LAW360 Tax Authority

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NY Regs Seek Narrow Protections From Tax On E-Commerce

By **Maria Koklanaris**

Law360 (August 9, 2023, 9:01 PM EDT) -- New York would advance a narrowed interpretation of when federal protections insulate businesses from state income tax on online commerce and would change sourcing of some receipts under a plethora of formal regulations the state proposed Wednesday for its 2015 corporate tax overhaul laws.

The **417 pages of proposed regulations** came eight years, many taxpayer comments and several iterations of drafts after the state passed legislation representing "the most extensive restructuring of New York State's corporate tax framework since the 1940s," according to a **summary** of some effects of the regulations from the state Department of Taxation and Finance. The legislation enacted mandatory combined reporting and market-based sourcing and established an economic nexus standard for the state franchise tax, among other changes. The department published the regulations covering those laws in Wednesday's edition of the state register.

After eight years, more than 80 taxpayer comments and several iterations of drafts, the New York tax department released 417 pages of proposed regulations Wednesday addressing business tax shield rules and other issues. (AP Photo/Hans Pennink)

In the summary, the department noted that it had received more than 80 comments and suggestions on its various drafts. Wednesday's proposed regulations are also open for comment, which must be made by Oct. 10. However, the department said that in some instances, it took a different approach to resolving

issues than the businesses and individuals submitting comments had asked it to.

"While the department implemented many comments and suggestions, it resolved some of the issues raised in a different manner than suggested," the summary said.

One of those issues was how to handle the Multistate Tax Commission's updated statement on interpreting P.L. 86-272, formally known as the Interstate Income Act. P.L. 86-272 insulates businesses from a state's tax on net income if their only connection to that state is soliciting sales of tangible personal property. The MTC's updated statement looks at an application of that connection for the internet age.

The department's proposed adoption of the MTC's updated statement of information in P.L. 86-272, which remains in the formal regulations published Wednesday, **drew swift reaction** from tax professionals when it was originally proposed in New York. The tax agency addressed that Wednesday, noted Jeffrey Reed, a tax partner at Kilpatrick Townsend & Stockton LLP.

"They explicitly state the areas on which they disagree with commentators — for example, deciding to include the additional rules for internet-based activities [losing] P.L. 86-272 protection despite commentators reasonably pointing out that those rules overreach," Reed said.

Some commenters advocated for the elimination of the additional rules for internet-based activities, arguing that rules of statutory
construction do not support the department's interpretation of P.L. 86-272, the department said in an accompanying document it called a **regulatory impact statement**. But it said other commenters concluded that the department has the authority to promulgate regulations that narrowly interpret the P.L. 86-272 protections.

Meanwhile, the proposed regulations make a change from prior drafts on the sourcing of a corporation's receipts **from passive investment customers**, which include categories of income such as hedge-fund or private-equity management fees. Timothy Noonan, a tax partner at Hodgson Russ LLP, said the initial proposed regulations sourced receipts from management fee-type income to the location where the contract is managed by the passive investment customer.

"But that's no longer the general rule in the department's published proposal," Noonan said. "Now, the benefit of services provided to a passive investment customer is presumed to be received at the location of the investors in [the] passive investment customer, unless the investor is holding the interest in the passive investment customer for a beneficial owner."

Noonan said the change "seems more in line with the idea behind market sourcing."

Noonan said the new regulations also present the tax agency's views on the sourcing of gains from the disposition of intangibles like goodwill, which is an intangible asset found when one company buys another.

Noonan said the regulations reflect that goodwill will be sourced based on the location where the value was accumulated, not based on the location where the buyer of such goodwill derives the benefit. To determine where the goodwill is accumulated, the new rules suggest the use of a three-year lookback of the taxpayer's business apportionment factor, unless "other facts and circumstances" indicate another time period is a better measure, Noonan said.

"It's possible there will be further public comment on this, and I think it's very likely there will be later litigation on this rule, as it can be argued it is not a reasonable application of the state's market-sourcing rules," Noonan said.

Marc Simonetti, founder of State Tax Law LLC, said he was concerned with a portion of the regulations reflecting the discretion the tax agency has over alternative apportionment, specifically the business apportionment factor related to business capital and business income.

Simonetti said the department is asserting discretion for alternative apportionment on whether a company's business apportionment factor reflects where its capital is employed.

"But that is not the statutorily enacted standard that the business apportionment factor is legislatively crafted to measure," Simonetti said.

He said any New York-headquartered company with a lot of capital employed in the state and customers all across the country could be subject to the alternative apportionment because market-sourcing provisions would cause its business apportionment factor to reflect the market. He said that does not reflect the company's business capital employed in New York.

"It is the wrong standard because it doesn't align with the sourcing method," Simonetti said.

Both Noonan and Kathleen Quinn, a tax partner at Jones Walker LLP, said they will be watching to see how the tax agency views the application of the regulations to prior tax years.

"Retroactive application of these regulations, even in the guise of 'this is not the retroactive application of the regulation, just an interpretation of an existing statute,' can create both opportunities and exposure for taxpayers," Quinn said. "It will be interesting to see how this plays out."

--Additional reporting by Paul Williams. Editing by Khalid Adad.

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