

Down the Rabbit Hole: N.Y. Updates Corporate Tax Apportionment Rules

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In this installment of Noonan's Notes, the authors discuss New York's detailed new apportionment rules, including the various sub-categories and the multistep hierarchy for digital products and other service and business receipts.

As we wrote in 2017, "market-based sourcing is the new normal."¹ And although New York was late to the market-based sourcing party, it's now clear that the state has arrived and taken on the role of the White Rabbit, leading taxpayers down a detailed, category-specific set of apportionment rules. These underlying rules aren't new, and most practitioners are now likely aware that as part of its 2014-2015 corporate tax reform, New York shifted to market-based sourcing for essentially all receipts — including sales of tangible personal

property, services, and intangible goods such as royalties.

What is new, however, are New York's ongoing updates to its draft corporate tax apportionment regulations, including a July makeover of the state's apportionment rules, with several noteworthy updates to the hierarchical sourcing methods for receipts from the sale of digital products and other services, as well as other business receipts. To its credit, New York has made a concerted effort to regularly update its article 9-A business corporation franchise tax regulations to incorporate the changes made by corporate tax reform legislation.² And while these rules remain in draft form, they provide detailed guidance and examples that are worth exploring.

Market-Based Sourcing

Market-based sourcing rules seek to tax a receipt based on where a customer receives or benefits from the product or service sold, rather than on the taxpayer's location. In that sense, states that have enacted market-based sourcing don't penalize a corporation for locating its headquarters or office in the state. This is especially true for single-factor, receipts-only states — such as New York and at least 25 other states — where the physical location of a company's offices now has little to no effect on its business income apportionment percentage.

At the same time, these rules allow states to tax a bigger set of corporations, including those with no physical presence in the state, so long as the

¹ Timothy P. Noonan and Elizabeth Pascal, "Market-Based Sourcing in New York and Beyond," *State Tax Notes*, June 19, 2017, p. 1159.

² All of New York's draft corporate tax regulations are available online. Comments to the draft regulations can be submitted to Kathleen D. O'Connell, Office of Counsel, State Department of Taxation and Finance, W.A. Harriman Campus, Building 9, Room 200, Albany, NY 12227, or by email at tax.regulations@tax.ny.gov.

taxpayers have established some other type of nexus (that is, factor-presence or economic nexus).³ Thus, in the new market-based sourcing landscape, the central question becomes how to determine where a customer receives or benefits from the product or service sold.

New York Apportionment: Hierarchy of Methods

By the time New York shifted to market-based sourcing, more than 20 states had already adopted those sourcing rules for some or all of their receipts. That number has now climbed to nearly 30. But with the party getting crowded, New York has found a way to distinguish itself.

Specifically, New York now apportions business income and business capital using specific rules for 11 different sub-categories of receipts, applying unique sourcing rules for everything from sales of tangible personal property to financial transactions; from railroad and trucking business receipts to aviation service receipts; and from digital products to other services and other business receipts.⁴ And for two of these receipt categories — (1) digital products and (2) other services and other business receipts — the state has adopted a hierarchy of sourcing methods, resembling Alice in Wonderland's rabbit hole, that requires taxpayers to sequentially work down a list of sourcing methods to determine where each receipt is earned. Taxpayers are instructed to exercise annual due diligence (and document the steps taken) before abandoning an upper-tier sourcing rule and moving down the list.⁵ And for corporations with fewer than 250 business customers, the due diligence standard may require requesting information from its business customers to determine the receipt or benefit location of the sale.⁶

Under these rules, the basic hierarchy for digital products is:

- (1) the customer's primary use location;
- (2) where the digital product is received by the customer;
- (3) the prior year's sourcing method for the same type of receipts; and
- (4) the sourcing method from the current year for any receipts that can be sourced using methods 1-3 above.⁷

For other service and other business activity receipts, the basic hierarchy is:

- (1) where the customer receives the benefit of the service;
- (2) the service delivery destination;
- (3) the prior year's sourcing method for the same type of receipts; and again
- (4) the sourcing method from the current year for any receipts that can be sourced using methods 1-3 above.⁸

But as the state's recently updated corporate tax apportionment regulations make clear, there's more than meets the eye with this basic hierarchy.

What's New?

New York significantly updated its hierarchy of sourcing methods for digital products and other services and other business receipts as part of its most recent round of edits to the draft apportionment regulations. The state's updates include:

- new "special" sourcing rules for some transactions (for example, digital facilitation of in-person services, sales of intangibles, and management services to passive investment customers);
- expanded rules for reasonable approximation;
- new guidance for digital product receipts involving intermediaries; and
- the inclusion of "unusual events" in the business apportionment factor formula.

But before outlining these changes, it will be helpful to lay out the current sourcing methods detailed in the new regulations.

³New York adopted a bright-line \$1 million economic nexus threshold as part of its 2014-2015 corporate tax reform. N.Y. Tax Law section 209(1)(b).

⁴See N.Y. Tax Law section 210-A.

⁵20 NYCRR 4-2.18(a)(2) (Draft, July 3, 2019).

⁶20 NYCRR 4-2.18(a)(2); 20 NYCRR 4-2.3(a)(2) (Draft, July 3, 2019). For sales to business customers, taxpayers may be required to make inquiries to the customer as to the receipt or benefit location, unless the taxpayer has more than 250 such customers who each purchase substantially similar services, and no more than 5 percent of the taxpayer's receipts come from any one customer (that is, the "inquiries safe harbor").

⁷N.Y. Tax Law section 210-A(4).

⁸N.Y. Tax Law section 210-A(10).

Sourcing Digital Product/Digital Service Receipts

Hierarchy	Business Customer	Individual Customer
1. NEW! Special rules for facilitation of in-person services (e.g., ride sharing); services to tangible personal property (TPP); services to real property; and sales of computer software at retail locations	In-person services = performance location Services to TPP = TPP receipt location Service to real property = property location Retail software sales = retail location	In-person services = performance location Services to TPP = TPP receipt location Service to real property = property location Retail software sales = retail location
2. Where the customer primarily uses the digital property or digital service	As indicated by the books and records of the taxpayer without regard to billing address, or through reasonable inquiries to customer; otherwise, use reasonable approximation.	Billing address or reasonable approximation (no customer inquiry required).
3. NEW! Reasonable approximation	<ul style="list-style-type: none"> • Sourced receipts method. • General information — e.g., population. 	<ul style="list-style-type: none"> • Sourced receipts method. • General information — e.g., population.
4. Receipt location	Where the contract of sale is managed by the customer; otherwise, billing address.	Sales records or other evidence available to the taxpayer.
5. Prior year's sourcing for same type of receipts	Cannot apply this method in first tax year on or after January 1, 2015.	Cannot apply this method in first tax year on or after January 1, 2015.
6. Sourcing for current tax year	Apportionment percentages from other digital product or digital service receipts that can be sourced using higher levels of hierarchy.	Apportionment percentages from other digital product or digital service receipts that can be sourced using higher levels of hierarchy.
7. NEW! Intermediary transactions	Where the end consumer receives the benefit (no consumer inquiry required).	Where the end consumer receives the benefit (no consumer inquiry required).

Sourcing Other Service Receipts

Hierarchy	Business Customer	Individual Customer
1. NEW! Special rules for in-person services (e.g., doctors); services to TPP; services to real property; and sales of intangibles	In-person services = performance location Services to TPP = TPP location Services to real property = property location Sales of intangibles = where intangible value was accumulated	In-person services = performance location Services to TPP = TPP location Services to real property = property location Sales of intangibles = where intangible value was accumulated
1-a. NEW! Special rules for management services to passive investment customers (e.g., hedge funds)	Where the passive investment customer uses the investment or management decisions. If, however, the taxpayer (that is, management service provider) has been granted authority to execute management decisions, the benefit is received where the taxpayer executes those decisions — that is, the performance location.	Where the passive investment customer uses the investment or management decisions. If, however, the taxpayer (that is, management service provider) has been granted authority to execute management decisions, the benefit is received where the taxpayer executes those decisions — that is, the performance location.

Sourcing Other Service Receipts (Continued)

Hierarchy	Business Customer	Individual Customer
2. Where the customer receives the benefit of the service	As indicated by the books and records of the taxpayer without regard to billing address, or through reasonable inquiries to customer; otherwise, use reasonable approximation.	Billing address or reasonable approximation (no customer inquiry required).
3. <i>NEW!</i> Reasonable approximation	<ul style="list-style-type: none"> • Sourced receipts method. • General information — e.g., population. 	<ul style="list-style-type: none"> • Sourced receipts method. • General information — e.g., population.
4. Delivery destination	Where the contract of sale is managed by the customer; otherwise, billing address.	Sales records or other evidence available to the taxpayer.
5. Prior year's sourcing for same type of receipts	Cannot apply this method in first tax year on or after January 1, 2015.	Cannot apply this method in first tax year on or after January 1, 2015.
6. Sourcing for current tax year	Apportionment percentages from other services or business activities that can be sourced using higher levels of hierarchy.	Apportionment percentages from other services or business activities that can be sourced using higher levels of hierarchy.
7. Intermediary transactions	Where the end consumer receives the benefit (no consumer inquiry required).	Where the end consumer receives the benefit (no consumer inquiry required).

Expanded 'Special Rules'

One of the more noteworthy changes in the state's updated draft apportionment regulations is the inclusion of "special rules" for certain transactions (for example, digital facilitation of in-person services, sales of intangibles, and management services to passive investment customers — that is, hedge funds). The new rules go on to change the overall hierarchal structure so that taxpayers are now instructed to apply the new special rules before applying sourcing methods from the ordinary hierarchy. In other words, if you're dealing with a receipts category that falls under a special rule, you'll have to first apply the special sourcing rules before invoking the general hierarchy.

The new special rules include management services provided to passive investment customers. Passive investment customers are defined as an "unincorporated entity . . . that pools capital from passive investors for the purpose of trading or making investments in stocks, bonds, securities, commodities, loans, or other financial assets, but does not otherwise conduct an active business." In plain speak, that means hedge funds.

And under the new rules, all management services — including "services relating to the rendering of investment advice, making determinations as to when sales and purchases of securities are to be made, or the selling or purchasing of securities constituting assets of the passive investment customer, and related activities"⁹ — are now to be sourced first to the location where the passive investment customer uses the investment or management decisions.¹⁰ If you're paying attention, that should sound a lot like traditional market-based sourcing. But where the passive investment customer turns around and grants broad discretionary authority to a third party (including the taxpayer) to execute the investment advisory or investment management decisions on behalf of the passive investment customer (as is common in hedge fund management structures), then where the benefit is received is presumed to be where the entity granted that authority executes the decisions, regardless of the passive investment customer's location.¹¹

⁹ 20 NYCRR 4-2.18(c)(1)(v)(a) (Draft, July 3, 2019).

¹⁰ 20 NYCRR 4-2.18(c)(1)(v)(b) (Draft, July 3, 2019).

¹¹ 20 NYCRR 4-2.18(c)(1)(v)(c) (Draft, July 3, 2019).

This example outlines the state's new proposal:

Management Corp., an investment management corporation with an office in New York, provides investment advisory services in exchange for a fee. Management Corp. enters into a contract with Hedge Fund to provide the fund with investment advisory services. Also, the contract authorizes Management Corp. to have broad discretionary authority to manage funds and securities of Hedge Fund (including authority to purchase, sell, and otherwise trade securities of Hedge Fund) in a manner consistent with the investment strategy of the fund. Management Corp. is providing its services to an entity that is not an investment company as defined under Tax Law Section 210-A(5)(d); therefore, receipts from these services are sourced under the special rules for management services provided to passive investment customers.

Management Corp. must source the receipt to the location where Hedge Fund uses the investment advice to make investment decisions. Because Hedge Fund has granted broad discretionary authority to Management Corp. to manage its funds and securities, it is presumed that where Hedge Fund receives the benefit is where Management Corp. executes these investment advisory and management decisions. Management Corp. makes and uses the investment advisory and management decisions for Hedge Fund at Management Corp.'s office in New York; therefore, the entire receipt is included in both New York receipts and everywhere receipts.

Not judging the conclusion here, but this sounds like the exact opposite of market-based sourcing and more like a retreat to cost of performance.

Reasonable Approximation

Under both the old and new draft apportionment regulations, reasonable

approximation can be used as an alternative method for determining where a customer either receives the benefit of a service or other business activity or primarily uses a digital product or digital service. Taxpayers can only revert to the reasonable approximation method, however, if the actual benefit location is not known to the taxpayer or, for business customers, it cannot be determined through reasonable customer inquiries (or where obtaining the benefit location "would require the taxpayer to expend undue effort and expense beyond the standard amount of due diligence" as required by the law and regulation).¹²

And although reasonable approximation was also permitted under the state's last set of draft regulations, the new regulations note that if a taxpayer lacks the information needed to ascertain where the benefit of any similar receipts is received (the source receipts method), the taxpayer may now turn to reasonable approximation based on criteria such as "general population or a subset of the general population."¹³

The state's prior draft regulations noted that taxpayers could "not use reasonable approximation based on population to determine the location at which a customer primarily receives the benefit of a service." So the new rules represent a major shift, as under the old regulations, taxpayers had to skip population theory and move straight to delivery destination when following the hierarchy of methods referenced above. Now, however, taxpayers may "use statistical information based on the general population or a subset of the population (such as a specific demographic) of the entire country or a region of the country" when reasonably approximating the population of customers who primarily use their service or digital product.¹⁴

Intermediary Transactions for Digital Products

Both the state's other business service and digital product or digital service regulations

¹² 20 NYCRR 4-2.18(c)(3); 20 NYCRR 4-2.3(c)(3) (Draft, July 3, 2019).

¹³ 20 NYCRR 4-2.18(c)(4); 20 NYCRR 4-2.3(c)(4) (Draft, July 3, 2019).

¹⁴ 20 NYCRR 4-2.18(c)(4)(ii); 20 NYCRR 4-2.3(c)(4)(ii) (Draft, July 3, 2019).

contain rules for intermediary transactions. Intermediary transactions include instances in which a service is either (1) provided by the taxpayer, at the direction of an intermediary, directly to the location of an end consumer, or (2) provided to intermediaries but then passed on to end consumers, so long as the taxpayer remains obligated to provide a substantial portion of the service after it is passed on to the end consumer.¹⁵ Also, the new draft apportionment regulations for sales of digital products and digital services expand the definition of intermediary transaction to digital products or digital services that are “made readily available by the taxpayer (e.g., through a website) at the request of the intermediary to be accessed by the consumer and the taxpayer actively maintains or interacts with the digital product or digital service after the consumer receives or accesses it from the intermediary.”¹⁶ Think digital apps and other hosted services.

Under the new rules, these intermediary transactions are sourced first using the hierarchy of methods as applied to the end consumers.¹⁷ In other words, taxpayers must first try to determine where the end consumers primarily use or benefit from their services or digital products. It is only when the hierarchy cannot be applied to the end consumer that taxpayers are to apply any of the various sourcing methods directly to the intermediaries.¹⁸ And under the reasonable inquiries method, taxpayers may still be required to make inquiries to an intermediary, but never to the end consumers, regardless of the number of business customers that the taxpayer has or the percentage of receipts from any one customer.¹⁹

The following example highlights these concepts:

App Design Corp. (the taxpayer), a corporation located in State B, provides mobile phone application design services to its customer, Bank Corp. (the intermediary), which has branches in New

York and other states. Bank Corp. contracts with App Design Corp. to have it design an app that will be readily available for free download by any Bank Corp. account holders (the consumers). App Design Corp. will also provide periodic updates to ensure that the app runs smoothly and that the information transmitted through the app is secure. App Design Corp. is receiving receipts from Bank Corp. in an intermediary transaction because App Design Corp. is making its digital product readily available to consumers at the request of Bank Corp., and App Design Corp. maintains involvement with the app after consumers download it.

Bank Corp. primarily uses the digital service where the consumers download and use the app. App Design Corp. cannot determine information on New York account holders who download the app based on its own books and records because it does not have information on either the primary use location or where the app is received by the consumers. Therefore, App Design Corp. must make reasonable inquiries to Bank Corp. for location statistics on account holders who download the app. Bank Corp. cannot provide App Design Corp. with any information after reasonable inquiries, so App Design Corp. should look to publicly available information — such as the number of Bank Corp.’s bank branches within and outside New York — and use the percentage of branches in New York to reasonably approximate based on customer information the primary use location of the app.

Unusual Events

In addition to the specific updates to the digital product and other services and other business receipt rules described earlier, New York also amended its general apportionment regulations (20 NYCRR 4-1) in July. And the state has now proposed including receipts from “unusual events” in the business apportionment factor formula, which represents a major shift

¹⁵ 20 NYCRR 4-2.18(b)(9); 20 NYCRR 4-2.3(b)(8) (Draft, July 3, 2019).

¹⁶ 20 NYCRR 4-2.3(b)(8)(i)(c) (Draft, July 3, 2019).

¹⁷ 20 NYCRR 4-2.3(g)(1) (Draft, July 3, 2019).

¹⁸ 20 NYCRR 4-2.3(g)(3) (Draft, July 3, 2019).

¹⁹ 20 NYCRR 4-2.3(g)(2) (Draft, July 3, 2019).

from prior versions of its draft regulations. We're not talking here about events like the Noonan family reunion (itself admittedly an unusual event), but rather transactions outside the normal course of business.

Under the original draft apportionment regulations, receipts from "sales of real, personal, or, intangible property that [arose] from unusual events [were] not included in New York receipts or everywhere receipts." The state cited the following example:

Corporation C, a consulting firm, sells its office building and the accompanying parcel of land for a gain, which is properly reported as business income. The gain is not included in Corporation C's New York receipts or everywhere receipts because it is an unusual event.

This has changed, however, and all receipts are now to be included in the apportionment fraction, regardless of whether they are earned in the ordinary course of business. The state's proposal is outlined in the following example:

Corporation B sells all the assets of one of its divisions for a gain, which is properly reported as business income. The assets sold consist of real property, tangible personal property, and goodwill. The portion of the gain attributable to the sale of tangible personal property shall be apportioned to New York using the rules for receipts from the sales of tangible personal property; the portion attributable to the sale of real property shall be apportioned to New York using the rules for receipts from the sale of real property; and the portion attributable to the sale of goodwill shall be apportioned to New York using the rules for receipts from other business activities.

The inclusion of these transactions that are outside the ordinary course of business is a significant change and will dramatically affect the receipts factor for many taxpayers who have sold or are selling a business. This may also have an unintended consequence of making it more expensive for a New York-based taxpayer to buy a business. Under the new formula, a seller will have to include gains from the sale of tangible and

intangible assets if, under the new market-sourcing rules, the benefit is received by the purchaser in New York. So an out-of-state seller may find itself with significantly more New York tax if the purchaser is in New York and receives the benefit of the deal in the state.

Also, what happens if a taxpayer did a deal in 2017 and sourced the gain under the old draft rules, which excluded unusual events? Presumably the new draft regulations could be retroactively applied to allow for a refund, or possibly even an assessment? Circumstances could arise when doing so could be unfair or potentially impermissible under an estoppel theory in which, for example, a taxpayer relied on the old draft in planning a transaction.

Alternative Apportionment

In connection with the change for usual events, the state has also added new alternative apportionment rules that expand on the commissioner's ability "in his or her discretion or at the request of the taxpayer, to adjust the business apportionment factor in order to properly and fairly reflect the taxpayer's activities within New York."²⁰ Under these new rules, the party seeking to vary the business apportionment factor bears the burden of proof to demonstrate by clear and convincing evidence that the business apportionment factor determined under ordinary sourcing rules does not result in a proper reflection of the where the taxpayer earned its business income. And the party seeking to vary the business apportionment factor must demonstrate that the standard statutory formula "attributes income or capital to the State out of all proportion to the business transacted by the taxpayer in the State."²¹

The state provides the following example in its new draft regulations:

Corporation A's only office is in New York. Corporation A invests in stocks for its own account and performs administrative and investment advisory services for customers located solely in New York.

²⁰ 20 NYCRR 4-4.1(a) (Draft, July 18, 2019).

²¹ 20 NYCRR 4-4.1(d) (Draft, July 18, 2019).

Ninety-five percent of its income consists of dividends and net gains from its stock holdings, while the remaining 5 percent consists of the fees it receives for the administrative and investment advisory services. Under Tax Law section 210-A(5)(a)(2)(G), dividends and net gains from stock are not included in the numerator or denominator of the business apportionment fraction unless the commissioner determines under Tax Law section 210-A(11) and this section that inclusion of those dividends and net gains is necessary to properly reflect the taxpayer's business income or capital.

In this instance, under the statutory formula, the receipts generating 95 percent of the taxpayer's income would not have any representation in the business apportionment fraction. Accordingly, to properly reflect the taxpayer's business income, it is appropriate to include the dividends and net gains from the stock holdings in the business apportionment fraction. The dividends from the stock of corporations domiciled in New York would be included in the numerator of the business apportionment fraction. The net gains would be included in the numerator of the business apportionment fraction to the extent that the purchasers are in New York. The total amount of dividends and net gains would be included in the denominator of the business apportionment fraction.

So while it appears that the default is now to include all receipts in the business apportionment fraction, taxpayers may — under some circumstances — request a discretionary adjustment where this method “attributes income or capital to the State out of all proportion to the business transacted by the taxpayer in the State.”

Conclusion

Market-based sourcing is not new, and New York was far from the first state to require corporate taxpayers to source their receipts using this method. But since first enacting its market-

based sourcing rules in 2015, New York has gone all in with detailed, category-specific apportionment rules, including a multistep hierarchy for digital products and other service and business receipts.

While the new rules may at times feel like an adventure in Wonderland, New York does deserve credit for publishing and updating its draft apportionment regulations. And while we definitely don't agree with all of the new proposals, this is the best that taxpayers have until the regulations are formally adopted through the state administrative process. So before you file your next New York corporate tax return, take some time, review the rules, read the regulations, study the examples and, if all else fails, give us a call. ■