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In this installment of Noonan's Notes, Noonan and Banks address questions regarding New York's draft apportionment regulations for investment managers under the state's market-sourcing regime.

Over seven years have passed since New York adopted market sourcing for corporate taxpayers. During that time, the Department of Taxation and Finance has been publicly mulling over draft regulations interpreting the new statutory provisions. As this process appears to be coming to an end, one topic relating to how investment managers handle apportionment under the state's market-sourcing regime has sparked several questions. So while we wait for these draft regulations to be finalized, we thought it made sense to get ahead of some of the issues in the draft that we expect will be the source of some controversy or debate in the near future. In this article, we address the new questions around investment managers.

Statutory Background

As a refresher, New York's "new" market sourcing statute changed the way corporations were required to source their receipts from services.[1] Before the change, the corporate apportionment rules generally provided that receipts from the sale of services were sourced to where the services were performed. But as outlined in the legislative history underlying New York's 2015 tax reform, those historical sourcing rules "violate[ed] basic tax policy principles by taxing similarly-situated taxpayers differently, and in some instances it creates disincentives to increasing a corporation's activities in New York."[2] So the shift to a more market-based system for apportioning receipts, in the eyes of the Legislature, would modernize the tax code and eliminate "impediments to businesses wishing to expand their New York activity."[3]

To accomplish this, the statute delineates specific sourcing rules for many categories of services, such as railroad, trucking, aviation, and advertising. For all the rest, there is a catchall provision that says that receipts from services not addressed in the statute are included in the numerator of the apportionment fraction "if the location of the customer is within the state."[4] And making the determination of whether the location of the customer is in the state requires application of a hierarchy method, which looks first to whether the benefit

[1] These rules are "new" as of 2015 when New York's corporate tax reform was implemented.

[2] New York State Division of the Budget, "2014-15 New York State Executive Budget Revenue Article VII Legislation Memorandum in Support," at 5.

[3] *Id.*

[4] N.Y. Tax Law section 210A-(10).

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is received in New York.[5] If so, then look no further, because it is a New York receipt.[6]

Draft Regulations Generally

The department's draft apportionment regulations add steps to the analysis. Under the regulations, there are "special rules" for determining where the benefit is received and a "general rule" for determining where the benefit is received.[7] The special rules apply to four categories of services: (1) in-person services such as dental services; (2) services related to tangible personal property such as dry cleaning; (3) services related to real property such as landscaping; and (4) sales of intangible property such as goodwill.

In the draft regulations, the special rules for determining where the benefit is received are followed by the general rule, which is again, another catchall if the specific rules do not apply. The introductory paragraph of the general rule explains that determining where the benefit is received depends on whether the customer is an "individual customer" or a "business customer."

For individual customers the answer is easy: The benefit of the service or other business activity is presumed to be received at the customer's billing address, and if the corporate taxpayer does not have the customer's billing address, it must use a "reasonable approximation."[8] But for business customers the analysis is slightly more complicated, involving both a billing address safe harbor, and separate rules for intermediary transactions and for when the benefit is received both within and outside New York.[9]

Draft Regulations: Passive Investment Customers

Even though the general rule in the draft regulations begins with the instruction that the determination of where the benefit is received depends on whether the customer is an individual or business customer, there is a third category of customer described in this section of the draft regulations — the "passive investment customer," which is a passthrough entity that is neither an individual nor a business customer.

In the draft regulations, a passive investment customer "means a customer that is an unincorporated entity, such as a limited partnership, general partnership, limited liability company, limited liability partnership, or trust, 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 that does not otherwise conduct a trade or business."[10]

Given that the statute does not distinguish between types of customers for purposes of applying the general market sourcing rules, and the statement in the draft regulations that the general sourcing requirements turn on whether a customer is an individual or business, this third category of customer under the general rule tends to jump out at the reader.

Under the draft regulations, in the case of a passive investment customer, the benefit of the service or other business activity is presumed to be received at the location "where the contract is managed by the passive investment customer."[11] The location where the customer manages a contract means "the primary location at which an employee or other representative of a customer serves as the person with responsibility for monitoring or managing the day-to-day execution of the contract of sale with the corporation."[12]

If we only looked at the current draft of the regulations, it would be difficult to pinpoint why the department carved out this separate rule for passive investment customers, or how it believed this provision would be implemented. Indeed, the draft describes the passive investment customer, but not what services might be provided to it. But here's where the department's transparency into its regulatory process comes in handy, because a

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[5] *Id.*

[6] For further analysis generally of these market-sourcing rules, see Timothy P. Noonan and Elizabeth Pascal, "Market-Based Sourcing in New York and Beyond," *State Tax Notes*, June 19, 2017, p. 1159.

[7] New York State Department of Taxation and Finance, Draft Regulations sections 4-4.3 and 4-4.4.

[8] Draft Regulations section 4-4.4(a).

[9] *Id.*

[10] Draft Regulations section 4-4.1(b)(3).

[11] Draft Regulations section 4-4.4(c).

[12] Draft Regulations section 4-4.1(e).

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prior version of the draft regulations provided insight into the types of services the department had in mind. Specifically, a since-deleted provision explained that services to passive investment customers "include 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."[13]

The removal of the definition for services provided to passive investment customers does not change the fact that these unique sourcing provisions will reach *all* receipts from passive investment customers other than ones falling under the special rules, such as landscaping. As a result, investment advisory fees derived from services provided to investment partnerships will be apportioned to New York if the state is the primary location from where an employee or other representative of the investment partnership serves as the person with responsibility for monitoring or managing the day-to-day execution of the contract of sale between the corporate taxpayer and the passive investment customer for investment advisory services.

But therein lies the rub — this looks less like market sourcing than a lot of the other situations that are outlined in the draft regulations.

Here's why: If a taxpayer is engaged in the business of providing investment services to multiple investors, it usually does so through an investment vehicle, such as a hedge fund or similar type of investment fund. That fund, usually set up as a passthrough entity such as a partnership, is usually managed by the investment manager, who also serves as general partner in the fund. If that fund is a regulated investment company, then even before New York tax reform, the Tax Law provided for apportionment rules that looked to a more market-based system, sourcing receipts from these services based on where the investors were located.[14] But for other investment funds, the rules in the new draft regulations will apply.

Thus, under those draft rules, here's how the analysis would work:

- The "passive investment customer" — which is defined as "an unincorporated entity . . . that pools capital from passive investors" — is the partnership that pools the capital. The underlying investors who provided the capital are *not* the customers.
- For the corporate investment manager that provides services to the passive investment customer, the determination of New York receipts is a "circular" process. The corporate investment manager looks to the location where the passive investment customer manages the contract. In the typical fund setup, the person doing the managing ends up being the corporate investment manager (that is, the general partner of the fund). And the "location where the contract is managed" is defined as the primary location where an employee or other representative of the customer monitors and manages the day-to-day execution of the contract. In other words, sourcing is based on the location of the investment manager.

This regulatory interpretation is interesting, given New York's overall approach to shift to more of a market-based sourcing regime. Indeed, for investment managers, choice-of-entity considerations can be significant, particularly in New York State and New York City, where apportionment rules vary greatly based on the entity type.[15] For example, an investment manager that is taxed as a partnership is required to apportion income using what some view to be an antiquated three-factor formula, based on property, payroll, and gross income percentages that often results in the allocation of income mostly to where the investment manager is based. For corporations, however, whether electing as an S corporation or not, market-sourcing would be

[13] 2019 version, Draft New York Regulations at 4-2.18(c)(1)(v)(a).

[14] N.Y. Tax Law section 210-A.5(d).

[15] For additional background on New York State and City apportionment, see Noonan, Doran J. Gittelman, and Jeffrey S. Gold, "Setting the Table on Allocation and Apportionment in New York," *Tax Notes State*, Apr. 27, 2020, p. 475.

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the expected result under New York's new rules. But the interpretation in the draft regulations could often lead to the opposite result.

For this reason, this interpretation has been criticized in a recent report issued by the Tax Section of the New York State Bar Association on the basis that, by using an apportionment approach that looks more like a place-of-performance rule, the draft regulations are inconsistent with the legislative intent underlying the tax reform process in general.[16] Nonetheless, the department has explained that its interpretation is designed to be modeled after the Multistate Tax Commission's Model General Allocation and Apportionment Regulations.[17] So it remains to be seen how investment managers will respond to these new regulations if they are not amended before the final version is issued. Either way, we can expect more developments on this issue in the coming years. ■

[16] New York State Bar Association Tax Section, "Report on Draft Business Apportionment Factor Regulations" (Sept. 2, 2022).

[17] Multistate Tax Commission, "Summary of the Model General Allocation and Apportionment Regulations (2018)."

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