Practitioners Applaud New York's Draft Business Apportionment Regs

Posted on Jul. 10, 2019

By Paige Jones

The New York state tax department's recent draft regulations on business apportionment for receipts from digital products and services provide needed clarity, according to tax practitioners.

The New York State Department of Taxation and Finance on July 3 released draft rules on how to source receipts under the state's business apportionment law for digital products and for other services and business activities, replacing prior draft regulations on the issues for business corporate taxpayers.

Timothy Noonan, a partner with Hodgson Russ LLP, told *Tax Notes* on July 8 that the state tax agency's inclusion of 20 examples in its draft rules on digital services and business activities should be applauded.

"One of the biggest issues that practitioners have in states that have implemented market-sourcing regimes is applying the general hierarchy rules to a specific taxpayer's unique set of circumstances," he said, adding that it's critical for practitioners to have agency documentation with context and examples.

"The department appears to have recognized this, and the inclusion of so many new examples should help with what should be a somewhat rocky transition into the new world of market sourcing, especially as audits of these issues start to heat up," Noonan continued.

The draft rules on digital services and products are the latest in the state tax department's larger effort to update its business corporate franchise tax regulations after overhauling the corporate tax system in 2015.

Kathleen Quinn of McDermott Will & Emery told *Tax Notes* July 8 that the services/business activities draft rule's sourcing of receipts from management services provided to "passive investment customers" is interesting.

The rule defines a passive investment customer 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 that does not otherwise conduct an active business."

Quinn said the rule provides that the "benefit of such services is received at the location where the decision to use the management services is made."

"I think this draft rule most accurately pinpoints where the benefit of such investment management services is received (as opposed to the domicile of the underlying investors or beneficiaries, for example), because where the investment is managed is where the investor is relieved of its obligation to perform the investment management services itself and thus, where the benefit of outsourcing such services is received," she added.

On the digital products draft rule, Noonan said the state tax department added a new category of digital receipts related to digital services "apparently to distinguish between services that are fully automated and services that include some human interaction." Services with some human interaction are to be sourced based on the general rule for services, which has prompted litigation in the past, he said.

"There were several litigated cases on this issue under the old regime for taxing services, prior to the switch to market sourcing in 2015," Noonan said. "It's interesting to see that this same debate (automated services vs. somewhat automated services) still has relevance under the new regime."

Noonan also pointed out that the prior version of "these digital sourcing rules did not have special categories for in-person services or services related to tangible or real property — categories that are part of the normal tests used for sourcing services under the other set of draft regulations."

The new draft rules "add in these special categories for digital products and services too, apparently to align the regulations for digital services with the regulations for other services," Noonan said.

Comments on the two draft rules must be submitted to the tax department by October 9.