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New Stock Identification Requirements for New York Corporate Tax Exemption

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Effective for tax years beginning on or after January 1, 2015, pursuant to legislation enacted last year, income from "investment capital" is exempt from New York State franchise tax for corporate taxpayers otherwise subject to tax in New York (*i.e.*, corporations with a nexus to New York, including corporations doing business in whole or in part, owning or leasing property, maintaining an office or deriving receipts from New York activity). For purposes of the new law, investment capital means investments in stocks, bonds and other securities (corporate and governmental) not held for sale to customers in the regular course of business, exclusive of subsidiary capital, stock issued by the taxpayer and stock in entities included in a New York unitary or combined return. The legislation applies the same principles to the New York City corporation tax.

Under legislative amendments enacted earlier this year and recently released guidance from the New York State Department of Taxation and Finance, in order for a corporation's income from investments in stock to qualify as exempt investment income for New York State and New York City tax purposes, the corporation must identify the relevant stock as being held for investment on the day on which it is acquired. It is important to note that this applies to both dealers and non-dealers in securities. Further, there are special rules regarding corporations that are partners in partnerships holding investments in stock, whereby the partnership is responsible for making the required identification, as discussed further below. This aspect of the guidance leaves open important questions and concerns relevant to investment funds that may have corporate partners subject to tax in New York.

New Definition of Investment Capital

Technical Memorandum TSB-M-15(4)C, (5)I, "Investment Capital Identification Requirements for Article 9-A Taxpayers" (the "Memorandum"), was released on July 7, 2015.[1] The Memorandum lays out a five-part test for investments in stock of non-subsidiary and non-unitary or combined corporations to qualify as investment capital under the new definition. To satisfy this test, investments in stock must:

1. Satisfy the definition of a capital asset under section 1221 of the Internal Revenue Code of 1986, as amended (the "Code"), at all times the taxpayer owned such stock during the tax year;
2. Be held by the taxpayer for investment for more than one year;
3. Generate long-term capital gains or losses under the Code on disposition;
4. For stocks acquired on or after January 1, 2015, have never been held for sale to customers in the regular course of business after the close of the day on which the stock was acquired; and
5. Before the close of the day on which the stock was acquired, be clearly identified in the corporation's records as stock held for investment in the same manner as required under section 1236(a)(1) of the Code for the stock of a dealer in securities to be eligible for capital gain treatment (whether or not the corporation is a dealer in securities subject to section 1236).

Identification Procedures

The Memorandum focuses on the fifth element of the investment capital test, first addressing identification procedures for dealers, for whom the requirement is generally that they must have clearly identified the stock as stock held for investment under section 1236(a)(1) of the Code; there is no separate New York identification process.[2] While this seems straightforward, one potential complication is that many corporate dealers, as a general matter, do not follow the identification procedures described in section 1236(a)(1) of the Code since there is no preferential tax rate for corporate taxpayers on capital gains at the federal level. It is also important to note that there is no transition rule (allowing the identification to be made before October 1, 2015 for stock acquired before that date, as discussed below) for dealers – all stock must have been identified by the close of the date acquired.

For non-dealers, there is a transition rule providing that stock acquired before October 1, 2015 that otherwise meets the investment capital requirements must be clearly identified in the corporation's records as stock held for investment any time before October 1, 2015. Stock acquired on or after October 1, 2015 must be identified by the close of the day it is acquired. The identification procedures laid out in the Memorandum for non-dealers are twofold:

1. The stock must be recorded in an account maintained for investment capital purposes only, separate from any account maintained for stock held for sale to customers, which account may be maintained for recordkeeping purposes only or may be a separate depository account maintained by a clearing company as nominee for the corporation.
2. The investment capital account must disclose certain identifying information about the stock, including information regarding the sale of the stock if it is sold and the length of time any stock that was sold was held.

With respect to options, any stock acquired pursuant to an option is properly identified as investment capital if the option was properly identified as investment capital before the close of the day on which it was acquired.[3]

Corporate Partners in Partnerships Holding Investments in Stock

If a corporate partner in a partnership uses the aggregate method to compute its tax, the corporation's proportional share of stock held by the partnership may qualify as investment capital if the investment capital identification requirements, including the timing of the identification, are satisfied by the partnership. This raises some troubling questions with respect to investments by corporations in non-dealer partnerships, where the partnerships will not be making identifications under section 1236 of the Code. The Memorandum specifically states that if a corporation becomes a partner in a non-dealer partnership on or after October 1, 2015, and the partnership had not been following the identification procedures outlined above prior to the date the corporation became a partner, then only stock acquired on and after the date the corporation became a partner can be timely identified so as to meet the identification requirements. This does not seem to be an equitable outcome, especially in the case of a non-dealer partnership with no prior connection to New York State or New York City that may not have had any reason to know of or believe it would be required to follow these investment capital identification procedures at the time of a given stock acquisition.

Further, even if the corporate partner is already a partner in a non-dealer partnership acquiring stock at the time of a given acquisition, the partnership may not be aware of the corporation's New York tax nexus and/or it may not be inclined to undertake to satisfy these identification requirements on behalf of that corporate partner.

Open Questions

An important question that is not answered in the Memorandum is when the necessary identification must occur with respect to a corporation that is not a New York taxpayer when stock is acquired, but later becomes a New York taxpayer.

The guidance provided in the Memorandum warrants careful consideration by corporate investors with any current or possible future tax nexus to New York State and/or New York City. Further, investment funds should be aware of this guidance and may wish to consider inquiring about the New York tax status and asking certain related questions of their corporate partner investors.

If you would like to discuss the Memorandum or any New York State or City tax matters generally at any time, please contact any of the lawyers listed on this alert or the member of the Proskauer Tax Group with whom you normally consult on these matters.

[1] The Memorandum can be found here: http://www.tax.ny.gov/pdf/memos/multitax/m15_4c_5i.pdf.

[2] Under section 1236(a)(1) of the Code, gain by a dealer in securities from the sale or exchange of any security will not be considered gain from the sale or exchange of a capital asset unless the security was clearly identified in the dealer's records as a security held for investment before the close of the day on which it was acquired. Relevant Treasury Regulations require "an accounting separation of the security from other securities," accomplished by a "method of identification satisfactory to the Commissioner."

[3] In the case of stock acquired after October 1, 2015 pursuant to an option acquired prior to October 1, 2015, for non-dealers, such option must have been clearly identified as held for investment prior to October 1, 2015 in order to qualify as investment capital.

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