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In this installment of Noonan's Notes, the authors review the inconsistent sourcing rules and apportionment formulas in New York State and New York City as they apply to partnerships and other flow-through entities — including the changes under the corporate tax reform enacted in 2015.

Every state employs a combination of sourcing rules and apportionment formulas to determine how much of a business's income will be taxable.[1] These methods are often applied inconsistently between the state and municipal levels and vary based on the form of the taxpayer (for example, partnership, C corporation, S corporation, etc.).

New York's take on this is especially complicated. This is due in part to state and city corporate tax reform in 2015 that changed the rules significantly, and in part because, well, it's New York. In this article, we outline these changes and review the nuances in New York State and City and tell you which sourcing rule goes to which apportionment and when. The idea for this article was inspired in part by our guest coauthor, CPA Jeffrey S. Gold, who had the good sense to get all of these rules into one handy table, which we share later in the article.

I. Introduction: The Three-Factor Formula

As a business, most states can only tax a part of your income. To determine how much of your income will be subject to tax, the state multiplies your total business income (plus or minus some modifications) by an apportionment formula.[2] This formula comprises a ratio or factor, or a multitude of factors that are driven by your business's data. The numerator of the ratio is the amount of a specific value in the state and the denominator is the amount of that value everywhere. Historically, under Article IV of the Multistate Tax Compact, the Uniform Division of Income for Tax Purposes Act, the suggested apportionment formula included three equally weighted factors: property, payroll, and sales — though the UDITPA rules have basically gone the way of pleated khaki pants: They are not in style anymore.

Apportionment rules apply for entities and entity-level taxes, like the state and city taxes on corporations and the Metropolitan Transit Authority (MTA) surcharge tax. But New York's apportionment rules are also extremely relevant for nonresident owners of flow-through entities — including noncorporate forms — doing business in New York, since their New York-source income is determined based on such rules.

Spoilers. We've mostly moved on from the three-factor formula and even double-weighted sales.[3] And while there are nuanced formulas for some industries, many states have simplified the general formula to include only a ratio of a

[1] Some states do not impose a corporate income-based tax, but instead employ a tax on alternative bases such as gross receipts or profit margins (*e.g.*, Nevada, Ohio, Oregon, Texas, and Washington). These states and tax types are not addressed in this article.

[2] In states that apply a business income versus nonbusiness income distinction (such as California), nonbusiness income is specifically allocated. *See* Cal. Rev. & Tax. Code section 25120(d). Nonbusiness income typically includes all income other than business income. *Id.*; UDITPA section 1(e). Business income generally is defined as "arising from transactions and activity in the regular course of the taxpayer's trade or business." *See, e.g.*, UDITPA section 1(a). States will also specifically allocate some receipts, such as sales of real property or some intangibles.

[3] A double-weighted-sales-factor formula uses four factors — including property, payroll, and two sales factors — to give double weight to the sales factor and equal weight to both the property and payroll factors. *See, e.g.*, Ala. Code section 40-27-1.

business's sales in and outside the state; that is, a single-sales-factor formula. But as we'll see, not all states have adopted this formula, and some, like New York, did not adopt it uniformly.[4] So a single sales factor may only apply to some forms of business — or regarding specific taxes.

II. Single Sales Factor and Market-Based Sourcing

How are these various factors determined? To oversimplify: For property, it's usually the value of your property in the state; and for payroll, total wages paid to employees for work within the state. For sales, it's complicated.

Sales of physical goods (that is, tangible personal property) are generally sourced to the destination of the good, which makes sense.[5] Contrast that to sales of other than tangible personal property, such as service receipts, where the location is harder to define. The original UDITPA method was to source non-tangible personal property receipts based on where the "costs of performance" were incurred.[6] In its purest form, this method looked to where the income-producing activities were. When the income-producing activities occurred both in and outside a state, the receipt was sourced to where the greater proportion of income-producing activity was performed.[7] Income-producing activities were measured by the costs associated with performing the services.[8] In practice, this meant looking at things such as wages and expenses dedicated to specific invoices, customer accounts, engagements, etc.

In 2014 the Multistate Tax Commission proposed a revision to UDITPA, changing the sourcing rules for sales other than those of tangible personal property to a market-based approach.[9] Market-based sourcing looks to where the customer is, which is routinely determined by a hierarchy of rules, beginning with where the benefit of the sale is received. Many states have since adopted this approach, presumably because it favors in-state companies. States such as New York, however, have only partially adopted it.[10]

Recap. The general trend over the past few years has been to move away from the three-factor apportionment formula to a single-sales-factor formula, and from a cost-of-performance method of sourcing sales of non-tangible personal property to market-based sourcing. Many states have made the transition. Others (like New York) took a pick-and-choose approach, applying different methods to different tax types.

III. Putting It on the Table: Table 1 and Table 2

Now that you have a lay of the land, let's take a close look at what New York is doing and tee up that chart, which is included as Table 1 below. This handy chart outlines the different rules in the state and the city as applied to C corporations, S corporations, and partnerships/limited liability companies.

Also, to help illustrate how these sometimes funky rules can play out for a real-life taxpayer (OK, we made one up), see Table 2, which summarizes the different allocation percentages that would apply to the same facts based on tax type and entity type.

IV. New York State Apportionment Rules

First a quick note to help with any confusion. Neither New York State nor New York City uses a business/nonbusiness delineation for corporate or individual taxes. Rather, all business income is subject to apportionment — or as New York State and City sometimes call it, a business allocation percentage (BAP).[11] Following are the allocation formulas and sourcing rules relating to sales factors employed by the state (in this section) and New York City (in Section V).

[4] Some states may permit the use of a single sales factor (*e.g.*, Arizona, Massachusetts, or North Dakota) and others allow it as a default in which a business-specific alternative does not apply (*e.g.*, Mississippi).

[5] UDITPA section 16.

[6] UDITPA section 17.

[7] *Id.*

[8] *Id.*

[9] Multistate Tax Commission, Amendments to the Multistate Tax Compact Article IV section 18(c) (July 2014). The MTC adopted regulations governing market-based sourcing in 2017.

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

[11] Although New York does not follow a business/nonbusiness distinction, it has specific allocation rules and treatment for nonbusiness income, such as income from investment and subsidiary capital.

Table 1.

	C Corporations	S Corporations	Partnerships, LLCs, Etc.
New York State			
Apportionment formula	Single sales factor	Single sales factor	Three factor formula (gross income, property, payroll)
Sourcing of receipts			
Services	Market-based sourcing	Market-based sourcing	Office where sale was negotiated or consumated / agent is based
Tangible personal property	Destination	Destination	Origination
MTA surcharge			
Apportionment formula	Three factor formula (gross income, property, payroll)	N/A	N/A
Sourcing of receipts			
Services	Market-based sourcing	N/A	N/A
Tangible personal property	Destination	N/A	N/A
New York City			
Apportionment formula	Single sales factor	Single sales factor	Single sales factor
Sourcing of receipts			
Services	Market-based sourcing	Place of performance	Place of performance
Tangible personal property	Destination	Destination	Destination

C Corporations

Corporations taxed as federal C corporations subject to New York State's general business corporation tax (Form CT-3) apportion business income using a BAP driven by a single sales factor.[12] Sales of tangible personal property are sourced to the destination of the sale.[13] Sales of things other than tangible personal property, such as sales of other services or business receipts, use a market-based sourcing approach — to the customer location.[14] New York moved to this market-based system in 2015. The market for a sale is determined in New York by a "hierarchy of methods" beginning with where the benefit is received.[15] If the receipt is for a sale to a business, the benefit received is indicated by the customer's books and records; for individuals, it is indicated by their billing address.[16]

> ***Example.*** Imagine you are a small toilet paper retailer, registered as a C corporation, with central operations in New York City. You have an office and warehouse on Randall's Island worth $5 million and a $50,000 annual payroll expense paid to employees in New York City. Assume also that your annual cost of goods sold (COGS) is $50,000. Last year

[12] N.Y. Tax Law section 210-A(1).

[13] N.Y. Tax Law section 210-A(2)(a).

[14] N.Y. Tax Law section 210-A(10)(a); *see also* New York State Draft Regs. section 4-2.18(a)(1). Special sourcing rules apply to specific industries, service receipts, and financial instruments. For purposes of this article, we discuss the default sourcing for other services.

[15] N.Y. Tax Law section 210-A(10)(b)(1).

[16] Draft Regs. section 4-2.18(c)(2)(ii) and (c)(2)(i).

> you generated $900,000 of receipts from the sales of toilet paper, $100,000 of which were from sales destined for New York City. The balance was shipped outside New York State. You also acted as a consultant to a college in Wyoming, where you received an additional $100,000 for a live online presentation you gave out of the New York City office, on the "Dos and Don'ts of Using Toilet Paper." Your BAP for the year is 10 percent. To determine this, we use the single sales factor, with a numerator of $100,000 (receipts from the sale of tangible personal property sourced to a destination in New York) and a denominator of ($1 million). Your New York State receipts do not include the receipts from the presentation services because the benefit was not received by a customer in New York.

MTA Surcharge. The state imposes an additional tax, the MTA surcharge, on C corporations doing business in a metropolitan commuter transportation district (MCTD).[17] But oddly, these rules require the use of a BAP that equally weights property, payroll, and sales factors.[18] The factors, however, are computed differently. For the MTA surcharge, the numerator of the ratio is the amount of a specific value in the MCTD, and the denominator is the amount of that value in New York State.[19] Receipts generated from the sale of tangible personal property for the MTA surcharge are sourced to the destination of the sale.[20] Receipts generated from sales of other than tangible personal property use market-based sourcing.[21]

So the MTA surcharge is a mishmash of the rules. The BAP is affected by the amount of the business's payroll and property, different than it is for state corporate tax purposes. But the sales factor does incorporate the new market-based sourcing rules. Go figure. You'll also notice that this creates a higher BAP for the toilet paper retailer.

> ***Example:*** Whereas before we had a 10 percent sales factor ($100,000 NYC sales/$1 million everywhere), we now have a 100 percent sales factor ($100,000 MCTD sales/ $100,000 NYS sales). We now also have property and payroll factors to consider. Because the entirety of the business's property and payroll is in New York County, the property and payroll factors are 100 percent.[22] Layering in these factors, we determine that the BAP has increased to 100 percent (100 percent sales + 100 percent property + 100 percent payroll/3).[23]

S Corporations

Businesses incorporated as federal S corporations subject to New York State's S corporation franchise tax (Form CT-3-S), which is just a fixed-dollar minimum tax, follow the general business corporation tax rules and use a BAP driven by a single sales factor.[24] Receipts generated from the sale of tangible personal property are sourced to the destination of the sale, and receipts generated from the sale of other than tangible personal property use market-based sourcing.[25] Applying this to the example above, the S corporation would have the same BAP as the C corporation — 10 percent.

But flow-through entities like S corporations are typically not subject to an entity-level income tax. Where the S status is respected, the shareholders receive a pro rata share of the business's income, which they report on their individual returns and on which they pay personal income tax.

If you are a nonresident shareholder of a New York S corporation, you will be subject to New York State personal income tax on your distributive share of the S corporation's New York-source income.[26] In practice, this is all provided to you on

[17] The MCTD includes Bronx, Dutchess, Kings, Queens, Nassau, New York, Orange, Putnam, Richmond, Rockland, Suffolk, and Westchester counties. N.Y. Tax Law section 209-B(6) citing PBA section 1262(1); *see also* New York State Instructions for Form CT-3-M (2019).

[18] N.Y. Tax Law section 209-B(2).

[19] *Id.*; *see also* New York State Instructions for Form CT-3-M (2019).

[20] N.Y. Tax Law section 209-B(2)(b) citing N.Y. Tax Law section 210-A.

[21] *Id.*

[22] N.Y. Tax Law section 209-B(2)(a) and (c).

[23] N.Y. Tax Law section 209-B(2)(d).

[24] N.Y. Tax Law section 210(1)(d); *see* New York State Instructions for Form CT-3-S (2019).

[25] N.Y. Tax Law section 210-A(2)(a).

[26] N.Y. Tax Law section 632(a)(2).

Schedule K-1. But because you have been so patient, we will take you behind the scenes, where the magic happens.

> ***Example.*** You're now a New York nonresident and you own 50 percent of the toilet-paper-making S corporation. You just received a K-1 that says that you have an additional $45,000 of New York-source income. Exploring your inner accountant, you determine that the S corporation had $1 million of business income and a 10 percent BAP resulting from the $100,000 of tangible personal property receipts sourced to New York State. You take the next step and multiply the taxable income of $900,000 ($1 million of receipts less $50,000 of expenses and $50,000 of COGS) by the BAP (10 percent) to reach the S corporation's New York taxable income of $90,000. As a 50 percent owner, you will receive 50 percent of this income, resulting in an additional $45,000 of New York-source income.

Partnerships, LLCs, Etc.

Businesses such as partnerships, sole proprietors, and LLCs classified as partnerships for federal income tax purposes apportion business income using a BAP that equally weights gross income, property, and payroll factors.[27] Partnerships and LLCs classified as partnerships compute this on Form IT-204. Nonresident sole proprietors allocate income to New York State on Form IT-203-A attached to their New York State nonresident income tax return, Form IT-203.[28]

Not only do these entities use three factors instead of just one, but there's an important distinction in the calculation of the sales factor, which for New York purposes is called the gross income percentage. For these entities, gross receipts generated from all sales (tangible personal property or otherwise) are sourced to where the sale originated, not to its destination or to where the customer is located.[29] Specifically, New York State sources these receipts to New York — where the "services [are] performed by or through an office, branch or agency of the business located within New York State . . . includ[ing] all sales negotiated or consummated, and charges for services performed, by an employee, agent, agency or independent contractor chiefly situated at, connected by contract or otherwise with, or sent out from, offices, branches of the business, or other agencies, situated within New York State."[30]

> ***Example.*** Same facts as above, but this time you are an LLC treated as a partnership for federal tax purposes. You now apportion your business income using a three-factor formula and source sales to the office location where the sales were negotiated or consummated, and where the agent or employee performing the services was chiefly situated. As a result, you now have a 100 percent BAP in New York. All of your property and payroll are in New York, and the sales of toilet paper and your services are sourced to New York because they are based out of the office on Randall's Island.

Why would New York State do this? It could be because unincorporated businesses tend to be in service industries, and New York has a lot of those. Consider all the in-state professional service companies originating sales in a skyscraper in midtown, invoicing out-of-state businesses. Or the start-ups working out of a loft down in the Flatiron District, conferencing clients abroad. These rules result in higher taxes for those in-state businesses. But is it really that deliberate? This could just be a vestige of the old rules, when corporations also used a traditional three-factor method for apportioning income. The corporate rules changed with the 2015 tax reform, while these rules — which find their home under the personal income tax law — just haven't caught up.

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[27] N.Y. Comp. Codes R. & Regs. tit. 20, section 132.15(a); *see* New York State Instructions for Form IT-204 (2019).

[28] Members of a partnership must also separately compute a metropolitan commuter transportation mobility tax on an addendum to Form IT-204, "MCTD Self Employment Earnings." This income subject to the mobility tax is apportioned using a three-factor MCTD allocation percentage. The numerator of this allocation formula is the same as the MCTD amount for the MTA surcharge allocation formula (MCTD only). However, the denominator is not limited to New York State, but instead includes everywhere factors (totals in and out of the state).

[29] N.Y. Comp. Codes R. & Regs. tit. 20, section 132.15(f).

[30] *Id.*

Again, however, this ends up really being relevant to nonresident owners of these businesses. Because these are flow-through entities, the partner will have to pay personal income tax on its distributive share of the business's income. A New York nonresident partner, like a shareholder of an S corporation, includes in its New York taxable income its portion of the business's New York-source income as determined by the BAP.[31]

V. New York City Apportionment Rules

C Corporations

Businesses incorporated as federal C corporations subject to New York City's business corporation tax (Form NYC-2 and NYC-2.5) use a BAP driven by a single sales factor.[32] Sales of tangible personal property are sourced to the destination of the sale.[33] Sales of other than tangible personal property, as with the state, are sourced using the market-based method to location of the customer.[34] This location is also determined by a hierarchy beginning with where the benefit is received.[35] This is no different than the state rules for C corporations. Once again on our fact pattern this would result in a 10 percent apportionment.

S Corporations

The city effectively doesn't recognize S elections. Businesses incorporated as federal S corporations are subject to New York City's old general corporation tax, Form NYC-3L. This tax also uses a single sales factor BAP,[36] and receipts generated from the sale of tangible personal property are sourced to the destination of the sale.[37] But here's the kicker: Receipts generated from the sales of services are sourced — using a variation of the cost-of-performance method — to the place where the service is performed.[38] The city has *not* followed the C corporation rules and moved to market-based sourcing.

> ***Example.*** Toilet Paper Co.'s BAP would increase to 20 percent. This is because we now need to account for the sourcing of your service receipts, which are located at the place of performance. Because you performed these services online, out of your Randall's Island office, it is likely that New York would view these as New York City receipts. Therefore, we have $100,000 from sales of toilet paper destined for New York City and $100,000 of receipts from services performed in New York City over a total of $1 million in receipts.

Why the disconnect? There's no rhyme or reason to it. The city has apparently decided it would be too expensive to allow city-based S corporations to use market-based sourcing (despite the fact that the city would presumably capture a lot more taxes from non-city-based S corporations under a market-based sourcing regime). This also has the potentially unintended consequence of really hurting those companies that decide to set up shop in the city. Indeed, one of the positive policy aspects of the market-based sourcing regime now used by many jurisdictions is the export of the tax base — allowing the burden of the local tax to be shared by companies and taxpayers from around the county. The city's insistence on limiting the application of the market-based sourcing rules for S corporations (and for the unincorporated business tax, see below) seems like a missed opportunity.[39]

[31] N.Y. Tax Law section 632(a)(1).

[32] N.Y.C. Admin. Code section 11-654(3); *see* New York City Instructions for Form NYC-2 (2019).

[33] N.Y.C. Admin. Code section 11-654.2(2)(a).

[34] N.Y.C. Admin. Code section 11-654.2(10)(a) and (b)("The hierarchy of methods is as follows: (1) the benefit is received in the city; (2) delivery destination; (3) the receipts fraction for such receipts within the city determined pursuant to this subdivision for the preceding taxable year; or (4) the receipts fraction in the current taxable year determined pursuant to this subdivision for those receipts that can be sourced using the hierarchy of sourcing methods in subparagraphs one and two of this paragraph."); *see also* New York City Instructions for Form NYC-2.5 (2019).

[35] *Id.*

[36] N.Y.C. Admin. Code section 11-604(1)(E)(a)(4); *see also* New York City Instructions for Form NYC-3L (2019).

[37] N.Y.C. Admin. Code section 11-604(3)(a)(2)(A).

[38] N.Y.C. Admin. Code section 11-604(3)(a)(2)(B).

[39] It is true that the city, at least for S corporations subject to the general corporation tax, has not implemented economic nexus provisions, so its ability to tax non-NYC-based S corporations is slightly more limited than the state's ability to tax out-of-state corporations. But still, as we all know, it doesn't take much to establish nexus these days. We would guess that the city would do just fine if it expanded market-based sourcing to all corporate taxpayers.

Table 2. Toilet Paper Co.'s Allocation Percentages

	C Corporations			S Corporations		Partnerships, LLCs, Etc.	
	New York State	*MTA Surcharge*	New York City	New York State	New York City	New York State	New York City
Property percent	*N/A*	*100%*	*N/A*	*N/A*	*N/A*	*100%*	*N/A*
Payroll percent	*N/A*	*100%*	*N/A*	*N/A*	*N/A*	*100%*	*N/A*
Sales percent	*10%*	*100%*	*10%*	*10%*	*20%*	*100%*	*20%*
BAP	**10%**	**100%**	**10%**	**10%**	**20%**	**100%**	**20%**

Partnerships, LLCs, Etc.

Like the state, the city imposes an entity-level tax on flow-through entities like partnerships, sole proprietors, and LLCs classified as partnerships for federal income tax purposes. These entities are subject to New York City's unincorporated business tax (Form NYC-204 for partnerships and LLCs taxed as partnerships, and Form NYC-202 for individuals and single-member LLCs), and are required to apportion business income using a single-sales or gross income factor BAP.[40] Receipts generated from the sale of tangible personal property are sourced to the destination of the sale (based on shipment).[41]

But regarding services, there is some funkiness. The city's regulations provide that, like the state's rules for LLCs and partnerships, services are sourced to the office where the sale was negotiated or consummated — or where the agent performing the services is chiefly situated. But these regulations are not up to date. The statute was amended more than 10 years ago to say that after July 1, 2007, services actually get allocated to the place where the services are performed![42] This of course only highlights the confusion around apportionment; it's odd to have a statute and regulation so out of sync.

> ***Example.*** Under these facts, as an LLC or partnership, you would have the same New York City BAP for unincorporated business tax purposes as an S corporation would for general corporation tax purposes — 20 percent.

VI. The Takeaway

Table 2 really says it all. You can see the wide disparity in the apportionment percentages between tax types and entity types. It really underscores the importance of the kinds of choice-of-entity discussions we all should be having with our clients.

As Carl the Exterminator said to Jerry Seinfeld when Jerry was asking why his apartment had fleas: "I don't explain them, Mr. Seinfeld, I just exterminate them."[43] When explaining the confusing and at times contradictory apportionment rules in New York, we find ourselves sometimes thinking the same thing: We can't explain why the rules are the way they are, but we do have to deal with them.

As you can see, the application of these rules varies and at times can be confusing. In New York especially, figuring out a company's BAP and correlating sourcing method is difficult. New York State and City's rules have changed dramatically over the years and, although hard to imagine, have become more uniform. Clearly, however, states — including New York — have been systematically simplifying their apportionment formulas and trending toward market-based sourcing. For now, fragments of the old three-factor formula and cost of performance remain in New York. Ideally this explanation and the handy chart will provide a roadmap to spot those quirks and a starting point to determine your business's taxable income in New York. ■

[40] N.Y.C. Admin. Code section 11-508(c) and (i)(1); *see also* New York City Instructions for Form NYC-204 (2019).

[41] N.Y.C. Admin. Code section 11-508(c)(3).

[42] N.Y.C. Admin. Code section 11-508(c)(3)(C) ("charges for services performed shall be allocated to the city to the extent that the services are performed within the city").

[43] "The Fusilli Jerry" (1995).