By virtue of the Tax Reform and Rate Reduction Act of 1987 (L. 1987, c. 817), Article 9-A now requires taxpayers to characterize each deduction as either (1) directly attributable to subsidiary, investment or business capital or income (including gains and losses) arising therefrom, or (2) not directly attributable to subsidiary, investment or business capital or income (including gains and losses) arising therefrom. This memorandum is intended to set forth acceptable methodologies for making such characterizations. References in this memorandum to subsidiary "capital" should be understood to refer also to income (including gains and losses) from that type of capital, and references to investment capital should be understood to refer also to investment income. References to Form CT-3, CT-3-ATT and federal Form 1120 are to the 1987 versions. It will be assumed here that the taxpayer files federal Form 1120. If a different return is used, appropriate adjustments must be made in applying this memorandum. For those tax years which begin in 1987, insofar as the procedures outlined here differ from those set forth in the instructions for the CT-3 and CT-3-ATT, the taxpayer may elect to use either such instructions or this memorandum.

Deductions which are directly attributable to subsidiary capital are required to be added back to federal taxable income in computing entire net income (Tax Law, § 208.9(b)(6)). Deductions which are directly attributable to investment capital are subtracted from income derived from investment capital in computing investment income (Tax Law, § 208.6). Deductions which are directly attributable to business capital require no special treatment.

The taxpayer's deductions which are not directly attributable to one of the three types of capital are treated as indirectly attributable to the three types of capital. The sum of such indirectly attributable deductions is apportioned among the three types of capital by formula. The portion thus indirectly attributable to subsidiary capital is required to be added back to federal taxable income in computing entire net income (Tax Law, § 208.9(b)(6)). The portion thus indirectly attributable to investment capital is subtracted from income derived from investment capital in computing investment income (Tax Law, 208.6). The portion thus indirectly attributable to business capital is automatically reflected in the computation of business income and requires no special treatment.

In order to determine the addition to be made with respect to deductions attributable to subsidiary capital, and the subtraction to be made in computing investment income, the taxpayer should use the following procedure.

**Step 1 - Direct Attribution**

The taxpayer should determine which deductions are directly traceable, whether in whole or in part, to subsidiary capital, investment capital and business capital. If the taxpayer determines that a particular deduction is directly attributable to more than one type of capital, the taxpayer may apportion that deduction between or among the types of capital, using any method that reasonably determines the appropriate amount. Any deductions not directly attributable to
subsidiary capital, investment capital or business capital will be attributed indirectly by formula (see Steps 2 and 3).

The following are examples of deductible expenses which may be directly attributable in whole or in part to subsidiary capital:

(1) interest incurred to purchase subsidiary capital;
(2) salaries of officers and employees engaged in the management, supervision or conservation of subsidiary capital;
(3) legal expenses relating to subsidiary capital;
(4) stewardship expenses relating to a subsidiary (see Treasury Regs § 1.861-8(e)(4)); and
(5) rent or depreciation with respect to a building, a portion of which is dedicated to the management of subsidiaries.

The following are examples of deductible expenses which may be directly attributable in whole or in part to investment capital (see 20 NYCRR 4-8.4):

(1) interest incurred to purchase or carry investment capital;
(2) safe deposit box rentals;
(3) financial news subscriptions;
(4) salaries of officers and employees engaged in the management and conservation of stocks, bonds and other securities included in investment capital;
(5) investment counsel fees;
(6) custodian fees;
(7) cost of insurance and fidelity bonds covering investment capital; and
(8) legal expenses relating to investment capital.

The following are examples of deductible expenses which may be directly attributable in whole or in part to business capital:

(1) rent, depreciation, repairs and maintenance with respect to production facilities;
(2) interest incurred to purchase or build a manufacturing plant;
(3) costs of shipping goods to customers;
(4) salaries of employees directly engaged in manufacturing, sales, service, etc.; and
(5) An expense the reimbursement of which, received in the form of a management fee paid by a subsidiary of the taxpayer, is included in entire net income.

Note that the above examples are not exclusive.

Where an expense is directly attributable to more than one type of capital, a reasonable method of apportionment should be used to determine the portion of the expense which is directly attributable to each type of capital. The following are examples of such apportionment methods:

(1) One-fourth of the taxpayer's floor space is used for the offices of the department charged with overseeing the taxpayer's subsidiaries, and one-eighth of the floor space is used for the investment department. The remainder is used in the taxpayer's service business. Accordingly, one-fourth of the taxpayer's rent and other expenses attributable to the building, if the taxpayer rents the building, or depreciation, repairs and other expenses attributable to the building, if the taxpayer owns the building, is directly attributable to subsidiary capital, and one-eighth of such expenses is directly attributable to investment capital. The remainder is directly attributable to business capital.

(2) Twenty of the taxpayer's employees spend approximately one-half of their time monitoring the taxpayer's investments. The annual salaries and wages of those 20 employees equals $125,000. Therefore, $62,500 (1/2 x $125,000) of salaries expense is directly attributable to investment capital. The taxpayer may determine the amount of the pension and profit-sharing plans deduction (federal Form 1120, line 24) which is directly attributable to investment capital by identifying the portion of the deduction specifically applicable to those 20 employees and multiplying that amount by one-half.

(3) The taxpayer owns a computer. In addition to its general business use, the computer is used to track the taxpayer's investments. The deductible expenses related to the computer, e.g., rent or depreciation and repairs, could be apportioned between, and directly attributed to, business and investment capital, based on the amount of computer time spent on each.

(4) Included in the taxpayer's insurance expenses are premiums for insurance on a building the taxpayer owns and premiums for insurance on a vessel owned by the taxpayer which is used solely for shipping its product. The amount of the premiums attributable to the taxpayer's building will be directly attributable to business capital, investment capital and subsidiary capital in the same manner as its depreciation deductions (see example (1)). The insurance expense with respect to the vessel will be directly attributable to business capital.

Step 2 - Total Amount of Deductions Subject to Indirect Attribution

The total amount of deductions subject to indirect attribution to subsidiary and investment capital by formula is determined as follows:
(1) Subtract from the amount of federal deductions included at federal Form 1120, line 27 the following:

(a) those federal deductions included in such line 27 amount which are required to be added back to federal taxable income in computing entire net income, other than the amount of such deductions directly or indirectly attributable to subsidiary capital, and

(b) the New York excess depreciation add-back described at Tax Law.208.9(b)(11) (relating to the disposition of certain decoupled property) to the extent that such amount was included in (2)(d), below, for prior taxable years which began on or after January 1, 1987.

(2) Increase the amount arrived at in (1) by the following deductions which are subtracted from federal taxable income in computing entire net income.

(a) interest expense attributable to interest income not includable in federal taxable income but required to be included in entire net income (e.g., municipal bond interest), to the extent such interest expense is not deducted for federal purposes. (Tax Law, § 208.9(b)(2); see also Franchise Tax Regulations, 20 NYCRR 3-2.3(a)(2)).

(b) in the case of a taxpayer organized outside the United States, deductions attributable to income which is not included in federal taxable income but is required to be included in entire net income (e.g., foreign source income). (Tax Law, § 208.9(c); see also Franchise Tax Regulations, 20 NYCRR 3-2.3(a)(9)).

(c) the portion of wages and salaries paid or incurred for the taxable year for which a deduction is not allowed pursuant to section 280C of the Internal Revenue Code. (Tax Law, § 208.9(a)(7)).

(d) depreciation deductions permitted under Article 9-A with respect to "decoupled" property pursuant to Tax Law, § 208.9(a)(11), (12).

(e) deductions arising from "decoupling" from federal safe harbor lease provisions pursuant to Tax Law, § 208.9(a)(10).

Note: The New York net operating loss deduction is not listed here because (1) no part of such deduction is attributable to subsidiary capital and (2) insofar as any portion of it is attributable to investment capital, that portion is separately treated at Form CT-3-ATT, Schedule E, line 41.

(3) Reduce the amount arrived at in (2) by those deductions included therein which were determined in Step 1 to be directly attributable to subsidiary, investment or business capital.
Step 3 - Indirect Attribution

To determine the amount of deductions indirectly attributable to subsidiary capital, multiply the total amount of deductions subject to indirect attribution (arrived at in Step 2) by the following fraction:

\[
\frac{\text{average value of assets included in subsidiary capital}}{\text{average value of all assets}}
\]

To determine the amount of deductions indirectly attributable to investment capital, multiply the total amount of deductions subject to indirect attribution (arrived at in Step 2) by the following fraction:

\[
\frac{\text{average value of assets included in investment capital}}{\text{average value of all assets}}
\]

Note: The method included in the instructions for the 1987 Form CT-3 and CT-3-ATT differs from that provided here and may be used for tax years which begin in 1987 only.

For purposes of the above formulas, real property and marketable securities should be valued at fair market value, while all other property should be included at the value shown on your books in accordance with generally accepted accounting principles (GAAP). The procedure for averaging should be that employed in computing line 32 of the CT-3. For taxable years which begin in 1987 only, taxpayers may elect to value all of their assets at federal adjusted basis.

As an alternative to the method of indirect attribution set forth above, the taxpayer may employ an alternative method which is demonstrated, to the satisfaction of the Commissioner of Taxation and Finance, to be more appropriate. For further information write to New York State Department of Taxation and Finance, Technical Services Bureau, Corporation Tax Instructions and Interpretations, Building 9, State Campus, Albany, New York 12227.

Step 4 - Determining the Add-Back for Entire Net Income and the Subtraction for Investment Income

The amount of deductions directly attributable to subsidiary capital, determined pursuant to Step 1, is included on line 5 of the CT-3, and the amount of deductions indirectly attributable to subsidiary capital, determined pursuant to Steps 2 and 3, is included on line 6 of the CT-3.

The sum of the amount of deductions (1) directly attributable to investment capital, determined pursuant to Step 1, and (2) indirectly attributable to investment capital, determined pursuant to Steps 2 and 3, is included at Form CT-3-ATT, Schedule E, line 39.