New York Tax Reform to Impact Captive Insurance Companies

On March 31, 2014 New York Governor Andrew Cuomo signed into law the 2014-2015 New York State Budget, which results in significant changes to the corporate franchise tax. These changes include the expansion of the nexus standard and the implementation of unitary combined reporting. These changes will likely result in an increase in state taxes paid by captives and parents with New York sourced income.

Expanded Nexus Standard Based Upon Economic Presence

New York's corporate franchise tax under Article 9-A of the New York Tax Law is imposed on domestic and foreign corporations for the privilege of existing and doing business in New York. In addition to the existing nexus standards under New York law (e.g. doing business, employing capital, owning or leasing property or maintaining an office in New York State) corporations are now subject to New York's taxing jurisdiction based upon economic presence in New York. Generally, "economic nexus" is established if a corporation's receipts from an activity within the state total at least $1 million. Corporations with less than $1 million but at least $10,000 of receipts within New York will be considered "deriving receipts from activity" in New York (and subject to the corporate franchise tax) if the corporation is part of a unitary group that has $1 million or more in receipts attributable to New York sourced income.

Combined Unitary Reporting Specifics

In addition to expanding the nexus standard by adding economic presence to the list of activities making a corporation subject to the corporate franchise tax, New York has adopted unitary combined reporting. The adoption of this reporting regime increases the likelihood that a captive will be subject to the corporate franchise tax under Article 9-A of the New York Tax Law, rather than the New York premium tax under Article 33. The applicability of the corporate franchise tax under combined unitary reporting applies regardless of whether the captive is licensed or has its domicile in New York.

Under the prior law, a captive insurance company was generally not subject to the corporate franchise tax (although it was subject to the New York premium tax) and not included on a combined return. There was an exception to this rule, however, if the captive was overcapitalized (or "stuffed"). New York created this exception based upon the concern that the state was losing revenue because some captive insurance companies earned significant non-premium revenues. Under the prior law, a captive was considered to be overcapitalized if fifty percent or less of its gross receipts for the taxable year consisted of premium income. New York has essentially expanded this exception, so much so that it has become more of a rule.

Under the new law, the concept of a "combinable" captive retains the same fifty percent threshold as under the prior law for "overcapitalized" captives. However, the requirement under the prior law that "substantial inter-corporate transactions" exist between the captive and affiliates has been stricken. The elimination of this requirement increases the likelihood that a captive will be subject to combined unitary reporting. In addition, the definition of "premium" has been limited to "premiums from arrangements that constitute insurance for federal income tax purposes." Thus, if a captive has been organized as an insurance company under state law, and is not recognized as an insurance company for federal tax purposes, none of the premium income "counts" towards the fifty percent threshold, and the captive will likely be required to file combined unitary reports with the parent. In this way, New York disregards the captive's status as an insurance company and imposes a tax under Article 9-A as if it were a general business corporation. Additionally, because the captive insurance company is included in the combined group, premium deductions are eliminated for insureds.

Bases Calculations and Business Income Computations

The calculation of bases under the new Tax Law has also changed. Rather than being subject to one of four bases as under the prior law, the combined group will be required to calculate tax on three different bases, and pay the highest of the alternative amounts. The three alternative amounts will be (1) business income base tax, (2) capital base tax, and (3) fixed-dollar minimum tax (attributed to each member of the combined group). The capital and fixed-dollar minimum bases include a credit for taxes paid to other states on identical bases. The prior minimum taxable income base and the separate tax on subsidiary capital have been repealed.

Under the new law, there is a decrease in the rate of tax on business income (from 7.1 percent to 6.5 percent). Additionally, the capital tax, which is currently applied at a rate of 0.15 percent with the maximum capped at $1 million for most taxpayers, will remain the same for tax years beginning before January 1, 2016 (although the cap will be increased to $5 million beginning on and after January 1, 2015). Thereafter, the rate of tax will be incrementally reduced each year until January 1, 2021, when the rate will be zero percent. The fixed dollar minimum tax will, as before, be based on a taxpayer's New York sourced receipts, but increases incrementally up to $200,000 for taxpayers with over $1 billion of New York receipts. The prior law capped the fixed dollar minimum tax at $5,000.

In terms of calculating "business income" under the combined unitary reporting regime, the new law retains the Finnigan computation method. The group members' income, apportionment, and attributes (net operating losses) are aggregated and applied against the group's aggregate business income to compute the group business income. The result is that the income and factors for all members of the combined group return are aggregated to arrive at a single business income and apportionment percentage to compute New York business income that is subject to the statutory tax rate.

Apportionment

The net income base under the new law is the "combined business income of the combined group that is apportioned to the state". Business income will be apportioned using a single-receipts factor based on the customer's location. There will be a hierarchy of methods used to determine whether a customer is located within New York based upon delivery destination, billing address, or zip code.

Conclusion

Although the recent tax law changes in New York will likely result in higher taxes paid by parents and captives in the unitary group, taxpayers should not be alarmed into thinking that all income of the foreign captive will be subject to New York taxation. As discussed above, taxpayers will apportion New York sourced income from all income earned in a taxable year, and credits will be given for taxes paid to other states on identical bases. On the other hand, more captives will be subject to the general corporate franchise tax under the new combined reporting regime than before. Additionally, although the rate of tax on business income has been decreased under the new law, the higher caps on the capital tax and fixed dollar minimum tax could also result in an overall increase in franchise taxes paid by both “combinable” captive insurance companies and taxpayers who have always been subject to the tax.

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