



Direct and Indirect Attribution of Interest Deductions for Article 9-A Taxpayers

Legislative amendments enacted by the 2014-15 and 2015-16 New York State budgets made significant changes to Article 9-A of the Tax Law that affect the attribution of interest and noninterest deductions, and created a safe harbor election in lieu of interest attribution for certain types of income. This memorandum explains the safe harbor election and provides the method for directly and indirectly attributing interest deductions for tax years beginning on or after January 1, 2015.

Chapter 59 of the Laws of 2014 (Part A) and Chapter 59 of the Laws of 2015 (Part T) made significant changes to the definitions of investment capital and investment income, created a new “other exempt income” category of income, and eliminated separate treatment of subsidiary capital and income. All noninterest deductions are now attributable to business income, and the methodology for the attribution of interest deductions changed. In addition, the amendments created a safe harbor election in lieu of interest attribution for certain types of income. These changes affect the attribution of interest deductions under Article 9-A of the Tax Law for tax years beginning on or after January 1, 2015.

This memorandum sets forth the new definitions of investment capital, investment income, and other exempt income, and the required methodology for the attribution of interest deductions. It also explains the safe harbor election. This TSB-M does not address the attribution of liabilities in computing the tax on business capital, which is covered in the applicable tax return instructions. This memorandum is effective for tax years beginning on or after January 1, 2015, and supersedes TSB-M-88(5)C and TSB-M-95(2)C for those years.

Definitions

- *Investment capital*¹ means investments in stocks² of non-unitary corporations that:
 - satisfy the definition of a capital asset under section 1221 of the Internal Revenue Code (IRC) at all times the taxpayer owned such stock during the tax year;
 - are held, or presumed to be held³, by the taxpayer for investment for more than one year;

¹ See Tax Law section 208.5 and TSB-M-15(4)C, (5)I.

² See Tax Law section 208.4.

³ If a taxpayer acquires stock that is a capital asset under IRC section 1221 during the tax year, and owns that stock on the last day of the tax year, it will be presumed, solely for purposes of determining whether that stock should be classified as investment capital after it is acquired, that the taxpayer held that stock for more than one year. See Appendix 1, *Investment Capital Holding Period Presumption*, for more information on the presumption and certain exceptions to the presumption.

- if disposed of, generate (or would generate) long-term capital gains or losses under the IRC;
- for stock acquired on or after January 1, 2015, have never been held for sale to customers in the regular course of business after the close of the day on which the stock was acquired; and
- before the close of the day on which the stock was acquired, are clearly identified in the corporation's records as stock held for investment in the same manner as required under IRC section 1236(a)(1) for the stock of a dealer in securities to be eligible for capital gain treatment (whether or not the taxpayer is a dealer of securities subject to section 1236). For stock acquired prior to October 1, 2015, that was not subject to IRC section 1236(a), such identification must have occurred before October 1, 2015. (For further information, see [TSB-M-15\(4\)C,\(5\)I](#), *Investment Capital Identification Requirements for Article 9-A Taxpayers*.)

Additionally, when income or gain from a debt obligation or other security cannot be apportioned to New York State as a result of United States constitutional principles, the debt obligation or other security is considered investment capital (Tax Law section 208.5(e)).

Investment capital does not include:

- stock in a corporation that is conducting a unitary business with the taxpayer,
- stock in a corporation that is included in a combined report with the taxpayer pursuant to the commonly owned group election in Tax Law section 210-C(3), or
- stock issued by the taxpayer.

If the taxpayer, or all the members of a combined group, own or control, directly or indirectly, less than 20% of the voting power of the stock of a corporation, that corporation will be presumed to be conducting a business that is not unitary with the business of the taxpayer for purposes of determining whether or not the stock constitutes investment capital.

- *Investment income*⁴ means income, including capital gains in excess of capital losses, from investment capital, to the extent included in computing entire net income (ENI)⁵, less any interest deductions allowable in computing ENI which are directly or indirectly attributable to investment capital or investment income. However, any amount treated as dividends under IRC section 78 is not included in investment income. In no case shall investment income exceed ENI. Furthermore, investment income determined without regard to the 40% safe harbor reduction or any interest deductions directly or indirectly attributable to investment capital or investment income (*gross investment income*) is limited to the greater of the income that New York cannot constitutionally

⁴ See Tax Law section 208.6.

⁵ See Tax Law section 208.9.

apportion (see Tax Law section 208.5(e)) or 8% of a taxpayer's ENI, or if a combined group, 8% of the combined group's ENI, after the elimination of all intercompany transactions and activity. This limitation on investment income does not impact the value of investment capital.

- *Other exempt income*⁶ means the sum of exempt controlled foreign corporation (CFC) income and exempt unitary corporation dividends. However, any amount treated as dividends under IRC section 78 is not included in other exempt income.
 - *Exempt CFC income* means the income required to be included in the taxpayer's federal gross income in accordance with IRC section 951(a), received from a corporation that is conducting a unitary business with the taxpayer but is not included in a combined report with the taxpayer (*gross exempt CFC income*), less any interest deductions directly or indirectly attributable to that income. Stock that pays or could pay exempt CFC income is referred to in this memorandum as *exempt CFC stock*.
 - *Exempt unitary corporation dividends* means those dividends from a corporation that is conducting a unitary business with the taxpayer but is not included in a combined report with the taxpayer, less any interest deductions directly or indirectly attributable to such income. Stock that pays or could pay exempt unitary corporation dividends is referred to in this memorandum as *exempt unitary corporation stock*. Exempt unitary corporation dividends include exempt cross-article dividends. *Exempt cross-article dividends* means dividend income received from unitary corporations taxable under Article 9 or 33, or that would be taxable under Article 9 or 33 if subject to tax, less any interest deductions directly or indirectly attributable to such income. Stock that pays or could pay exempt cross-article dividends is referred to in this memorandum as *exempt cross-article stock*.

In addition, the term *gross exempt unitary corporation dividends* means exempt unitary corporation dividends determined without regard to any interest deductions directly or indirectly attributable to such income; and the term *gross exempt cross-article dividends* means dividend income received from unitary corporations taxable under Article 9 or 33, or that would be taxable under such articles if subject to tax, determined without regard to any interest deductions directly or indirectly attributable to such income.

- Exempt CFC stock, exempt unitary corporation stock, and exempt cross-article stock is always considered business capital and is subject to the capital base tax.

Attribution of interest deductions

The law requires taxpayers (including combined groups) to subtract:

⁶ See Tax Law section 208.6-a.

- from gross investment income, any interest deductions directly or indirectly attributable to investment capital or gross investment income,
- from gross exempt CFC income, any interest deductions directly or indirectly attributable to that income, and
- from gross exempt unitary corporation dividends, including gross exempt cross-article dividends, any interest deductions directly or indirectly attributable to those dividends.

Note: Interest deductions must be attributed to each class of income or capital identified above, regardless of whether or not such income is actually earned in a particular tax year. In lieu of direct and indirect interest attribution, the 40% safe harbor election may be made (see below).

Investment income and other exempt income are subtracted from ENI in the computation of business income. In no case can either investment income or other exempt income exceed ENI, nor can the total of investment income and other exempt income exceed ENI⁷. These limitations on investment income and other exempt income do not impact the value of investment capital or the capital associated with other exempt income. If the total interest deductions directly and indirectly attributable to gross investment income or investment capital exceed investment income, the excess amount must be added back to ENI⁸. If the total interest deductions directly and indirectly attributable to gross other exempt income exceed gross other exempt income, the excess amount must be added back to ENI⁹.

For a combined group, all computations must be done as if the combined group is a single corporation, after the elimination of all intercompany transactions and activity, when computing income amounts and the attribution of interest deductions or making the 40% safe harbor election.

A corporate partner using the aggregate method to determine its tax with respect to its interest in a partnership must include its distributive share of each partnership item of receipts, income, gain, loss and deduction and the corporation's proportionate part of each asset and liability from that partnership, after the elimination of all inter-entity transactions and activity, when computing income amounts and the attribution of interest deductions or making the 40% safe harbor election.

40% Safe harbor election

In lieu of performing direct and indirect interest attribution, taxpayers, or the designated agent¹⁰ of a combined group, may elect to reduce the amount of gross investment income, gross exempt CFC income, and gross exempt unitary corporation dividends (excluding gross exempt cross-article dividends), by 40%. Interest deductions are required to be directly and

⁷ See Tax Law section 208.8.

⁸ See Tax Law section 208.6(a).

⁹ See Tax Law section 208.6-a(d).

¹⁰ See Tax Law section 210-C.7.

indirectly attributed to gross exempt cross-article dividends regardless of whether or not the election is made.

The taxpayer, or the designated agent of a combined group, may invoke or revoke the election at any time within the statute of limitations for each applicable tax year by filing an original or amended return. If the designated agent of a combined group makes or revokes the election, the election or revocation applies to all members of the combined group. The Tax Department may not revoke the election made by the taxpayer or the designated agent of a combined group.

If the taxpayer, or the designated agent of a combined group, makes or revokes the election, it applies to all the following classifications of income: gross investment income, gross exempt CFC income, and gross exempt unitary corporation dividends. The absence of investment capital or gross exempt CFC income or gross exempt unitary corporation dividends does not preclude a taxpayer, or the combined group, from making the election. A taxpayer or a combined group with investment capital but no gross investment income is permitted to make the election.

The taxpayer, or a combined group's designated agent, must use Form CT-3.1, *Investment and Other Exempt Income and Investment Capital*, and its instructions to make the election and report the respective income reductions. Form CT-3.1 must be attached to Form CT-3 or CT-3-A.

If the election is made and the taxpayer or the combined group does NOT own exempt cross-article stock, follow the instructions for Form CT-3.1 and do **not** complete Steps 1-4 of this memorandum.

If the election is made and the taxpayer or the combined group owns exempt cross-article stock, continue with the instructions below.

Attribution methodology for direct and indirect interest deductions

The following procedures for determining direct and indirect interest deductions must be used by a taxpayer or, in the case of a combined group, the designated agent, that:

- does not make the 40% safe harbor election, or
- makes the 40% safe harbor election and owns exempt cross-article stock.

Note: References to Forms CT-3, CT-3-A, and CT-3.1 are to the 2015 versions.

Step 1 - Total amount of interest deductions subject to attribution

The total amount of interest deductions subject to attribution for a taxpayer or a combined group is determined as follows. For a combined group, all computations must be done as if the combined group is a single corporation, after the elimination of all intercompany transactions and activity. A corporate partner using the aggregate method to determine its tax

with respect to its interest in a partnership must include its distributive share of total interest deductions, after inter-entity eliminations, in this computation.

- (A) Subtract from the amount of interest expense deductions included in your CT-3, Part 3, line 1 amount, or your CT-3-A, Part 3, line 1a amount, those federal interest expense deductions required to be added back to federal taxable income in computing ENI.
- (B) Increase the amount arrived at in Step 1(A) by the following deductions, subtracted from federal taxable income in computing ENI, to the extent such expenses are not deducted for federal tax purposes:
 - (1) interest deductions attributable to interest income not includable in federal taxable income but required to be included in ENI (e.g., municipal bond interest). (Tax Law section 208.9(b)(2))
 - (2) in the case of a taxpayer organized outside the United States that is not treated as a domestic corporation for federal purposes, interest deductions attributable to treaty income not included in federal taxable income that would be treated as effectively connected if not for the treaty, if taxation by states is not prevented. (Tax Law section 208.9(b)(1)(ii))
 - (3) in the case of a taxpayer organized outside the United States that is not treated as a domestic corporation for federal purposes, interest deductions attributable to income from any state or local bond that would be treated as effectively connected income if it was not excluded from gross income by IRC section 103(a). (Tax Law section 208.9(b)(1)(iii))

The amount arrived at in Step 1(B) above is the total interest deductions subject to direct and indirect attribution for gross investment income or investment capital, gross exempt CFC income, gross exempt unitary corporation dividends, gross exempt cross-article dividends, and business income or business capital. Continue with Step 2.

Step 2 - Direct attribution

The taxpayer, or a combined group, must determine which interest deductions are directly traceable, whether in whole or in part, to gross exempt cross-article dividends, gross exempt unitary corporation dividends, gross exempt CFC income, gross investment income or investment capital, and business income or business capital. A corporate partner using the aggregate method to determine its tax with respect to its interest in a partnership must include its distributive share of interest deductions directly traced by the partnership in this computation. If the taxpayer determines that a particular interest deduction is directly attributable to more than one type of income or capital, the taxpayer may apportion that interest expense between or among the types of capital and income, using any method that reasonably determines the appropriate amount.

(A) **Regardless of whether or not a taxpayer or the designated agent of a combined group has made the 40% safe harbor election**, the total amount of interest deductions arrived at in Step 1(B) must be reduced by the interest deductions included therein that are directly traceable to gross exempt CFC income, gross exempt unitary corporation dividends, gross exempt cross-article dividends, gross investment income or investment capital, and business income or business capital. The amount arrived at in this step is the amount of total interest deductions subject to indirect attribution for gross exempt CFC income, gross exempt unitary corporation dividends, gross exempt cross-article dividends, and gross investment income or investment capital. Continue with Step 3.

The following are examples of interest deductions that are directly traceable in whole or in part to gross exempt unitary corporation dividends, gross exempt CFC income, gross exempt cross-article dividends, gross investment income or investment capital, or business income or business capital:

- interest incurred to purchase or carry stock of corporations that generates such income or capital;
- interest incurred to purchase or carry investment capital (investment capital);
- interest incurred to purchase or build a manufacturing plant (business capital);
- interest incurred to purchase or carry the stock of a combined affiliate (business capital);
- interest incurred by a partnership to purchase or carry investment capital that is included in your distributive share of income or loss from that partnership (investment capital);
- an interest deduction the reimbursement of which, received in the form of a management fee paid by an entity not included in the combined group of the taxpayer, is included in ENI (business capital), or
- interest incurred to purchase or carry reverse repurchase agreements and security borrowing agreements (business capital). The amount of such interest deductions that is subject to direct tracing is the interest expense associated with the sum of the average fair market value (FMV) of a taxpayer's repurchase agreements plus the average FMV of the taxpayer's securities lending agreements. However, this sum is limited to the sum of the average FMV of the taxpayer's reverse repurchase agreements plus the average FMV of the taxpayer's securities borrowing agreements. Note: If the sum of the average FMV of reverse repurchase agreements and security borrowing agreements exceeds the sum of the average FMV of repurchase agreements and security lending agreements, then all such interest deductions are directly traceable to business capital. Otherwise, see the illustration below for the methodology to use to compute the amount of such interest deductions directly traceable to business capital.

Illustration:

<i>Average FMV of repurchase agreements and security lending agreements</i>	<i>\$105</i>
<i>Average FMV of reverse repurchase agreements and security borrowing agreements</i>	<i>\$100</i>
<i>Interest deductions for repurchase agreements and security lending agreements for the year</i>	<i>\$2</i>
<i>Average cost of funds (\$2/\$105)</i>	<i>1.904%</i>
<i>Amount of \$2 interest deduction directly traceable to reverse repurchase agreements and security borrowing agreements (business capital) (\$100 x 1.904%)</i>	<i>\$1.90</i>

Step 3 - Indirect attribution

For purposes of the computations below, only those assets and liabilities required to be included in the valuation of business and investment capital for purposes of computing the tax on the capital base are included. Real property and marketable securities should be valued at FMV, while all other property should be included at the value shown on the taxpayer's, or all of a combined group's members' books, in accordance with generally accepted accounting principles (GAAP). If a taxpayer's assets include reverse repurchase agreements and/or security borrowing agreements, then the sum of the FMV of such assets must be reduced, but not below zero, by the sum of the FMV of all repurchase agreements and/or security lending agreements included in the taxpayer's liabilities. The value of all other assets must be determined without reduction for liabilities. The procedure for averaging should be that employed in computing the tax on the capital base found on Part 4 of Form CT-3 or Form CT-3-A. If the numerator of a fraction measured by income is equal to zero, and the denominator of a fraction measured by income is an amount greater than zero, the respective income fraction is zero. A combined group must compute the fractions below using the total assets, liabilities, and income of the combined group's members after intercompany eliminations. A corporate partner using the aggregate method to determine its tax with respect to its interest in a partnership must include its distributive share of each partnership item of receipts, income, gain, loss, and deduction and proportionate part of each asset and liability from that partnership, after the elimination of all inter-entity transactions and activity, when computing the fractions below.

If the 40% safe harbor election is made and the taxpayer or combined group owns exempt cross-article stock, complete Step 3(A), Exempt cross-article dividends, and then continue with Step 4.

If the 40% safe harbor election is NOT made, complete Steps 3(A) through 3(D) and then continue with Step 4.

(A) Exempt cross-article dividends

Generally, to determine the amount of interest deductions indirectly attributable to gross exempt cross-article dividends, multiply the total amount of interest deductions

subject to indirect attribution (from Step 2 (A)) for the taxpayer, or a combined group, by the following fraction:

$$\frac{\text{average value of the taxpayer's investment in exempt cross-article stock}}{\text{total average value of all taxpayer's assets}}$$

If, during the taxable year, the taxpayer's investment in exempt cross-article stock generates both taxable business income (net capital gains) and gross exempt cross-article dividends, multiply the numerator of the above fraction by:

$$\frac{\text{gross exempt cross-article dividends}}{\text{total gross income from exempt cross-article stock}^*}$$

*the sum of gross exempt cross-article dividends and net capital gains in excess of capital losses from the sale of stock that generates or could generate gross exempt cross-article dividends

(B) Exempt unitary corporation dividends

Generally, to determine the amount of interest deductions indirectly attributable to gross exempt unitary corporation dividends (other than gross exempt cross-article dividends), multiply the total amount of interest deductions subject to indirect attribution (from Step 2(A)) for the taxpayer, or a combined group, by the following fraction:

$$\frac{\text{average value of the taxpayer's investment in exempt unitary corporation stock (other than exempt cross-article stock)}}{\text{total average value of all taxpayer's assets}}$$

If, during the taxable year, the taxpayer's investment in exempt unitary corporation stock (other than exempt cross-article stock) generates both taxable business income (net capital gains) and gross exempt unitary corporation dividends, multiply the numerator of the above fraction by:

$$\frac{\text{gross exempt unitary corporation dividends (other than gross exempt cross-article dividends)}}{\text{total gross income from exempt unitary corporation stock (other than gross exempt cross-article dividends)}}^*$$

*the sum of gross exempt unitary corporation dividends and net capital gains in excess of capital losses from the sale of stock that generates or could generate gross exempt unitary corporation dividends

(C) Exempt CFC income

Generally, to determine the amount of interest deductions indirectly attributable to gross exempt CFC income, multiply the total amount of interest deductions subject to indirect attribution (from Step 2(A)) for the taxpayer, or a combined group, by the following fraction:

$$\frac{\text{average value of the taxpayer's investment in exempt CFC stock}}{\text{total average value of all taxpayer's assets}}$$

If, during the taxable year, the taxpayer's investment in exempt CFC stock generates both taxable business income (net capital gains) and gross exempt CFC income, multiply the numerator of the above fraction by:

$$\frac{\text{gross exempt CFC income}}{\text{total gross income from exempt CFC stock}^*}$$

*the sum of gross exempt CFC income and net capital gains in excess of capital losses from the sale of stock that generates or could generate gross exempt CFC dividends

(D) Investment capital

To determine the amount of interest deductions indirectly attributable to investment capital or gross investment income, multiply the total amount of interest deductions subject to indirect attribution (from Step 2(A)) for the taxpayer, or a combined group, by the following fraction:

$$\frac{\text{average value of taxpayer's assets included in investment capital}}{\text{total average value of all taxpayer's assets}}$$

Step 4 - Reporting Interest Deductions Attributable

Interest deductions directly and indirectly attributable to business income or business capital are not reported on Form CT-3 or Form CT-3-A as such deductions are already correctly reflected in the computation of business income.

If the 40% safe harbor election is made, a taxpayer, or a combined group, must report the amounts of interest deductions directly and indirectly attributable to **gross exempt cross-article dividends** computed in Steps 2 and 3 on Schedule B, Part 2 of Form CT-3.1. The amounts of interest deductions directly attributable to gross investment income or investment capital, gross exempt unitary corporation dividends or gross exempt CFC income computed in Step 2 are **not** reported on Form CT-3.1. Form CT-3.1 must be attached to Form CT-3 or Form CT-3-A.

If the 40% safe harbor election is NOT made, a taxpayer, or a combined group, must report the amounts of interest deductions directly and indirectly attributable to gross investment income or investment capital, gross exempt unitary corporation dividends, gross exempt CFC income, and gross exempt cross-article dividends computed in Steps 2 and 3 on Schedules B and C of Form CT-3.1. Form CT-3.1 must be attached to Form CT-3 or Form CT-3-A.

Note: A TSB-M is an informational statement of existing department policies or of changes to the law, regulations, or department policies. It is accurate on the date issued. Subsequent changes in the law or regulations, judicial decisions, Tax Appeals Tribunal decisions, or changes in department policies could affect the validity of the information presented in a TSB-M.

Appendix 1

Investment Capital Holding Period Presumption

If a taxpayer acquires stock that is a capital asset under IRC section 1221 during the tax year and owns that stock on the last day of the tax year, it will be presumed, solely for purposes of determining whether that stock should be classified as investment capital after it is acquired, that the taxpayer held that stock for more than one year. Provided, however, if the taxpayer can determine, at the time it files its original return for the tax year in which it acquired the stock, whether or not it actually held the stock for more than one year, then the presumption in the preceding sentence does not apply, and the actual period of time during which the taxpayer owned the stock is used to determine whether the stock could be classified as investment capital.

If a stock is treated as investment capital in the preceding tax year due to the presumption and is not actually held by the taxpayer for more than one year, the taxpayer must either:

- file an amended return for the preceding tax year to reflect the fact that the stock is not considered investment capital (and any related income is not investment income); or
- on the current year's tax return,
 1. increase its business capital by the amount of investment capital claimed for that stock on the preceding year's tax return, net of any liabilities attributable to that stock claimed on the preceding year's tax return, and
 2. increase its business income by the amount of income and net gains (not less than zero) from that stock included in investment income in the preceding year, less either any interest deductions directly and indirectly attributable to that stock or if the safe harbor election is made, less 40% of the gross investment income from that stock claimed on the preceding year's tax return.

The addback of previously presumed investment income and previously presumed investment capital from stocks that did not meet the holding period requirement is computed on Form CT-3.1, Schedule F, and reported on Part 3 and Part 5 of Form CT-3 or CT-3-A.