AN ALERT FROM THE BDO FINANCIAL INSTITUTIONS & SPECIALTY FINANCE PRACTICE

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SUBJECT

NEW YORK STATE ENACTS MAJOR BANK TAXATION REFORM

DETAILS

The New York legislature has voted to approve Governor Cuomo's proposals for sweeping reform of the New York State Tax Law under Chapter 60. Broadly, the legislation repeals the Article 32 tax upon banking institutions and renders banks subject to tax under Article 9A, as materially changed by the legislation.

The new law requires captive REITS (those owned 50 percent or more by a bank) to join the bank in filing a combined New York State return without any subtraction for REIT dividend payments. However, REITs in place as of April 1, 2014, were effectively grandfathered in by an amendment to the draft legislation, which gives back the 60 percent deduction on REIT dividends.

Investment income has been redefined to limit it to dividends from, and gains upon, the sale of stock of subsidiaries not included in the combined return and, as so limited, is exempt from taxation.

The tax rate on "business income" (entire net income less investment income) is reduced from 7.1 percent to 6.5 percent, but is not effective until January 1, 2016. Whereas, the other changes to the tax law are effective from January 1, 2015.

The metropolitan commuter transportation district (MCTD) tax surcharge is made permanent and raised from the current 17 percent rate to a rate of 25.6 percent. Further, the reach of the tax surcharge has been expanded via a change from a physical presence nexus standard. The banks subject to these changes are those with $1 million or more in receipts or 1,000 or more cards issued from the MCTD.

A consequence of the repeal of Article 32 is the elimination of the "Alternative Entire Net Income" base, which added back the subtractions for the REIT dividend, U.S. obligations interest and municipal bond interest. Prior to the legislation, Article 9A had a similar "minimum taxable income" base, which is also repealed. Accordingly, banks are now to be taxed at the highest of

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their calculated business income tax, their capital tax or the fixed dollar minimum tax. The capital tax is 15bp times apportioned business capital (capital less investment capital), which, for a bank with $50 million in capital, would yield a capital tax amount of $75,000. The fixed dollar minimum tax is based on New York receipts and for most community banks would be around $5,000. Therefore, the typical community bank will pay not less than the capital tax amount.

Most important to banks without a grandfathered REIT are the two new alternative subtraction modifications. The first is essentially a percentage-of-taxable-income bad debt deduction computed as the excess of 32 percent of taxable income before the deduction over the amount of the federal bad debt deduction already taken. This deduction is only available to thrifts and to "community banks," which can satisfy the qualified thrift lender 60 percent assets test. A community bank is defined to mean a commercial bank with not more than $8 billion in total assets. Not many commercial banks are likely to qualify for this deduction, due to an asset mix weighted toward commercial lending rather than residential mortgages.

To meet the assets test, at least 60 percent of the bank's total assets for regulatory purposes at the year-end (or, by election, on average for the year) must be comprised of:

- Cash
- Federal and state obligations
- Residential and church real property loans
- Share/deposit loans
- OREO
- REMIC investments
- Residential Mortgage-backed Securities
- Loans to schools and school loans
- Operating assets used in the residential lending business

The second new subtraction modification is an exclusion of one-half of the net interest income of the institution from residential mortgages and small business loans. This exclusion is available to community banks, as previously defined. However, unlike the bad debt deduction which is available to all thrifts, the interest exclusion is available only to thrifts of not more than $8 billion in assets. Residential mortgage loans secured by real property located in the state qualify for the interest exclusion. Small business loans must be made to a "small business"(a term undefined by the legislation) and either secured by real property located in the state and, if not secured, made to a borrower located in the state. In each case, only those loans originated (or "table-funded" under a commitment agreement with the mortgage banker) in amounts of $5 million or less will qualify.

As noted above, these two new subtraction modifications are mutually exclusive and neither can be taken if the institution has owned a captive REIT during the taxable year. So, banks must decide whether to keep their grandfathered REIT, or to close it down and take one of the new subtraction modifications instead.

Apportionment will be very different for banks after 2014, when the legislation's repeal of the three-factor formula of Article 32 takes effect and the state goes instead to a single factor based on receipts. Moreover, the sourcing of receipts is now based upon a market standard with the location of the security, or the domicile of the borrower and the address of the customer driving the sourcing of receipts. This is in contrast to the former SINAA (solicitation, investigation, negotiation, approval and administration) standard, which is based on the location associated with the revenue activity.

Interest income from government debt is sourced entirely outside New York State, but the impact of non-New York State municipals on the apportionment factor is diluted as 50 percent of the income from these municipals is removed from the apportionment denominator. Interest income from government sponsored mortgage-backed securities, reverse repos and fed funds is sourced 92 percent outside of New York State.

Net operating losses incurred in years before 2015 are to be aggregated into a new "prior net operating loss conversion subtraction pool," adjusted upward for the effect of the change in tax rate and allowed as a deduction against post 2014 business income for the next 20 years (through 2036) at the rate of only one-tenth of the pool per year. Seemingly to mitigate the adverse effect of this new severe limitation, the statute permits a one-time election to be made with a timely filed 2015 tax return to deduct the prior net operating loss conversion subtraction pool at the rate of one-half per year in each of the years 2015 and 2016 at the cost of forfeiting any portion of that NOL carryforward unused at the end of 2016.

As to net operating losses incurred in years after 2014, they continue to enjoy a 20-year carryforward period and, now, a three-year carryback period, which is subject to the proviso that no post-2014 NOL may be carried back to a year before 2015.

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The special additional mortgage recording tax credit, the low income housing credit, the credit for certified rehabilitation, the credit for servicing mortgages, the Empire Zone investment credit, the Empire Zone employment credit, and the QEZE credit for real property taxes have been retained and are available to offset the business income and capital taxes, but not the fixed dollar minimum tax.

One must not forget that the new state legislation does not affect the taxing regime of the City of New York. The complexity of return preparation to assure maximum advantage under the new rules has measurably increased. Forecasting the impact of the new rules upon the bank's state tax liability well in advance of the effective date of January 1, 2015 may be prudent.

The consensus is that the legislation was enacted March 31, 2014 and therefore would be given effect for deferred tax accounting in the period which includes that date.

BDO's financial institutions professionals are available to advise as to the impact of the legislation upon your institution. For more information, contact Glenn James, partner and Financial Institutions Practice Leader for the New York region at gjames@bdo.com.