral policy options to modernize the current tax system with the goals of increasing its simplicity, fairness, economic competitiveness and affordability. Some of the most significant elements of the corporate tax reform package include the merger of the bank tax into the corporate franchise tax, expanded application of economic nexus, and adoption of water’s-edge unitary reporting. The Report proposes an estate and gift tax reform package that would increase the estate tax exemption, repeal the generation-skipping transfer tax, reinstate the gift tax and close a perceived loophole in the income tax treatment of certain resident trusts.

SPECIFIC RECOMMENDATIONS OF THE REPORT
The Report recommends many changes to the current tax system; this memorandum highlights a few of the most important.
A. CORPORATE TAX REFORM

1. Merge the Bank Tax into the Corporate Franchise Tax

New York has a franchise tax on general business corporations (Article 9-A, the "corporate franchise tax") and a franchise tax on banking corporations (Article 32, the "bank tax"). Financial service companies and banks are taxed under different regimes, even though the Gramm-Leach-Bliley Act, which became law almost 15 years ago, changed the federal regulatory system to permit the cross ownership of finance and banking firms. There have been a number of proposals since the enactment of the Gramm-Leach-Bliley Act to combine the bank tax with the corporate franchise tax, and the Report recommends that New York merge the bank tax into the corporate franchise tax.

2. Expand the Application of Economic Nexus

The Report recommends that all companies that avail themselves of New York’s market (that is, have economic nexus with New York) should be subject to tax by the State, regardless of whether they have any other connection with New York. In other words, a corporation could become a New York taxpayer without a physical presence in New York. Many states have moved towards economic nexus; while there have been Federal Constitutional challenges to economic nexus, other states have successfully defended their rules in state courts, and the Supreme Court has denied petitions for certiorari in several of those cases.

3. Adopt Full Water’s-Edge Unitary Combined Filing

New York is nominally a separate filing state, but domestic corporations that are New York taxpayers related by ownership or control of eighty percent (80%) or more with substantial intercorporate transactions must file a combined report. The Report proposes that New York adopt full water’s-edge unitary combined filing with an ownership test of more than fifty percent (50%), such that all firms meeting the ownership test that are engaged in a unitary business would be required to file a combined report. Thus, the substantial intercorporate transactions test would be eliminated, and a domestic corporation without any assets or customers in New York, but which is engaged in a unitary business with a related New York taxpayer, would be part of the New York unitary group.

4. Source Income Solely by Reference to the Location of the Customer

The Report proposes that business income be apportioned to New York (and taxed by New York) using a single receipts factor based on the customer’s location. Thus, receipts from services would generally be sourced to New York if the customer is located in the State. Currently, the corporate franchise tax is already using a single receipts factor, while the bank tax uses a three-factor formula (receipts, deposits, and wages).
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5. Provide for the Mandatory Attribution of Interest Expenses to Exempt Income
The Report recommends providing for the mandatory attribution of interest expenses to exempt income, with expanded direct tracing of interest expense in certain situations.

6. Streamline the Corporate Audit Process
The Report asserts that more than twenty percent (20%) of corporate tax collections is collected as the result of the audit process, rather than upon the filing of an initial tax return. The Report suggests that the corporate tax reforms would lower that percentage, and also proposes that the New York State Department of Taxation and Finance (the “Department”) follow the programs of the Internal Revenue Service to streamline the audit process to change the current audit dynamic and to accelerate the collection of revenue.

7. Conform the New York City General Corporation Tax
The Report notes that, ideally, New York City would conform its corporate tax laws to any new corporate tax structure that New York State enacts.

B. ESTATE AND GIFT TAX REFORM

1. Raise the Estate Tax Exemption
Under current law, each resident of New York has an exemption from New York estate tax of $1 million. To address concerns that the current exemption is too low (e.g., the Federal exemption is $5.25 million) and may serve as a factor in taxpayer migration from New York to other states that do not impose any estate tax (for example, Florida), the Report recommends raising the exemption to $3 million.

2. Eliminate the Generation-Skipping Transfer Tax
The Report recommends repealing the generation-skipping transfer tax, which is not a major source of revenue.

3. Reinstate the Gift Tax
New York repealed its gift tax in 2000. In 2010, the Federal gift tax exemption was increased to align it with the Federal estate tax exemption, currently $5.25 million. The Report concludes that the increase in the Federal gift tax exemption encourages taxpayers to make gifts which reduce the size of their New York taxable estates, with a corresponding loss of New York estate tax revenue. The Report proposes two options to address the impact of the Federal change on New York estate tax revenues. Under the “preferred” option, New York could reinstate the gift tax, which would subject gifts above a certain threshold to tax rates in line with the New York estate tax. Alternatively, New York could require estates to add back the value of any gifts above a certain threshold before determining the value of the estate.
4. Close “DING” Trust Loophole

The Report proposes closing a perceived loophole created by so-called “DING” trusts (an acronym for “Delaware Incomplete Non-Grantor Trusts”). Under this arrangement, a New York resident would fund a trust in Delaware for the benefit of persons including the settlor. The trust would be structured such that gifts to the trust are treated as incomplete for Federal gift tax purposes, but are deemed to be completed transfers to a separate taxpayer for income tax purposes. The result purportedly accomplished by such a trust is to allow the New York resident settlor of the trust to avoid New York income tax on the trust’s income, even though the settlor has not made a completed gift (subject to Federal gift tax) of the trust assets.

The Report proposes two alternatives to close this perceived loophole. The first proposal is to treat DING trusts as grantor trusts for New York income tax purposes, with the result that the settlor of the trust would be subject to New York tax on the trust’s income. The second proposal is to tax the accumulated income of such trusts at the point in time that the income is distributed to a New York resident.

C. TAX SIMPLIFICATION

1. Establish a 14-Day Rule for Nonresidents

A nonresident individual working for any period in New York during the year is technically subject to New York taxes on income earned during this period, even if the individual works in New York for only one day. Notwithstanding this technical interpretation, the Department adopted audit guidelines in 2005, and issued further guidance in 2012, under which the Department generally will not assert that an employer should have withheld New York income tax on amounts paid to a nonresident employee unless the employee works in New York for more than 14 days during the year. The Report proposes conforming the law to the audit guidelines by adopting a 14-day threshold. The 14-day threshold would not apply to athletes and entertainers performing in New York, or to nonresidents with a permanent place of abode in New York.

2. Coordinate New York State and New York City Audits

The State and City conduct only a few dozen joint audits each year. The Report recommends increasing the coordination between the State and City to simplify the audit process, expedite the completion of audits and increase certainty and predictability for taxpayers.

The Report also recommends that the State and City adopt a compliance assurance process (“CAP”), based on the IRS CAP Program. A State and City CAP would allow taxpayers to resolve issues before filing their tax returns, with the goal of reducing, if not eliminating, the need for lengthy post-filing audits.

3. Repeal the Stock Transfer Tax

Although the stock transfer tax generates $12 billion a year, the tax is one hundred percent (100%) rebated to taxpayers, and has been since 1981. (The tax had served as security for certain municipal
bonds; those bonds, however, were retired in 2008.) The Report proposes repealing the tax, noting that, should New York want in the future to raise revenue from a tax on securities transactions, the existing tax would not be a useful model. Thus, according to the Report, keeping the stock transfer tax serves no purpose.

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CONTACTS

<table>
<thead>
<tr>
<th>New York</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>James I. Black III</td>
<td>+1-212-558-3948</td>
<td><a href="mailto:blackj@sullcrom.com">blackj@sullcrom.com</a></td>
</tr>
<tr>
<td>Charles T. Dowling</td>
<td>+1-212-558-3845</td>
<td><a href="mailto:dowlingc@sullcrom.com">dowlingc@sullcrom.com</a></td>
</tr>
<tr>
<td>Andrew S. Mason</td>
<td>+1-212-558-3759</td>
<td><a href="mailto:masona@sullcrom.com">masona@sullcrom.com</a></td>
</tr>
<tr>
<td>David C. Spitzer</td>
<td>+1-212-558-4376</td>
<td><a href="mailto:spitzerd@sullcrom.com">spitzerd@sullcrom.com</a></td>
</tr>
<tr>
<td>Zena M. Tamler</td>
<td>+1-212-558-1675</td>
<td><a href="mailto:tamlerz@sullcrom.com">tamlerz@sullcrom.com</a></td>
</tr>
<tr>
<td>Basil P. Zirinis</td>
<td>+1-212-558-3848</td>
<td><a href="mailto:zirinisb@sullcrom.com">zirinisb@sullcrom.com</a></td>
</tr>
<tr>
<td>Jeffrey S. Arbeit</td>
<td>+1-212-558-3160</td>
<td><a href="mailto:arbeiti@sullcrom.com">arbeiti@sullcrom.com</a></td>
</tr>
<tr>
<td>Joseph E. White</td>
<td>+1-212-558-4192</td>
<td><a href="mailto:whitejoe@sullcrom.com">whitejoe@sullcrom.com</a></td>
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<table>
<thead>
<tr>
<th>London</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Basil P. Zirinis</td>
<td>+44-20-7959-8585</td>
<td><a href="mailto:zirinisb@sullcrom.com">zirinisb@sullcrom.com</a></td>
</tr>
</tbody>
</table>