ASSESSMENT OF PUBLIC COMMENT

DEPARTMENT OF TAXATION AND FINANCE

Written comments were received regarding proposal TAF-32-23-00030-P ("the proposed rule") from the following industry representatives: American Catalog Mailers Association *(*ACMA), American Investment Council (AIC), Broadband Tax Institute (BTI), Business Council of New York State (BCNYS), Council on State Taxation (COST), Life Insurance Council of New York (LICONY), Managed Fund Association (MFA), New York Bankers Association (NYBA), Committee on State and Local Taxation of the New York City Bar Association (City Bar), Tax Section of the New York State Bar Association (State Bar), Securities Industry and Financial Markets Association (SIFMA), and State Taxes After Reform & Recession (STARR) Partnership. COST limited the scope of specific comments to the effective date and provisions related to qualified emerging technology companies, but did incorporate by reference the comments submitted by BCNYS and expressed support thereof. Therefore, comments attributed to BCNYS should also, by reference, reflect COST's support. In addition, comments were received from tax practitioners and one corporation.

As discussed in more detail in the regulatory impact statement for the proposed rule published in the *State Register* on August 9, 2023, the department has engaged stakeholders in the development of this rule since the enactment of the sweeping reform of New York State's corporate tax framework effected by Part A of Chapter 59 of the Laws of 2014, together with related, primarily technical and conforming amendments enacted by Part T of Chapter 59 of the Laws of 2015 and Part P of Chapter 60 of the Laws of 2016 (hereinafter referred to collectively as "Tax Reform"). The department reviewed and analyzed all comments received pre-proposal and made changes to the draft rule where appropriate. Many of the post-proposal comments acknowledged this collaboration over the years and expressed appreciation for changes included in the proposed rule in response to pre-proposal feedback. Section 8 of the regulatory impact statement addressed substantive changes made pre-proposal in response to such comments, as well as the department's reasons for rejecting certain suggested

alternatives. A majority of the written comments submitted in response to the proposed rule duplicated feedback submitted to the department during the development of the proposed rule that the department had rejected as inconsistent with the Tax Law, established department policy, related Federal provisions or the legislative objectives of Tax Reform, as lacking statutory authority, or as administratively impracticable. While some of the post-proposal comments referenced or attached pre-proposal comments, this assessment of public comment is limited to the explicit comments received during the notice and comment period that ended on October 10, 2023. The department considered alternatives proposed during the notice and comment period, whether or not they were repetitions of comments submitted pre-proposal, but made no substantial revisions in response. However, the department did make minor clarifying and technical changes to the proposed rule.

A. Imposition of Tax and Public Law 86-272

Public Law 86-272 generally exempts out-of-state sellers of tangible personal property from state taxation if their business activities in the state are limited to solicitation of orders. Tax Reform expanded a pre-reform limited version of a nexus standard based on New York activity without a physical presence in the state, (i.e., "economic nexus") to all article 9-A taxpayers deriving receipts in New York above a set dollar threshold (Tax Law section 209(1)(b)). Section 1-2.10 of the proposed rule provides guidance for corporations regarding the determination of the economic nexus and guidance for corporations conducting business via the internet regarding the interplay of the federal and state law. Both the ACMA and BCNYS objected to the provisions applicable to corporations conducting business via the internet, arguing that the language in Public Law 86-272 should be interpreted as it was understood at the time of its enactment in 1959, namely as requiring that the corporation must be physically present in the state before the Public Law 86-272 protections could be overridden. In addition, ACMA specifically endorsed the majority view of the State Bar set out in Report No.1471 (December 19, 2022) and incorporated such report by reference. That report, which was submitted to

the department in response to a pre-proposal draft published by the department in April 2022, concluded that Public Law 86-272, under the rules of statutory construction, should be interpreted consistent with its meaning at the time Congress enacted it. As such, the commentors advocated that the provisions be deleted from the proposed rule. BCNYS also questioned the provisions in the proposed rule that requires the inclusion of receipts from Public Law 86-272 protected activities (e.g., solicitation of orders for sales of tangible personal property) in determining whether the receipts threshold for economic nexus is satisfied.

The department disagreed with these comments because the provisions in the proposed rule are a rational interpretation of law. In addition, the provisions in the proposed rule regarding the scope of protected activities under Public Law 86-272 as they relate to internet related activities are consistent with positions taken by the Multistate Tax Commission and several other states and are supported by the minority view in the State Bar's Report No. 1471. The department has the authority to promulgate rules that narrowly interpret the Public Law 86-272 protections.

In addition, section 1-2.8(e) of the proposed rule provides that, for purposes of determining whether a corporation is deriving receipts from activity in New York, a corporation's New York receipts include the receipts from activities described in Public Law 86-272 and section 1-2.10 of the proposed rule. BCNYS questioned the cross-reference to section 1-2.10 in section 1-2.8(e) on the basis that section 1-2.10 deals with types of activities, rather than receipts. The department disagreed with this comment; the cross-reference is appropriate, as the phrase "described in section 1-2.10" modifies the word activities and not the word receipts.

B. Income and Capital

Tax Reform narrowly defined investment capital and generally exempted investment capital and income from tax. The new statutory definition of investment capital is limited to non-unitary stocks that meet certain criteria and assets New York cannot tax under the US constitution (constitutionally protected investment

capital). There is a corresponding subtraction for income from investment capital, subject to statutory limits. Business capital and income are generally defined as the residual amounts after the subtraction of investment capital and income. The department rejected alternatives proposed by NYBA and LICONY pertaining to the definitions of income and capital for the reasons discussed in more detail below.

1. Under Tax Law section 208(5)(a), to qualify as investment capital, non-unitary stock must satisfy five criteria. One of those criteria is that the stock must be identified in the taxpayer's records as held for investment in the same manner as under Internal Revenue Code (IRC) section 1236 (see section 3-4.3 of the proposed rule). NYBA commented that, for investment capital owned by a partnership, the department should allow the investment capital identification to be made at the corporate partner level when the corporate partners use the aggregate method to compute tax. The department rejected this alternative as inconsistent with the aggregate theory of partnership taxation employed in New York, which generally treats the corporate partner as doing what the partnership is doing. Thus, the partnership, as the owner of record of the stock, is the appropriate entity to make the required identification. In addition, identifying investment capital at the partnership level ensures that investments that potentially would qualify as investment capital that flow from partnerships to corporate partners generally are treated consistently between partners.

2. Section 3-5.1(a)(2)(i)*(h)* of the proposed rule excludes investments in a federal home loan bank (FHLB) and a federal reserve bank (FRB) from the definition of business capital without exception. NYBA opposed this exclusion, arguing that these investments may qualify as investment capital. They advocated for a change to the proposed rule to reflect the possibility that these investments may be investment capital. The department rejected the proposed changes to the definition of business capital as its legal analysis has concluded the FHLB and FRB investments would not meet the statutory definition of investment capital and, as such, must be business capital.

3. In addition to changing the definition of investment capital and income, Tax Reform also eliminated the concept of subsidiary capital and the preferential treatment of income generated by subsidiaries. Under prior law, a corporation was considered a subsidiary if more than 50% of its stock was owned by the taxpayer. Income from subsidiary capital was excluded when calculating entire net income (ENI), and subsidiary capital was excluded from the capital base tax; subsidiary capital instead was subject to a special preferential tax rate. Tax Reform eliminated this subsidiary capital taxation scheme. As such, subsidiary assets that do not qualify as investment capital constitute business capital post-Tax Reform. Under Tax Law section 210(5)(a), stock in a corporation that is conducting a unitary business with the taxpayer shall not constitute investment capital.

Section 3-5.1(a)(2)(i)*(c)* of the proposed rule provides that stock of corporations subject to the franchise taxes imposed by Tax Law article 9 or Tax Law article 33 (cross-article corporation stock) that are owned by the taxpayer and are part of the taxpayer’s unitary business are considered business capital. LICONY advocated for insurance corporation stock to be excluded from business capital and, therefore, not subject to the capital base tax, citing several legal theories that would in their view require the exclusion of this stock from the definition of business capital. These theories included the idea that such inclusion would result in prohibited double taxation of the stock. However, double taxation does not apply to the situation where two distinct taxpayers are taxed under two different taxing schemes. In addition, LICONY claimed that the inclusion of the insurance corporation stock in business capital would be unconstitutional because of a perceived mismatch between the capital being apportioned (investments in insurance subsidiaries) and the apportionment factor inputs (the parent’s factors, not the subsidiaries). However, in light of the fact that the investment in insurance subsidiaries represents the parent’s investments, utilizing the parent’s factor inputs in apportionment does not actually result in such a mismatch. The department rejected the alternative suggested by LICONY because it concluded that there is no legal basis to exclude these assets from the definition of business capital and a legislative change would be needed to accomplish this result.

Finally, LICONY also asked the department to adopt a policy of restraint regarding penalties for the understatement of tax imposed with respect to this issue under Tax Law section 1085(a) and 1085(k). However, because the imposition of penalties must be determined on a case-by-case basis, based on the particular facts, and these penalties may be waived only on a showing by the taxpayer that there was reasonable cause for the understatement or part thereof and, with respect to the substantial underpayment penalty, that the taxpayer acted in good faith, such a policy would not be appropriate for a regulation.

C. Capital Losses

1. The proposed rule in Subpart 3-7 provides detailed guidelines regarding the computation and application of capital losses. In particular, it continues the pre-Tax Reform categorization of losses by the type of asset that generates the loss. BCNYS expressed opposition to bifurcating investment capital and business capital gains/losses and the rule that prohibits the use of investment capital losses against business capital gains (and vice versa), arguing such rules require a clear statutory directive. The department rejected alternatives that would allow for losses from one type of capital to be used against gains from another type of capital. Because of the different tax treatment under article 9-A for the two types of income and capital, it is inappropriate to allow the losses from one type to offset the other type. In addition, this often may only be a "timing adjustment" for taxpayers that had (in the three year carryback period) or will have (in the five year carryforward period) gains/losses of the same type to offset and, therefore, taxpayers may be able ultimately to fully utilize those losses.

2. Corporations that generate capital losses in post-Tax Reform years are prohibited from carrying back those losses to a pre-Tax Reform year under section 3-7.5 of the proposed rule. However, corporations still receive the benefit of these losses because they may carry them forward to post-Tax Reform years. NYBA, arguing a lack of statutory authority, objected to this prohibition and advocated that the losses should be

allowed to be carried back to pre-Tax Reform years. The department rejected this alternative given that the significant changes under Tax Reform, most notably to the definitions of capital, the computation of tax, and the combined group composition, make the carryback of losses to years prior to Tax Reform inappropriate. In addition, because capital losses may be carried back only three years, this concern is of limited applicability and, in some instances, the loss and/or carryback years may already be closed.

D. Prior Net Operating Losses

Due to fundamental changes under Tax Reform to the statutory rules pertaining to the calculation and application of net operating losses (NOLs), pre-Tax Reform NOLs could not simply be carried into post-Tax Reform years. Instead, under Tax Reform, the losses sustained pre-Tax Reform were converted into a prior net operating loss conversion (PNOLC) subtraction pool that could be utilized in post-Tax Reform years (see Tax Law section 210(1)(a)(viii)). The PNOLC subtraction pool is computed using the following values from 2014 (the last pre-Tax Reform) tax year: the unabsorbed net operating loss (UNOL), the tax rate, and the business allocation percentage (BAP). This new subtraction was intended to create a fixed value of pre-Tax Reform NOLs and allow for that value to be easily subtracted in the computation of the business income base as reformed under Tax Reform. The amount of the subtraction that may be utilized in a tax year is limited and taxpayers cannot claim the subtraction for more than 20 years. The department rejected the alternatives pertaining to the PNOLC subtraction computation suggested by NYBA, as discussed in more detail below.

1. Section 3-8.2(b)(2)(iv) of the proposed rule addresses the computation of eligible NOL carryover amounts used in the PNOLC subtraction computation in instances where IRC section 382 applies. NYBA disagreed with this provision and argued that IRC section 382 should not impact the eligible NOLs used in the computation of the PNOLC subtraction computation. The department disagreed with NYBA's alternative

interpretation because the proposed rule is consistent with how the NOL amounts used in the calculation of the PNOLC subtraction pool were computed prior to the enactment of Tax Reform.

2. Section 3-8.12 of the proposed rule generally provides that changes to the UNOL can be made within the statute of limitations period for the return on which the PNOLC subtraction is first claimed and changes to the tax rate and BAP used in the calculation of the PNOLC subtraction pool must be made within the statute of limitations for amending the taxpayer's 2014 return. Any Federal changes finalized after the respective statutes of limitation have expired will not be considered in the computation of the PNOLC subtraction pool. The department rejected NYBA's proposed change to this rule to allow all Federal changes, no matter in what year they are finalized, to be included in the PNOLC subtraction computation. Given that Federal changes can occur many years after the close of a tax period and, therefore, many years into the period for claiming the PNOLC subtraction (if not already exhausted), a Federal change potentially would impact all years in which the subtraction was used, including those for which the statute of limitations has already expired. The department did not make this suggested change because it would create cascading impacts and undo the certainty intended by the PNOLC subtraction.

3. NYBA objected to the provision in section 3-8.12(c) stating that open years may be adjusted to account for errors in the calculation or application of the UNOL or the PNOLC subtraction in years where the statute of limitations has expired and suggested the provision be eliminated. The department rejected this suggested change because the correction of errors (e.g., math errors) has limited applicability.

E. Apportionment – General Rules

Tax Law section 210-A, as amended under Tax Reform, created a market-based approach to determine New York receipts and added additional sourcing rules to address significantly more receipts categories. The proposed rule contains very detailed guidance on the application of these sourcing rules for the business

apportionment factor (BAF). Comments were received from NYBA, SIFMA, BCNYS, and a corporation regarding the definition of business receipts.

1. Section 4-1.2(b)(6) of the proposed rule generally excludes reimbursements of expenses under certain cost-sharing arrangements from the BAF. Some commentors advocated for a specific cross-reference to 26 Code of Federal Regulations section 1.482.7(b) for the definition of cost-sharing arrangement, arguing that it is a term of art under the federal code and that, without an explicit definition, the provisions would be overly broad. Because section 1-1.1(a)(1) of the proposed rule provides that federal definitions are presumably followed when a term is not explicitly defined in the proposed rule, the department rejected this alternative as unnecessary.

2. In addition, the corporation commenting on the proposed rule objected to the exclusion of reimbursements for wages paid by a professional employer organization (PEO) from the BAF in section 4-1.2(b)(6) and illustrated in the example in section 4-1.2(c). A corporation claimed that the exclusion was contrary to the principle that every item included in income should be reflected in the fraction used to determine the portion of total income to be taxed by New York. In addition, BCNYS suggested the example be clarified, but did not suggest specific changes to the example.

The dollar amount of the reimbursements for the wages paid by a PEO has no correlation to the services provided by the PEO to the client company or the presence of the PEO in the state. For example, the BAF could be skewed when high wages are paid to out of state leased employees and low wages are paid to in-state employees. A PEO's level of services provided in the state is not dependent on the location of the leased employees, but the BAF would not reflect that reality if the reimbursements for the wages were included. Excluding the reimbursements for the wages would prevent distortion in the BAF. If a corporation feels that the reimbursements need to be included in the BAF to properly reflect its business income in the state, the corporation may request a discretionary adjustment. For these reasons, the department rejected the removal or

editing of this exclusion and example, concluding that it is a rational interpretation of the statute and ensures that the BAF appropriately apportions a PEO's income to New York.

3. Section 4-1.7 of the proposed rule re-incorporates rules related to the impact of Federal changes on the BAF historically included in pre-Tax Reform regulation section 8-1.2(b)(7). BCNYS argued that the rules are contrary to Tax Appeals Tribunal precedent, primarily its decision in *Matter of McDonnell Douglas (*January 8, 1998) that provided limited exceptions to the general statutory rules. The department concluded that the proposed rule correctly interpreted the underlying statute. However, if a factual situation similar to the one that appeared in the *McDonnell Douglas* case is presented, the Department would give due consideration to that Tribunal decision.

F. Apportionment – Commissioner's Discretion

In some instances, the statutory rules for computing the BAF may not result in a proper reflection of the taxpayer's business income or capital in the state. In such cases, either the taxpayer may request or the commissioner may exercise discretion to adjust the BAF. While the ability to adjust the sourcing methodology existed pre-Tax Reform, Tax Law section 210-A(11), as adopted under Tax Reform, explicitly provides that the party seeking the adjustment bears the burden of proof to establish that the adjustment is necessary. The proposed rule in section 4-1.6 continues the previous regulatory requirement that, unless the taxpayer receives permission to adjust the BAF prior to the deadline for filing its original return, it must file that return in accordance with the statutory requirements without any adjustment. However, the proposed rule also specifies that the taxpayer may file an amended return using its proposed discretionary adjustment without departmental approval if the department had not responded to its request before the original return was filed. In addition, a taxpayer may request reconsideration of a denial of a proposed discretionary adjustment on audit. These

provisions ensure that taxpayers always have a pathway to seek an adjustment while retaining the ability to timely file returns.

1. BCNYS advocated that taxpayers be allowed in all cases to file their original return using their proposed discretionary adjustment to the BAF without first making a request to the department, arguing that section 4-1.6(c) of the proposed rule is problematic from a logistical standpoint. The department rejected this alternative because the statute clearly provides that a taxpayer must affirmatively request an adjustment.

2. BCNYS also proposed that the department eliminate the provision in section 4-1.6(d) that states, "[t]he party seeking to vary the BAF must demonstrate that the application of the statutory formula attributes income or capital to New York State out of all proportion to the business transacted by the taxpayer in New York State" as it felt the standard is inconsistent, and possibly higher, than the statutory standard. The department rejected this alternative because the statutory language has long been interpreted to incorporate this standard (*Matter of Fairchild Industries, Inc.*, Tax Appeals Tribunal, March 9, 2000).

G. Apportionment – Qualified Financial Instruments

Tax Reform created a statutory election for sourcing certain financial receipts in recognition of the high volume of transactions of financial service companies in Tax Law section 210-A(5)(a)(1). In lieu of directly sourcing each receipt under the specific rules in Tax Law section 210-A(5)(a)(2), taxpayers can make an election that allows for 8% of income from certain types of financial instruments (termed qualified financial instruments, or QFIs) to be included in New York receipts. Section 210-A(5)(a) generally defines a QFI as an asset that is marked to market by the taxpayer under Internal Revenue Code (IRC) section 475 or 1256 or an asset of the same type as an asset that has been marked to market by the taxpayer. The election simplifies sourcing and provides certainty for both taxpayers and the department. Comments regarding QFIs were received from NYBA and SIFMA.

1. Under IRC section 475(a), a financial instrument is not required to be marked to market if it comes within one of the three exceptions listed in IRC section 475(b)(1). Section 4-1.1(c)(2) of the proposed rule states that in the case of a corporation that is a dealer in securities, if the financial instrument is a security that comes within one of the exceptions, it is deemed not to be marked to market. Commentors urged the department to eliminate this restriction, specifically objecting to the proposed rule's treatment of assets that come within one of the exceptions. The commentors argued that the provisions were inconsistent with the Tax Law and created additional compliance burdens. The department rejected this alternative because this provision is a rational interpretation of the statute.

2. The proposed rule in sections 4-2.4 and 9-4.3 provides that the taxpayer must first determine each type of QFI and then determine the amount of net receipt or gain (not less than 0) for each type subject to the same customer sourcing rule. NYBA argued for an alternative interpretation of the statute that would allow for one aggregate net value to be determined from all types of QFIs when the election is made. The practical implication of this approach would be that gains from one type of QFI, such as corporate bonds, could be offset by losses from a totally different type of QFI, such as commodities. The department rejected this alternative because the proposed rule is consistent with the determination of QFI by type.

3. As it would be impossible to enumerate every type of financial receipt that a corporation may earn now or in the future, Tax Law section 210-A(5)(2)(H) provides a catch-all category of other financial instruments that applies to financial instruments that are not otherwise explicitly enumerated. The proposed rule in sections 4-2.4 and 9-4.3 provides guidance on how to determine whether assets that fall into this other financial instruments category are QFIs and the netting of income from such assets. A variety of assets may fall into this other category, such as foreign currency swaps, money market accounts, and debt issued by foreign countries. In addition, some of these assets cannot be marked to market under the IRC sections referenced in the QFI definition. Certain other financial instruments may be considered QFIs if marked to market under the

specified IRC sections, but marking to market one type of other financial instrument under the specified sections of the IRC does not make all other financial instruments QFIs. NYBA and SIFMA argued that the department should consider all assets in this category as one type for receipt netting purposes to create certainty and limit audit issues. The department rejected this alternative as inconsistent with the requirement to determine QFIs by type, and because it could potentially extend QFI treatment to instruments that would not otherwise qualify as QFIs. Similarly, commenters advocated that stocks and partnership interests should be considered the same type of QFI because they are addressed by the same clause of the statute. The department likewise rejected this alternative as inconsistent with the requirement to determine QFIs by type.

H. Apportionment – Services to Passive Investment Customers

While Tax Law section 210-A(5)(d) explicitly provides for the sourcing of certain fees for services provided to regulated investment companies (RICs) to the location of RIC shareholders, it is silent as to the sourcing of similar receipts earned by corporations that are not broker-dealers for services provided to non-regulated investment funds ("passive investment customers"). The proposed rule in section 4-4.4(c) reflects the department's receptiveness to comments received on the last pre-proposal draft overwhelmingly urging it to source receipts for management, distribution, and administration services provided to passive investment customers primarily to the location of investors in the passive investment customer. In addition, the proposed rule contains a secondary method to be used when the location of the investors cannot be determined. These provisions in the proposed rule are largely modeled on similar rules in Tax Law section 210-A(5)(d) for services provided to RICs, aiming to provide consistency for sourcing of these types of receipts earned by non-broker dealers. Post-proposal comments on these provisions were mixed.

1. NYBA and SIFMA claimed there was no statutory authority for these provisions and they should be eliminated. The department rejected this alternative because these sourcing rules are a rational interpretation of

the statute and eliminating the passive investment customer rules would not provide taxpayers with needed guidance on how to source these types of receipts.

2. MFA suggested that the department use a direct tracing method rather than the average value of interest method, contending that direct tracing would be a more accurate and easily ascertained measure. The department rejected this direct tracing alternative because it would introduce more difficulty and uncertainty in the sourcing of these receipts than the average value method in the proposed rule.

3. MFA, BCNYS, and SIFMA advocated for additional changes regarding when the investor location is unknown. MFA and BCNYS recommended that the department clarify that, if a taxpayer can identify some, but not all, of the investors in a passive investment customer, taxpayers should be able to source the part of the receipts that can be identified based on the location of the investors and use an alternative for the part of receipts where the investor location is unknown. MFA argued investor location would be a more accurate method of sourcing and should be used where possible. In addition, MFA suggested that a reasonable approximation method be used when the services cannot be directly traced to investors, arguing that the alternative in the proposed rule would be akin to a cost of performance rule sourcing the receipts to New York. Lastly, SIFMA and NYBA suggested a safe harbor election to source 8% of these receipts to New York when investor location is unknown to be consistent with market-based sourcing premise.

The department rejected the alternative allowing sourcing of the pool of receipts by two different methodologies because such a scheme would be too difficult to administer and potentially subject to manipulation. In addition, the 8% election was rejected because there is no statutory authority to use an 8% rule, unlike the other 8% apportionment rules that are explicitly provided for in Tax Law section 210-A. Lastly, the alternative method in the proposed rule is not based on "cost of performance," but instead reflects the theory that, if the investor location is unknown, the next best measure of where the passive investment customer receives the benefit of these services is where the contract for such services is managed.

4. MFA suggested that the definition of investment management services be expanded to include services under investment sub-advisory agreements and include ancillary services. The department rejected this change as unreasonably broad, difficult to administer, and inconsistent with the rules for similar services to regulated investment companies.

5. Tax Law section 210-A(5)(b), as adopted under Tax Reform, included sourcing rules for registered broker-dealers that were enacted years before Tax Reform and included in prior Tax Law section 210(a)(3)(9) that generally look to the mailing address of the customer responsible for paying the fees. AIC and MFA proposed that the department extend the rule in section 4-4.4(c) relating to entities providing services to passive investment customers to registered broker-dealers so that all entities providing similar services use the same rule. SIFMA alternatively urged that, if the corporation could demonstrate that the customer responsible for paying the fee is someone other than an investment advisor, the taxpayer should be able to use that party's address. SIFMA further advocated for the use of an 8% safe harbor when the ultimate payor's address is unknown so taxpayers could use SIFMA's proposed alternative, rather than looking to the investment advisor. The department rejected these alternatives because the statute clearly provides different rules for registered broker-dealers that are consistent with the rules that existed pre-Tax Reform. Section 4-2.13 of the proposed rule, relating to registered broker-dealers, conforms to the statutory provisions in Tax Law section 210-A(5)(b).

I. Apportionment – Receipts from Digital Products/Services and Receipts from Other Business Receipts/Services

Tax Law sections 210-A(4) and 210-A(10) require that taxpayers use a hierarchy to source receipts from digital products/services and other business receipts and services, respectively. The rule when initially proposed incorporated a provision referenced as a 250 business customer "billing address safe harbor" in sections 4-

3.2(d)(1)(ii) and 4-4.2(d)(1)(ii) The State Bar, BCNYS, and NYBA submitted comments regarding the practical application of these provisions.

1. The State Bar and BCNYS advocated for the safe harbor to be elective. BCNYS also requested additional guidance on steps that would be required if the safe harbor is not used. The proposed rule states that the billing address safe harbor is a presumption; as a presumption it first must be applied, but, like any other presumptions in the proposed rule, it can be overcome by either the department or the taxpayer by clear and convincing evidence. The department changed the nomenclature in the proposed rule from “billing address safe harbor” to” business address presumption” to clarify that this is a presumption. As a presumption, the general provisions in section 4-3.2(e) and 4-4.2(e) of the proposed rule regarding how it may be overcome apply. Thus, the additional guidance requested by BCNYS is not needed.

2. Sections 4-3.8(d) and 4-4.8(d) of the proposed rule provide that if the business address presumption applies, the intermediary transaction rules do not apply. Rather, the corporation would source the receipts to the business customer’s billing address. NYBA opposed these provisions, instead advocating that, in the case of intermediary transactions, the business address presumption should apply to use the location of the underlying consumers to source the receipts. The department rejected this alternative because sourcing to the underlying consumers in this instance would be contrary to the simplicity the business address presumption provisions are designed to achieve.

J. Non-captive REITS

The rule provides that a non-captive REIT and a qualified REIT subsidiary must file a combined return. A tax practitioner urged the department to reconsider this requirement, arguing the department was incorrectly interpreting the law. Alternatively, if the requirement remains, the practitioner urged that clarifications should be made about the computation of the capital base and fixed dollar minimum tax on these combined returns.

The department concluded that the requirement that a non-captive REIT be included in a combined report with its qualified REIT subsidiary is a correct interpretation of law. However, in response to these comments, a clarifying change has been made to the capital base exemption language in section 9-4.1(b) to make clear that the capital base exemption applies if a non-captive REIT and a qualified REIT subsidiary are included in a combined report together. No changes are needed to address the appropriate fixed dollar minimum tax, as section 3-1.4 cross-references the amounts provided in Tax Law section 210(1)(d). That Tax Law section clearly imposes a fixed dollar minimum tax on non-captive REITs, with no reference to whether or not such entity is included in a combined report.

K. Qualified New York Manufacturers and Qualified Emerging Technology Companies

Currently, qualified New York manufacturers and qualified emerging technology companies are provided preferential tax treatment. The proposed rule in Subpart 9-1 and section 6-2.1(e) provides clarity regarding eligibility for these manufacturing and QETC tax preferences. COST, BTI, BCNYS, and the STARR Partnership submitted comments on these rules, generally reiterating alternatives similar to those submitted pre-proposal. The department rejected these alternatives for the reasons discussed below.

1. The proposed rule in section 9-1.3 contains specific criteria for determining which party to a contract where one company performs certain manufacturing tasks for the other is, in fact, the manufacturer for tax purposes, in order to prevent both parties to the contract from claiming the zero percent rate and other benefits available to qualifying New York manufacturers. The proposed rule specifies the tasks the company must perform to be a qualified New York manufacturer. BCNYS and the STARR Partnership urged the department to reconsider the proposed rule as it pertains to contract manufacturing, arguing it unnecessarily limits the applicability of the preferential rates for taxpayers involved in contract manufacturing. The department rejected alternatives that would have made it easier for a company to claim to be a manufacturer in contract

manufacturing situations when, in fact, it was not doing the actual manufacturing work. The proposed rule is a rational interpretation of the statute and limits the potential for abuse of this tax benefit.

2. BCNYS and the STARR Partnership also expressed opposition to the requirement in section 9-1.1(c) of the proposed rule that a good made by a qualifying New York manufacturer must be tangible, and the explicit exclusion of digital goods in section 9-1.2(b)(9), arguing the provisions are inconsistent with the statute and should be removed. The department rejected these alternatives because the proposed rule is a rational interpretation of the statute, based on long-standing judicial precedent (e.g., *Leisure Vue, Inc. v. Commissioner of Taxation and Finance*, 172 AD2d 872 (3d Dept. 1991)), and limits the potential for abuse of this tax benefit.

3. BCNYS and the STARR Partnership both expressed opposition to provisions in section 9-1.2 relating to the determination of qualified New York manufacturer. BCNYS urged the department to modify the provisions in section 9-1.2(b)(1) that provides that any processes that make a good more attractive for sale without substantially altering the good would not be considered manufacturing activities, arguing the exclusion as drafted is too broad. The STARR Partnership urged the department to strike section 9-1.2(a)(1)(ii)(a) that provides that the licensing of goods is not considered the sale of a good, arguing the provision is inconsistent with the statute. The department rejected these alternatives to remove the provisions because the proposed rule is a rational interpretation of the statute and limits the potential for abuse of this tax benefit.

4. In the case of a combined report, the proposed rule in sections 9-1.2(d) and 6-2.1(e) requires that each member of a combined group individually satisfy the requirements for QETCs for the combined group to be eligible for the preferential QETC tax computations. COST, BTI, and BCNYS opposed this requirement on the basis that it impermissibly narrows the preferential treatment available to QETCs in the case of combined groups. They advocated for the QETC determination to be made based on the activities of the combined group as a whole, rather than requiring each individual member to qualify. However, the department rejected

alternatives that would make this determination on a combined basis because the proposed rule is a rational interpretation of the statute and is designed to prevent inappropriate tax avoidance.

L. Separate Accounting Election

Section 9-2.6 of the proposed rule provides an election for certain foreign limited partners in computing tax (the separate accounting election) that largely parallels pre-Tax Reform regulation section 3-13.5. BCNYS questioned whether members of a combined group would be eligible for this election as it would be a change from the similar pre-Tax Reform rules. This question misconstrues the separate accounting election provisions. The election may not be made by a corporation that is a member of a combined group as articulated in section 9-2.6(a)(1) and, therefore, the department concluded that no changes were unnecessary.

M. Effective Date

Comments were received from the City Bar, State Bar, COST, BCNYS, and tax practitioners regarding the effective date of the proposed rule. Under State Administrative Procedure Act section 203, an adopted rule generally becomes effective when it is filed with the Secretary of State and the Notice of Adoption is published in the *State Register*. The comments, although referenced as relating to the effective date of the rule, actually concern the applicability of the rule's provisions to tax years beginning before that publication date. Some comments accepted that the rule should apply to tax years occurring before the adopted rule is filed and the notice of adoption published, and focused on the possible imposition of penalties for tax positions taken by taxpayers on returns that were contrary to certain provisions contained in the adopted rule. Other comments advocated that certain provisions in the proposed rule, such as the elimination of the "unusual events rule" (initially discussed in the Regulatory Impact Statement, Section 8 "Alternatives" Part D, paragraph 1), the specific provisions discussing the application of Public Law 86-272 to internet based activities, and the

provisions relating to when contract manufacturers can be considered qualifying New York manufacturers, be applied only on a prospective basis to tax years occurring after the adopted rule takes effect because they ostensibly were new interpretations of the department. The Tax Reform legislation (Part A of Chapter 59 of the Laws of 2014, together with related, primarily technical and conforming amendments enacted by Part T of Chapter 59 of the Laws of 2015 and Part P of Chapter 60 of the Laws of 2016) specifically provided that the amendments contained therein generally apply to taxable years beginning on or after January 1, 2015. The proposed rule interprets the statutory amendments of Tax Reform and, therefore, will be applied to the same periods. *Matter of Varrington Corp. v. City of New York Department of Finance*, 201 AD2d 282, aff'd 85 NY2d 28 ("…regulations interpreting tax statutes are retroactive to the effective date of the statute to which they relate unless the taxing authority limits such retroactive limitation…"). However, the department, based on a totality of the circumstances, may choose not to apply penalties in cases where taxpayers took a position in their tax filings prior to adoption of the proposed rule in reliance upon prior article 9-A regulations or prior drafts of the proposed rule.