Economic Incentives and Tax Controversy Issues

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Economic Incentive Programs

- In New York State, most economic incentive programs are defined in the General Municipal or Economic Development Law with the benefits realized under the Tax Law.
  - Empire Zones Program, Excelsior Program, START-UP NY Program
- For each of these programs, Empire State Development reviews and approves participants and tracks compliance requirements while the Department of Taxation and Finance (“DTF”) oversees the actual credits received when claimed on corporate or income tax returns.

Economic Incentive Programs

- The Brownfields Program is similar in that it is administered by the Department of Environmental Conservation, but again the credits are claimed on income and corporate tax returns with oversight from DTF.
- Qualified Emerging Technology Companies are defined under the Public Authorities law, but DTF oversees the tax credits.
- Sales tax benefits under any economic development program are also controlled by DTF.

Lingering Empire Zone Issues

- Calculation of the Tax Reduction Credit ("TRC")
  - DTF continues to reduce the amount of TRC allowed to shareholders of S corporations and members of limited liability companies or partnerships through the application of a "business allocation percentage".
  - Some shareholders of S corporations have had DTF reduce their TRC by the business allocation percentage reported on their S corporation return even though the shareholder is taxed on the full amount of income.
  - In other cases, DTF has applied a "modified" business allocation percentage.

Lingering Empire Zone Issues

- For a limited liability company or partnership, the business allocation percentage is a three factor. DTF has now started applying a modified business allocation percentage to subchapter S corporation shareholders based on this three factor approach. This matter has been litigated in the Division of Tax Appeals with a successful determination for the petitioners.
- In the matters of Batty and Pennefeather, the Administrative Law Judge found that the business allocation percentage did not factor into the calculation of the TRC.
- Despite this determination, DTF continues to apply the modified three factor business allocation percentage when conducting its Desk Audit review of the calculation of TRC for individuals.

Business Allocation Percentage Issue

- For a limited liability company or partnership, the business allocation percentage is a three factor.
- DTF has now started applying a modified business allocation percentage to subchapter S corporation shareholders based on this three factor approach.
- Three factor approach calculates an average of the receipts, property and wages factors.

Adjustments to New York Adjusted Gross Income

- DTF’s position on the add back of losses is also a factor in the calculation of the TRC.
- In some instances DTF continues to add back all losses (as opposed to net losses) to the New York Adjusted Gross Income (“AGI”) for purposes of calculating the TRC regardless of whether those losses reduced the AGI in the first instance.
- This issue is pending multiple hearings in the Division of Tax Appeals.

QETC Credit

- The QETC Facilities, Operations, and Training Credit is a program defined in the Public Authorities Law with the credits calculated within the Tax Law.

- DTF is the sole monitor of this credit as there is not an authority which approves a company for participation in this program.

QETC Credit

- In the fall of 2012, DTF issued its Technical Services Bulletin ("TSB") clarifying DTF's position that only a QETC which meets the primary products or services test can qualify for this credit.

- Prior to that TSB being issued, DTF's own position as evidence by its credit claim forms was that any QETC could qualify for the credit.

QETC Credit

- The Public Authorities Law which defines a QETC is very broad and subjective, and there have been no precedential determinations with respect to how this definition is to be applied.
- There are many petitions pending in the Division of Tax Appeals to address this issue.
- Although DTF has indicated many times over the past year that it would like to settle these cases, no reasonable settlement offer has been put forth.

Other Tax Controversy Issues

- Brownfield Credits – Although less hotly contested than some of the other economic development incentive programs, Brownfield's audits can be extensive in the documentation required to produce to substantiate the basis for the credits.
- Resident Credit Audits – DTF has taken some unusual positions with respect to allowing or refusing to approve resident credits.
- Sales Tax Audits – The sales tax division of DTF is separate from Desk Audit and tends, at times, to take extreme positions with taxpayers. These positions can often be contested and overcome.

Excelsior Tax Credit Program

- This economic development incentive program is administered by ESD with the credits claimed through individual and corporate tax returns.
- Excelsior credits are awarded as part of the Consolidated Funding Application, although a company can apply at any time to be admitted into this program.
- The company must agree to be decertified from the Empire Zones Program if already a participant and may lose some or all of its carry forward Empire Zone tax credits.

Excelsior Jobs Program

- Excelsior Jobs Tax Credit – 6.85% wages per new job
- Excelsior Investment Tax Credit – 2% qual. investments
- Excelsior R & D Tax Credit – 50% Federal R&D Credit
- Excelsior Real Property Tax Credit – only certain distressed areas and targeted industries

- The amounts of the credit are predicated on the number of jobs created and the amount of investment.

Eligible Participants in the Program

- Scientific Research & Development firms – 5 new jobs
- Software Development firms - 5 new jobs
- Agriculture firms - 5 new jobs
- Manufacturing firms - 10 new jobs
- Financial services back office - 50 new jobs
- Back office firms - 50 new jobs
- Distribution firms - 75 new jobs
- Other firms - 300 new jobs

Excelsior Tax Credit Program

- The credits are negotiated with ESD and do not increase if the company invests more dollars or creates more jobs than originally projected.

- The credits are only realized if the goals are met.

- ESD provides certificates and the credits are claimed on tax returns and are fully refundable.

Excelsior Tax Credit Program

- In summary, the Excelsior Program is one of the easiest programs to become approved for provided the business meets the eligibility criteria.

- ESD rarely, if ever, awards the maximum amount of credits allowed under statute.

- The credits are typically approved for a 10 year period and certificates will be provided to the business each year provided its benchmark goals are met.

START-UP NY Program

- The START-UP NY Program (the “Program”) promotes entrepreneurialism and job creation by transforming higher education to create Tax-Free communities across the State.

- The Program provides economic incentives to qualifying new businesses and, in some cases, existing businesses that are expanding and increasing employment, that locate in designated Tax-Free NY Areas which have a nexus to a sponsoring higher education institution.

- The Program places emphasis on Upstate New York.

- There is a specific focus on high-tech and start-up businesses to start, grow, and stay in New York.

How Does the Program Work?

- The sponsoring educational institution submits its proposed Plan for a Tax-Free NY Area to Empire State Development (ESD).
- ESD (through the Commissioner and Approval Board) approves the Tax-Free NY Area.
- A company that meets the eligibility requirements of the Economic Development Law applies to the Sponsor with final approval from ESD.
- The Department of Taxation & Finance oversees the benefits defined in the Tax Law and claimed on income tax, corporate tax and sales tax returns.

Benefits Available Under the Program

- Tax-Free NY Area Tax Elimination Credit.
- Exemption from Organization Tax imposed under Sections 180 and 181 of the Tax Law.
- Exemption from the MCTMT for payroll expenses and net earnings from self-employment.
- A refund of New York State and local sales and use taxes.
- Exemption from State or local real estate transfer tax or local real property transfer tax.
- Certain exemptions from real property taxes.
- Wage exclusion for eligible employees.

General Description of the Program

- Detailed process for the submission and approval of Plans to designate Tax-Free NY Areas and the eligibility criteria used in evaluating those plans.
- Detailed process for the application by businesses to participate in the Program and the eligibility criteria used to evaluate those applications.
- Penalty provisions are built into the Program for goals that are not fully realized by participating companies.
- Process for terminating a business from the START-UP NY Program and a process for administrative appeals of such terminations.

Approving Authority

- Both the Commissioner and the START-UP NY Approval Board are involved in the review and approval for Plans of vacant land or building space as a Tax-Free NY Area.
- All plans are reviewed by the Commissioner. These plans are also review by the Board in the following situations:
  – Private Universities and Colleges applying to become a sponsor.
  – Designation of 20 Strategic State Assets.
  – Finally, the Board has additional latitude to approve Tax-Free Areas in unique circumstances as set forth in the Regulations.

Eligibility Criteria for Designation as a Tax-Free NY Area

- By definition, this is land or vacant space of a University or College, or a designated area of a New York State incubator, that meets the eligibility criteria specified in Article 21 of the Economic Development Law, and has been approved by the Commissioner and, if necessary, the START-UP NY Approval Board.

Eligibility Criteria for Designation as a Tax-Free NY Area

- The rules vary depending on the type and location of the educational institution.
- In general, the educational institution cannot relocate housing, administrative, or student facilities in order to create vacant land or vacant building space.
- A New York State incubator with a bona fide affiliation to an educational institution is eligible:
  - Must provide written documentation of affiliation.
  - Must demonstrate that the mission and activities of the incubator align with the educational institution.

SUNY and Community College Campuses in Upstate New York

- Any vacant land or vacant space in any building located on campus.

- Up to 200,000 square feet of vacant land or vacant building space located within one mile of the campus.

Private Colleges and Universities in Upstate New York

- In total, up to 2.4 million square feet of vacant land or vacant building space in Upstate New York is eligible for designation.

- Private colleges and universities are not constrained by the prohibition against relocating existing operations or facilities to create vacant land or vacant building space.

Strategic State Assets

- The Approval Board may approve plans for up to 20 Strategic State Assets.

- Strategic State Assets are defined as land, a building, or group of buildings, owned by the State of New York that is closed, vacant, or for which notice of closure has been given.

- Vacant land or vacant building space designated under this provision will not count against any other square footage limitation.

Application Process for Approval as a Tax-Free NY Area

- The first step in the process is for the educational facility to create a proposed Plan and submit it for approval to the Commissioner.

- The Plan identifies the building space or lands proposed for designation with the specific address(es) and written legal description, including the total square footage of the space or acres of land.

Approval of an Application for Designation of a Tax-Free NY Area

- The Approval Board and the Commissioner will review applications. Preference will be given to plans that include under-utilized properties.
- The Approval Board will give priority for acceptance in counties that contain a city with a population of 100,000 or more, but without a university center.
- Finally, the Approval Board shall approve applications in a manner that ensures regional balance.

Eligibility Criteria for Businesses

- Only eligible businesses approved by the sponsoring educational institution and which locate on land or in vacant space designated as a Tax-Free NY Area are eligible to participate in the Program.

Types of Businesses Prohibited from Participating in the Program

- Retail and wholesale businesses
- Restaurants
- Real estate brokers
- Law firms
- Medical or dental practices
- Real estate management companies
- Hospitality
- Finance and financial services
- Businesses providing personal services
- Businesses providing administrative or support services
- Accounting firms
- Businesses providing utilities
- Businesses engaged in the generation or distribution of electricity, natural gas, or steam

Criteria for Participation in the Program

- The business must satisfy all of the following criteria:
  - Must be a **“new business”** at the time it submits its application;
  - Must be organized as a corporation, partnership, limited liability company or sole proprietorship;
  - Must be in compliance with all worker protection and environmental laws and regulations, and must not owe past due taxes of any kind;
  - The mission and activities of the business must align with the university or college sponsoring the Tax-Free NY Area;
  - Must demonstrate that it will create new jobs in its first year of operation; and
  - Must not be engaged in a line of business previously conducted **by a related person**.

Exceptions to the New Business Requirement

- A business that has successfully graduated as a New York State incubator business is eligible.

- If the business once operated in New York, but moved its operations out of State before June 1, 2013, and it agrees to relocate back to New York, restore jobs, and create additional jobs, the business can be eligible for participation.

Exceptions to the New Business Requirement

- If the company is not a “new business”, but the Commissioner determines that the business has demonstrated:
  - **It will create new jobs in the Tax-Free NY Area.**
  - **Neither it nor any related person has eliminated any jobs in the State in connection with this expansion.**

Summary of Businesses Eligible to Participate in the Program

- Cannot be one of the prohibited types of businesses.
- A new business in New York State creating employment.
- A business which successfully graduated as a New York State incubator.
- A business locating back to New York State under certain parameters.
- An existing business in New York State that meets the Commissioners requirements, demonstrating that it will create New York jobs even if it has ongoing operations and employees and/or was similar in ownership and operation to another business which operated in New York State.

Application Process for Businesses Seeking to Participate in the Program

- The business submits its application to a sponsor, and must incorporate in that application specific information mandated by ESD.
- As a part of its application, a business must agree to allow both the Department of Taxation and Finance and the Department of Labor to share its tax and employer information with ESD.
- The business must also allow ESD to access any and all books and records of the business.

Performance Benchmarks and Consequences

- The application must also identify performance benchmarks such as the number of net new jobs projected for creation.

- The application must state the proposed consequences for failure to meet performance benchmarks:
  - Suspension of participation in the Program for one or more tax years.
  - Termination of the business's participation in the Program.
  - Proportional recovery of tax benefits under the Program.

Approval Process

- Once the Sponsor receives the complete application and determines that the eligibility criteria are met, the sponsor can act on the application.

- If the Sponsor approves the application, it is then submitted to the Commissioner for final approval.
  – Commissioner may reject an application if it is determined that the eligibility criteria is not met.
  – If Commissioner does not reject the application within 60 days, the business applicant is deemed accepted into the Program.

Benefits Available To Businesses Approved for the Program

- Tax-Free NY Area Tax Elimination Credit.
- Exemption from Organization Tax imposed under Sections 180 and 181 of the Tax Law.
- Exemption from the MCTMT for payroll expenses and net earnings from self-employment.
- A refund of New York State and local sales and use taxes.
- Exemption from State or local real estate transfer tax or local real property transfer tax.
- Certain exemptions from real property taxes.
- Wage exclusion for eligible employees.

Tax-Free NY Area Tax Elimination Credit

- This credit is touted as eliminating all New York State income or corporate franchise tax for a participating business.

- The credit is calculated as the product of the Tax-Free NY Area Allocation Factor and the Tax Factor.

- This credit will not necessarily result in the elimination of all New York State tax liability attributable to the participating business.

Tax-Free NY Area Allocation Factor

- The percentage of the business's economic presence in the Tax-Free NY Area (this is the equivalent of the Zone Allocation Factor under the Empire Zones Program).
- The factor is determined by taking the sum of the Tax-Free NY Area Property Factor and the Tax-Free NY Area Wage Factor and dividing by two.
  - The **Tax-Free NY Area Property Factor** is determined by dividing the average value of the business's real and tangible personal property in the Tax-Free NY Area by the average value of the business's real and tangible property within New York State.
  - The **Tax-Free NY Wage Factor** is determined by dividing the total wages and other compensation paid to employees at the business's location in the Tax-Free NY Area by the total wages and other compensation paid to all of the business's employees within New York State.

Tax-Free NY Area Allocation Factor

- In all cases, regardless of corporate or income tax, this benefit is calculated after the NYS tax liability is reduced by any other allowable credits.

Tax Factor for 9-A Taxpayers

- The Tax Factor is the largest of the tax liability on:
  - Entire net income base
  - Capital base
  - Minimum taxable income base
  - Fixed dollar minimum tax

Tax Factor for Corporate Partners

- Corporate partners who are partners of a business approved to operate in a Tax-Free NY Area.
- The Tax Factor is the product of the applicable tax and a ratio of the partners' income from the partnership allocated within New York State to the partners' entire net income allocated within New York State.
- The income the partnership allocated within New York State is determined as if all of the partners were non-residents.
- The partners' entire income means entire net income or minimum taxable income allocated within New York State.

Tax Factor for Combined Group

- Tax Factor is a portion of the largest of the taxes computed on:
  - Entire net income base
  - Capital base
  - Minimum taxable income base
  - Fixed dollar minimum tax
- Attribution is computed by multiplying the tax for the combined group <u>after the deduction of any other tax credits</u> and the ratio of the business's income allocated within the State to the combined group's income allocated within the State.
- The business's income means the entire net income calculated as if the taxpayer was filing separately.
- Combined group income means entire net income or minimum taxable income as shown on combined return.

Tax Factor for Sole Proprietors and Partners

- The Tax Factor is calculated as a product of:
  - The tax liability after the application of other allowable credits, <u>and</u>
  - The ratio of the taxpayer's income from the business in the Tax-Free NY Area to the taxpayer's New York adjusted gross income.
  - The income from the business allocated within NYS shall be determined as if the sole proprietor or partner was a <u>**non-resident**</u> of New York State.

Tax Factor for Shareholders of a New York S Corporation

- The Tax Factor is calculated as the product of:
  - The tax liability after the application of other allowable credits, and
  - The ratio of the shareholder's income from the New York S corporation located in the Tax-Free NY Area to the shareholder's adjusted gross income.
- Do not include any wages paid by the approved business S corporation to the shareholder.
- The income allocated within the State is determined by multiplying the shareholders' share of the S corporation's income by a modified business allocation percentage computed using a three factor formula that includes property, receipts and wages.

Tax-Free NY Area Tax Elimination Credit

- Notwithstanding the name of this credit, it is unlikely that any type of company other than a C corporation will truly eliminate its NYS income tax liability.
- Any approved business operating in a Tax-Free NY Area which sells a significant portion of its products outside of the NYS and/or has property or stored materials and/or a sales force or other employees outside of the NYS, will not be able to eliminate all of its NYS income tax
- If any of the Receipts, Property, or Payroll factors are low, this will significantly decrease the amount of the credit and the individual will pay a substantial NY income tax liability.

Personal Income Tax Wage Exclusion

- All or part of the wages an approved business pays to "eligible employees" are exempt from NYS personal income tax. This benefit allows an eligible employee of the company for the first five years to subtract all of his or her wages paid by the company when computing NY adjusted gross income.
- For the second five years, the employee would be able to subtract the portion of his or her wages up to a range of $200,000 to $300,000 depending on the individual's respective marital filing status.

Definition of “eligible employee”

- An individual whose work is performed <u>exclusively</u> in the Tax-Free NY Area and must be in a “net new job”.

- The individual must work for the company for at least a six month period in the first tax year in which the individual claims the exemption.

- The company must be in compliance with the START-UP NY Program.

Challenges of the Wage Exclusion Benefit

- Each company is allocated a set number of jobs for this benefit; if the company hires more than the allocated amount, those individuals would not be eligible for the benefit.
- Individuals already working for a company that is accepted into the Program would not be eligible for the benefit, while any new hires would be eligible.
- Any individual hired after July 1st of any given year would not be eligible for the benefit for the balance of that tax year and would need to plan accordingly.
- The Regulations define an "eligible employee" as an individual whose work is performed <u>exclusively</u> in the Tax-Free NY Area; individuals that travel routinely from the Tax-Free NY Area location may not qualify for this benefit.

Challenges of the Wage Exclusion Benefit

- There is little precedent for the manner in which DTF will audit this credit and the required documentation that may be requested.
- Companies not in compliance with their Program job creation goals may cause issues for eligible employees anticipating this benefit.
- All employees in a company will not necessarily have the same benefit from this provision, and this disparity will need to be managed carefully by employers.

Sales Tax Exemption

- An approved business is eligible for a refund of NYS and local sales and use taxes. The refund applies to purchases and uses of property and services used predominantly (greater than 50%) at the Tax-Free NY Area location, and consumer utility services used 100% at the approved location.
- Contractors, subcontractors, and repair people can receive a refund of state and local sales tax paid through the purchase of tangible property that becomes an integral part of the facility.
- In all cases, the sales and use tax must be paid with a refund requested through DTF.

State or Local Real Estate Transfer Tax or Real Property Transfer Tax

- Leases of real property located in Tax-Free NY Areas to approved businesses are exempt from real estate transfer tax.

- This exemption also applies to any local real estate transfer tax or local real property transfer tax imposed by a county or municipality.

Real Property Tax Exemption

- The real property tax exemption is dependent on the university or college that is sponsoring the Tax-Free NY Area.
- The TSB contains a matrix outlining possible exemptions.
- This is very fact specific and can be determined when details of the sponsor and business undertaking are determined.

Examples of Specific Real Property Exemptions

- Property owned by a private college or university on or before June 1, 2013, exempt under Section 420-a of the RPTL will remain exempt if leased to an eligible business.

- Land owned by a private college or university with a building constructed thereon by an eligible business. The building would be taxable pursuant to Section 300 of the RPTL.

Examples of Specific Real Property Exemptions

- Property owned for a SUNY institution with the property owned by the State and leased to an eligible business, the property is tax-exempt pursuant to Section 404 of the RPTL.

- Where it's a SUNY sponsor and the land is owned by the State, but the building is constructed for the eligible business, the building is taxable per Section 564(1) of the RPTL.

Examples of Specific Real Property Exemptions

- Where it's a SUNY sponsor and the property is owned by the State and leased to an eligible business, the property is tax-exempt pursuant to Section 404 of the RPTL.

- Where it's a SUNY sponsor and the land is owned by the State, but the building is constructed for the eligible business, the building is taxable per Section 564(1) of the RPTL.

Examples of Specific Real Property Exemptions

- IDA Transaction – An eligible business can utilize the local industrial development agency in its project, and can receive an exemption through Section 412-a of the RPTL, but would likely be subject to a PILOT at the discretion of the IDA.

Tax Benefit Recapture

- The Program has significant tax benefit recapture provisions within both the Economic Development Law and the Tax Law. The penalty provisions included within the business's application for inclusion into the Program are subject to a negotiation process with the Commissioner and ESD staff.
- To remain eligible for the Program a business must
  - (1) maintain net new jobs created
  - (2) Maintain overall levels of employment between the business and any related person (test looks at employment levels before the application is submitted and in each year of participation.)
  - (3) Submit an Annual Report to the Commissioner.

Consequences

- An approved business which fails to meet the benchmarks is subject to the consequences determined by the business and the sponsor as stipulated in the business's application.
- ESD is responsible for monitoring and evaluating an approved business to determine its performance benchmarks are met.
- Any failure to meet performance benchmarks will be reported by ESD to the DTF.

Proportional Recovery of Tax Benefits

- The business must reduce the total amount of tax benefits claimed or received during the taxable year by the business or its owners by the percentage reduction in net new jobs promised in the performance benchmark.
- If tax benefits are reduced to less than zero, those negative amounts must be added back as tax and reported on the business's corporate franchise tax return or on the income tax return of the owners if this is a flow through entity.

Other Consequences

- The other consequences which may occur are a suspension of the business's participation in the Program for one or more tax years, or termination of the business's participation from the Program.
- In either of these cases the business would lose the entire benefit package for that given year or years.
- Exception - if the employer's participation in the Program is terminated during the employee's tax year, an employee eligible for the wage exclusion may claim the exclusion for all wages paid during his or her tax year, including wages paid after the date the business is terminated, but within the same tax year.

Summary

- The START-UP NY Program is complicated with extensive regulations under the Economic Development Law and the Tax Law.
- The benefits can be lucrative, but will not eliminate all tax depending on the type of entity and type of business.
- Applications for businesses should be carefully constructed as those businesses that fail to meet benchmark projections will be significantly penalized, and those businesses which under represent job creation will not receive the full amount of benefits available.

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