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The New York Corporation Franchise Tax for the UDITPA Practitioner

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Introduction

Subsidiary capital. Investment capital. Business capital. The New York corporation franchise tax contains unique terminology and apportionment rules that differ from those in the Uniform Division of Income for Tax Purposes Act. On account of those differences, making sense of the New York corporation franchise tax rules can be a challenge for practitioners who focus on jurisdictions that have enacted statutes closely adhering to UDITPA.

This article aims to aid the UDITPA practitioner by summarizing the New York corporation franchise tax rules and contrasting them with the UDITPA rules. The article first provides a big-picture overview of the three types of capital, which are pivotal to understanding the New York corporation franchise tax's mechanics. It then discusses each type of capital in detail, focusing on a few of the more significant questions that have been litigated regarding each type of capital. It closes by addressing an interesting recent controversy or unsettled issue for each capital type.

Overview

UDITPA contains a two-part apportionment classification scheme in which business income is apportioned and nonbusiness income is allocated.[1]

The New York scheme is slightly more complicated in that it contains three crucial parts. First, there is subsidiary capital, which is excluded from the tax base and is neither apportioned nor allocated. Second, there is investment capital, which is apportioned based on the issuer's allocation percentage (in other words, apportionment is based on the in-state presence of the issuer of a security, rather than based on the taxpayer's in-state presence). Finally, there is business capital, which is apportioned using a receipts factor that resembles UDITPA's sales factor. Each type of capital will be discussed in more detail below.

Subsidiary Capital

Under the corporation franchise tax, a taxpayer does not include "income, gains and losses from subsidiary capital" in its tax base.[2] That is a significant New York modification to federal taxable income. It is unique to New York, has no counterpart in UDITPA, and was designed to encourage companies to locate their headquarters in New York. The modification allows corporations to receive income from subsidiaries (such as dividend income and interest income) without having to include that income in the tax base.[3] Therefore, for example, a New York-headquartered company can receive hundreds of millions of dollars in interest income and dividend income from dozens of subsidiaries without having to include any of that income in the tax base.

There is a downside to the subsidiary capital modification, however. As stated in the statute, losses from subsidiary capital are excluded from the tax base. Accordingly, expenses attributable to subsidiary capital cannot be deducted. For example, suppose that a corporation rents three floors of an office building. Assume that the rental value of all three floors is the same and that one of the floors is used by a subsidiary. Since one-third the rent expense for the office building is attributable to a subsidiary, one-third of the rent expense would therefore be attributable to subsidiary capital and would not be deductible.[4] In the case of expenses

[1]*See* UDITPA section 9.

[2]N.Y. Tax Law section 208.9(a)(1).

[3]There is a special, separate tax on subsidiary capital and the rate is 0.9 mill for each dollar of subsidiary capital sourced to New York. *See* N.Y. Tax Law section 210.1(e).

[4]TSB-M-88(5)C (Oct. 14, 1988) Example (1).

indirectly attributable to subsidiary capital, deductions are disallowed by formula.[5]

New York courts have held that lower-tier corporations, or indirect subsidiaries, can count as subsidiaries for subsidiary capital purposes as long as they are beneficially controlled.[6] That means that the taxpayer must have dominion over the indirect subsidiaries so that the taxpayer possesses the ability to control the operations and stock of the indirect subsidiaries. Ultimately, that analysis centers on the degree of business activity performed by intermediate corporations (that is, the corporations between the taxpayer and the indirect subsidiaries). Based on case law, it is clear that indirect subsidiaries count for subsidiary capital purposes as long as intermediate companies are shell corporations. However, the analysis gets murkier if some level of business activity is performed by intermediate corporations. There are no hard-and-fast rules regarding how much business activity intermediate corporations can perform before subsidiary capital treatment is lost regarding indirect subsidiaries.

The subsidiary capital concept creates the potential for a double benefit. A parent corporation could receive interest income from subsidiaries that are excluded from the tax base as subsidiary capital, while at the same time the subsidiaries could claim interest expense deductions for the interest payments. To prevent such double dipping, the term "subsidiary capital" is defined in such a way that it does not include interest income that is deducted by a subsidiary for New York tax purposes.[7]

In accordance with the above, practitioners not fully familiar with New York's subsidiary capital concept should note that for New York corporation franchise tax purposes:

- subsidiary capital is excluded from the tax base;
- deductions from subsidiary capital are disallowed;
- indirect subsidiaries count as subsidiaries for subsidiary capital purposes only if they are beneficially controlled; and
- if subsidiaries deduct interest expense payments made to a parent, the parent cannot exclude the interest income from its tax base as subsidiary capital.

Investment Capital

Unlike income derived from subsidiary capital, income from investment capital is included in the tax base.

Investment capital[8] is defined to mean "investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business."[9] A regulation states that "stocks, bonds and other securities" includes the following items: (1) stocks and similar corporate equity instruments; (2) governmental debt instruments (federal, state, local, or foreign); (3) qualifying corporate debt instruments; (4) options on any item included in (1), (2), or (3); and (5) stock rights and stock warrants.[10] The regulation also lists items that do not constitute investment capital, such as futures contracts and some repurchase agreements.[11]

Once a taxpayer has isolated its investment income, that income must then be sourced. The sourcing rules for investment income under the New York corporation franchise tax do not in any way resemble the UDITPA sourcing rules for investment income. Under UDITPA, investment income is typically allocated to the taxpayer's commercial domicile.

In contrast, under the New York rules, investment income is sourced based on the business activity in New York of the *issuers* of stocks, bonds, or securities owned by a taxpayer. For example, suppose that a taxpayer owns shares of X Corp. The taxpayer sources income from the X Corp. shares (dividends, for example) based on X Corp.'s business activities in New York. To know how much of the income from the X Corp. shares to source to New York, the taxpayer looks up X Corp.'s "issuer's allocation percentage" or "IAP," which is published by the Department of Taxation and Finance and is also available on the Department's website.[12] If X Corp. has an IAP of 100 percent, all the taxpayer's income from the X Corp. shares must be sourced to New York. If X Corp. has an IAP of 50 percent, then half

[5]*See Id.* and TSB-M-95(2)C (Jan. 8, 1996).

[6]*See Racal Corp. and Decca Electronics, Inc.*, New York Tax Appeals Tribunal Docket No. 807361 (May 13, 1993); *Bankers Trust NY Corp.*, New York Tax Appeals Tribunal Docket No. 811316 (Mar. 14, 1996) (addressing the issue for purposes of New York's banking corporation franchise tax); and *Bankers Trust v. Tax Appeals Tribunal of the City of New York*, 93 AD3d 476 (N.Y. App. Div. 2012) (addressing the question for purposes of the New York City general corporation tax).

[7]N.Y. Tax Law section 208.4. *See also Matter of Woolworth Co. v. State Tax Comm.*, 126 A.D.2d 876, *aff'd* by 71 N.Y. 2d 907 (App. Div. 1987) (stating that the design of the statute is "to prevent a parent corporation from obtaining a double tax benefit by taking a deduction for interest payments on loans incurred for directly or indirectly financing investments in subsidiaries while at the same time the parent's income derived from such investments is tax free").

[8]N.Y. Tax Law section 208.6.

[9]N.Y. Tax Law section 208.5.

[10]*See* 20 NYCRR 3-3.2(b).

[11]20 NYCRR 3-3.2(a)(2).

[12]*See* http://www8.tax.ny.gov/CIAP/ciapHome (accessed Dec. 20, 2012).

of the taxpayer's income from the X Corp. shares must be sourced to New York.

A taxpayer's overall investment allocation percentage is computed by multiplying the amount of investment capital in each stock, bond, or other security by the issuer's allocation percentage of the stock, bond or other security; adding together the sums so obtained; and dividing the result by the total of the company's investment capital invested during the period in stocks, bonds, and other securities.[13]

The sourcing rule for investment income is based on the investee's presence in New York, not the taxpayer's presence in New York.

Again, the New York rule is advantageous from the standpoint of a New York-headquartered company. If New York had adopted the UDITPA sourcing rule for investment income, a New York-headquartered company with its treasury function in New York would generally be required to allocate all its investment income to New York. In contrast, under the New York sourcing rule, a corporation can locate its treasury function in New York and it will not be required to source any more investment income to New York on account of that location decision than if it had decided to locate its treasury function outside the state, since the sourcing rule for investment income is based on the investee's presence in New York, not the taxpayer's presence in New York.

The investment capital rules have been held to produce a departure from UDITPA in the context of the sale of a business. In most states, gain from the sale of a non-unitary business is allocated to the state of commercial domicile and is not included in the tax base.[14] However, in New York the tax department has been successful in arguing that it can tax gain from the sale of a non-unitary business so long as the non-unitary business itself has a connection to New York as determined by its IAP.[15] The rationale is that the investee's connection to New York provides an independent basis for taxing the investment, even if the investment serves a non-unitary function in a taxpayer's business. In *MeadWestvaco*, the U.S. Supreme Court noted that the department takes that position, but explicitly declined to rule on its constitutional validity.[16] Even assuming that the department's position is constitutional, it still may be possible to exclude gain from the sale of a business from the corporation franchise tax base if it can be shown that inclusion of the gain would be distortive on the basis that the investee has no connection to New York and is non-unitary.[17]

For the UDITPA practitioner, the New York investment capital rules may not only be unfamiliar, but may also pose practical difficulties. For example, even using advanced software, it may be onerous for companies that make a considerable amount of investments to separate those investments and run the issuer's allocation percentage computations. For a company operating in all 50 states that needs the issuer's allocation percentage numbers only for New York, it may be difficult to generate the computations for all investments and the exercise may not seem worthwhile. However, failure to apply the rules correctly or use of an artificially low IAP may lead to trouble in the event of an audit.

Business Capital

If income is not from subsidiary capital or investment capital, it is from business capital.[18] Accordingly, business capital operates as a default category that captures all income not derived from the other two types of capital.

Of the three types of capital, the business capital rules most closely resemble those in UDITPA. Business income is sourced using a business allocation percentage that consists of a single factor receipts formula.[19] The receipts sourcing rules vary depending on what type of receipt is being sourced. There are four main categories of receipts, each of which

[13]N.Y. Tax Law section 210.3(b).

[14]*See, e.g., General Mills, Inc. v. Mass. Comm'r of Rev.*, 440 Mass. 154 (Mass. 2003) (affirming lower court conclusion that gain from the taxpayer's sale of the Eddie Bauer clothing business was not included in the tax base because Eddie Bauer was a non-unitary business).

[15]*See Allied-Signal v. NYC Comm'r of Fin.*, 79 N.Y. 2d 73 (NY 1991); *AlliedSignal Inc. v. Tax Appeals Tribunal*, 645 NYS2d 895 (N.Y. App. Div. 1996).

[16]*See MeadWestvaco Corp. v. Ill. Dep't of Rev.*, 553 U.S. 16 (2008), stating:

> The State and its *amici* argue [that] the judgment . . . may be affirmed on an alternative ground. They contend that the record amply demonstrates that Lexis did substantial business in Illinois and that Lexis' own contacts with the State suffice to justify the apportionment of Mead's capital gain. . . . We decline this invitation because the question that the State and its *amici* call upon us to answer was neither raised nor passed upon in the state courts. . . . The case for restraint is particularly compelling here, since the question may impact the law of other jurisdictions. The States of Ohio and New York, for example, have both adopted the rationale for apportionment that respondents urge us to recognize today.

[17]*See McGraw-Hill, Inc.*, N.Y. Div. Tax Appeals, DTA No. 812371 (Sept. 21, 1995).

[18]N.Y. Tax Law section 208.8.

[19]*See* N.Y. Tax Law section 210.3(a)(10).

has its own sourcing rule: tangible personal property, services, property situated in the state (for example, rents and royalties), and all other business receipts.

Tangible personal property is sourced based on the point of delivery (a destination rule).[20] Services are sourced based on where they are performed.[21] Rentals of property are sourced based on where the property is situated and patents or copyrights are sourced based on place of use.[22] Other business receipts (sales of real property by dealers, sales of intangible personal property by dealers, interest income, and miscellaneous income) are sourced to New York if the receipts were earned within New York (obviously, this rule calls for interpretation — there are often arguments that a receipt was "earned" in any one of a number of different locations).[23]

Although the sourcing rules for the different categories are generally similar to the UDITPA equivalents, the "other receipts" rule represents a clear departure. A sometimes difficult issue is whether the other receipts sourcing rule should apply or one of the other sourcing rules should apply. An example of the tension between the sourcing rules is discussed below.

Recent New York Controversies Regarding Each Capital Type

Below are summaries of recent controversies that have arisen regarding each capital type.

Subsidiary Capital: Combined Reporting

Until recently, it was an open question whether gain from the sale of stock of a combinable subsidiary was required to be included in a combined return (called a combined report in New York). Many practitioners thought that the answer was no on the grounds that that gain constituted subsidiary capital that should be excluded from the tax base. But then a taxpayer litigated a case in which it sought to include its *loss* from the sale of a subsidiary's stock in its combined report.[24] The Tax Appeals Tribunal ruled for the taxpayer and held that based on administrative guidance the taxpayer could include its loss from the sale of the stock of the subsidiary in its combined report. The department quickly issued administrative guidance noting that under the decision's logic gain from the sale of stock of combinable subsidiaries would also have to be included in combined reports.[25] Therefore, based on present guidance, gain and loss from the sale of stock of subsidiaries are required to be included in income if the subsidiaries are required to be included in a combined report.

Investment Capital: 'Other Securities'

It is sometimes difficult to determine whether an instrument constitutes investment capital. The statute defining investment capital states that stocks, bonds, and other securities qualify as investment capital.[26] Of course, in most cases it is fairly easy to determine whether a given instrument is a stock or a bond. But it may be far less clear whether an instrument is an "other security." Adding to the confusion, the regulations do not provide a test to determine whether a given instrument qualifies as an other security, but the regulations instead list several examples of other securities.[27]

Therefore, it has fallen to the Tax Appeals Tribunal to flesh out how the term "other security" should be interpreted. About a year ago, in *Xerox*, the tribunal addressed that question and ruled that an instrument is an "other security" for investment capital purposes if it qualifies as a security under New York State Securities Law based on statutory definitions and case law interpreting those definitions.[28]

Accordingly, any practitioner unsure whether an instrument qualifies as an "other security" for investment capital purposes should start by considering *Xerox*, New York State Securities Law, and in particular the tests for determining whether an instrument is a security for New York State Securities Law purposes that are discussed in *Xerox*.

Business Capital: Receipts From Services or 'Other Receipts'

Under UDITPA, all sales other than sales of tangible personal property are sourced where costs of performance are highest.[29] Accordingly, if a taxpayer is providing a service, receipts from the sale of the service are sourced to where the seller's costs relating to the service are highest, based on costs of performance.

In New York, as discussed above, receipts from services are sourced based on where they are performed.[30] However, in recent rulings and in audits

[20] *See* N.Y. Tax Law section 210.3(a)(2)(A); 20 NYCRR 4-4.2.

[21] N.Y. Tax Law section 210.3(a)(2)(B); 20 NYCRR 4-4.3.

[22] N.Y. Tax Law section 210.3(a)(2)(C); 20 NYCRR 4-4.4.

[23] N.Y. Tax Law section 210.3(a)(2)(D); 20 NYCRR 4-4.6.

[24] *Bausch & Lomb*, New York Tax Appeals Tribunal, DTA No. 819883 (Dec. 20, 2007).

[25] TSB-M-08(3)C (Mar. 10, 2008) ("While *Matter of Bausch & Lomb* involved a loss on the sale of stock of an included subsidiary, its holding would also apply to gains from the sale of stock of an included subsidiary").

[26] N.Y. Tax Law section 208.5.

[27] *See* 20 NYCRR 3-3.2.

[28] *Matter of Xerox Corp.*, N.Y. Tax Appeals Tribunal Docket No. 822620 (Jan. 12, 2012).

[29] UDITPA section 17.

[30] N.Y. Tax Law section 210.3(a)(2)(B); 20 NYCRR 4-4.3.

the department has been taking the position that some services, particularly services with an electronic commerce component, are in fact not services, and therefore the sourcing treatment should be governed by the other receipts sourcing rule, rather than the services sourcing rule.[31]

For example, a recent ruling addresses how to source receipts earned by a marketer and processor of prepaid debit cards.[32] The company in the ruling charges a number of fees, including a monthly service fee, an account maintenance fee, and a convenience fee. The processing activities for those fees are performed and overseen by employees principally located in Texas, with software being used to manage cardholders' account data. One might therefore expect that the receipts from the fees would be sourced to Texas or to where the employees who are overseeing customer accounts are located. But the ruling concludes that the services sourcing rule does not apply to the fees and instead the other receipts sourcing rule governs. On that basis, the ruling states that the fees should be sourced, not to where the services associated with the fees are performed, but rather "based on where the customer initiates a transaction" (for example, if a card is swiped in New York, any fees associated with that transaction should be sourced to New York). The ruling states that if the state of initiation cannot be determined, the receipt should be sourced based on the state of the debit cardholder's mailing address. Accordingly, the ruling follows a market-based sourcing rule rather than a "where services are performed" sourcing rule. The ruling is noteworthy in that it is difficult to square with an earlier ruling under which credit card processing fees are sourced using the services sourcing rule.[33]

That ruling and others like it have created uncertainty about which of the two sourcing rules — the services sourcing rule or the other receipts sourcing rule — should apply in some fact patterns. It seems likely that the courts will ultimately have to determine when the services sourcing rule should apply as opposed to the other receipts sourcing rule. Unfortunately, the courts are likely to issue guidance on an ad hoc basis based on the fact patterns in specific cases, rather than issuing comprehensive rules that can be relied on by taxpayers performing different services than the ones addressed in court decisions. In the short term, corporations that provide data processing services or online services should be aware that the department may look to source the receipts from their services using a market-based sourcing rule rather than the "where performed" services sourcing rule.

Conclusion

The New York corporate income tax system contains unique terminology but need not be mystifying. The subsidiary capital concept is relatively straightforward. The business capital receipts sourcing rules generally mirror the UDITPA sales factor sourcing rules, although the "other receipts" category adds a measure of complexity (and sometimes uncertainty, as discussed above). The investment capital concept is difficult, but can quickly be grasped once it is understood that the focus is on the issuer's presence in New York rather than the taxpayer's New York presence. After the basic capital rules are internalized, the rest is largely a matter of filling in details. ☆

[31]*See, e.g.,* TSB-A-11(1)C (Dec. 28, 2010) and TSB-A-11(8)C (July 12, 2011).

[32]TSB-A-11(1)C (Dec. 28, 2010).

[33]*See* TSB-A-95(13)C (Aug. 4, 1995).