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The In-State Corporation's Solution to Expedia Apportionment

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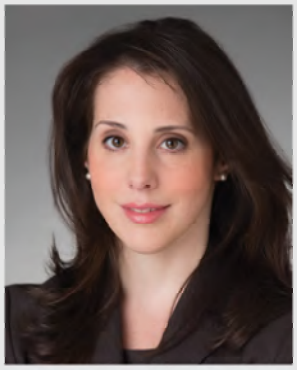

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In this installment of In a New York Minute, the authors say that while New York cases involving "other business receipts" may suggest that receipts from highly automated services should be assigned based on costs, companies with high in-state costs should consider using some other reasonable method.

The New York State Department of Taxation and Finance has lost three consecutive cases in which it asserted that receipts from highly automated activities should be treated as receipts from services (assigned based on where they were performed) or as "other business receipts" (assigned to where they were earned, which is where the customers access the automated activity, according to the department) rather than receipts from services (assigned to where the services were preformed, as urged by the taxpayers). For out-of-state sellers, these decisions could result in zero receipts being assigned to New York and a correspondingly low franchise tax liability. However, they suggest a much harsher result for corporations whose costs are overwhelmingly in New York.

But all hope is not lost. This article discusses a provision in the apportionment rules that is seldom relied on and has rarely (if ever) been litigated. This provision could allow in-state sellers to reach a much better result that the department may be all but defenseless against. Behold: some other reasonable method.

Background

Until New York's tax reform took effect for tax years starting on or after January 1, 2015, receipts from services were assigned based on where they were performed. For out-of-state corporations, that often meant having little or no receipts assigned to the numerator of the receipts factor. Of course, for decades the department's position was that receipts from highly automated activities were not in fact receipts from services, but rather fell into New York's catchall category of other business receipts (OBR).

OBR are assigned where earned. The department has interpreted "where earned" to be the place where customers access the highly automated activity. In fact, since 1988, it has issued

many advisory opinions reflecting the position that highly automated and electronic receipts are OBR that are earned where customers access the activity.[1] Thus, even though New York was a cost-of-performance (COP) jurisdiction before tax reform, the department's position was that these receipts were assigned on a market basis. As a result, some companies whose primary operations were outside the state had a higher apportionment percentage attributable to New York based on their customers' locations.[2]

Taxpayer Challenges

Then came three cases challenging the department's position. First was *Expedia Inc.*[3] In *Expedia*, the department treated the travel company's receipts as OBR to be assigned based on where customers accessed the website, which would have resulted in receipts assigned to New York when the customers had New York billing addresses.[4] The agency argued that for an activity to be a service, there must be human involvement at the taxable moment. The administrative law judge found no basis for the human touch argument and determined that Expedia not only did in fact provide a service, but that service receipts were to be assigned based on COP, which were entirely outside New York.

Next came *CheckFree*.[5] CheckFree is an electronic payment processor that allows its customers to accept payments from their customers electronically and seamlessly — such that the customers might not even know they are using the platform. Again, the department's position was that a highly automated electronic activity generated OBR. And again, an ALJ rejected the department's position that receipts from highly automated activities were OBR.

Most recently came *Catalyst*.[6] Catalyst provides subscriptions to electronic research tools. The department continued to assert that highly automated activities generated OBR, but a third ALJ weighed in and disagreed once more.

Impact of the OBR Line of Cases

ALJ decisions are non-precedential. The department did not appeal *Expedia* or *Checkfree* but did appeal *Catalyst*; a decision is not expected until early 2019. No one but the tribunal judges can predict how they'll decide, but our guess is that they'll affirm the decision. If that's the case, it would appear that corporations with most of their income-producing activities outside New York can enjoy a tiny New York sales factor for tax years starting before January 1, 2015, when tax reform converted the state to market-based sourcing.

But what about corporations with substantial in-state costs? Without some relief, these companies appear to be losers in the OBR cases. Many of these companies were hoping that at least one OBR case would go the other way, but none have. However, there may be a solution for these companies.

Conundrum Meets Solution

In-state corporations with receipts from highly automated activities must choose among a few options for apportioning receipts: One results in higher tax (too hot) and another is likely to be challenged (too cold), but the third would allow use of market sourcing instead of COP (just right).

The most obvious option would be to follow the OBR line of cases and treat the receipts from highly automated activities as receipts from services to be assigned based on costs of performance. Even before *Catalyst*, the

[1] *In re Alvarez & Marsal* (Advisory Opin.), TSB-A-11(8)C (N.Y.S. Department of Taxation and Finance, July 12, 2011) (commissions from electronic trading, clearing trades, digital auction fees, and data access fees); *In re Advisory Opin.*, TSB-A-11(1)C (N.Y.S. Department of Taxation and Finance, Dec. 28, 2010) (electronic processing of banks' transactions with cardholders); *Deloitte & Touche LLP* (Advisory Opin.), TSBA-02(3)C (N.Y.S. Department of Taxation and Finance, Apr. 18, 2002) (internet sales of gift certificates); *In re Insurance Services Offices Inc.* (Advisory Opin.), TSB-A-00(15)C (N.Y.S. Department of Taxation and Finance, Sept. 6, 2000) (internet service to access databases); and *In re New York Mercantile Exchange* (Advisory Opin.), TSB-A-99(16)C (N.Y.S. Department of Taxation and Finance, Apr. 7, 1999) (monthly subscription fees to access market data).

[2] For example, in *In re Expedia Inc.*, DTA 825025 and 825026 (N.Y.S. Division of Tax Appeals, Feb. 5, 2015), the receipts factor using COP would have been zero, whereas the receipts factor using customer location would have been substantially greater: $28 million, $70 million, and $116 million for the three years at issue in that case.

[3] *In re Expedia Inc.*, DTA 825025 and 825026.

[4] The department estimated the travel reservations generated by consumers in New York based on the SEC 10-K and census population data.

[5] *In re CheckFree Services Corp.*, DTA 825971 and 825972 (N.Y.S. Division of Tax Appeals, Jan. 5, 2017).

[6] *In re Catalyst Repository Systems Inc.*, DTA 826545 (N.Y.S. Division of Tax Appeals, Aug. 24, 2017), appeal pending.

department was far less likely to challenge this approach when it was taken by in-state corporations, although it often results in higher apportionment and tax.

The next option would be to treat the receipts from highly automated services as OBR and assign them based on market — in other words, to take the same position that the department itself has taken for decades. Unfortunately, because it was reviewed by the Division of Tax Appeals, this position is risky — even though it was long held by the department and even though the ALJ decisions are non-precedential. Because this position would result in lower apportionment and lower tax, the department could still challenge it, which would be more likely when the taxpayer has high in-state costs. (Of course, it would be offensive for the department to challenge the position when taken by in-state companies while continuing to assert it for out-of-state companies.) Still, it may be difficult for a taxpayer to convince the administrative forum to accept a position it has already rejected three times.

Finally, we get to our point. An in-state company can reach the best of all worlds and avoid the argument whether receipts from highly automated activities are from services or are OBR, but still assign the receipts by market: It can use some other reasonable method.

The ALJs have stated in no uncertain terms that receipts from highly automated activities are receipts from services. Fine — let's work with that. While COP is the default rule for assigning receipts from services performed inside and outside the state, the department's regulations under both article 9-A (general corporations; quoted later)[7] and article 32 (banks)[8] provide an alternative.

Where a lump sum is received by the taxpayer in payment of services performed within and without New York, the portion of the sum attributable to services performed within the state is determined based on the relative values of — or amounts of time spent in performance of — those services within and without New York, or by some other reasonable method. Full details must be submitted with the taxpayer's return.

What would be some other reasonable method and what must a taxpayer do to use one? Let's start with the obvious — "other" means that it must be different than the default rule for services. The default rule is COP, so some other reasonable method must be different from COP.

"Reasonable" means just that: A taxpayer cannot assert an entirely random method for assigning receipts to New York (such as assigning receipts based on the portion of the company's female board of director members over the total number of board of director members) and expect it to be accepted as reasonable. If only we had some guidance regarding what the department thinks is a reasonable way to assign receipts from highly automated activities . . . oh wait, we do.

We have long-standing department guidance regarding its view that those receipts are to be assigned based on market. And it's fairly safe to assume that the department would agree that its historic method was, at the very least, reasonable.[9] In fact, even after the department lost in *Expedia*, it continued to argue that market was the most appropriate apportionment method in its briefings in *CheckFree* and *Catalyst*.[10]

So it seems clear that assigning receipts from highly automated services by customer access location would be a reasonable method. What must a taxpayer do to use it? Not all that much.

While the regulation provides that "full details must be submitted with the taxpayer's return," the provision is not limited to other reasonable methods. Even if the provision could somehow be viewed as a prerequisite for using other reasonable methods, it is highly questionable whether the department would be able to deprive a taxpayer of a reasonable filing

[7] 20 NYCRR section 4-4.3(d)(1).

[8] 20 NYCRR section 19-6.7(c) ("Where services are performed both within and without New York State, the portion of the receipt attributable to services performed within New York State is determined on the basis of the relative value of, or amount of time spent in performance of, such services within New York State, *or by some other reasonable method*." Emphasis added).

[9] That the ALJs determined that receipts from highly automated activities are receipts from services, rather than OBR, does not alter this conclusion. The department's historic position had two parts: first, that receipts from highly automated activities were OBR; and second, that those receipts were to be assigned based on where customers access the activity. The OBR ALJ decisions only addressed the first part.

[10] See briefs filed by the department in *CheckFree* and *Catalyst*, including in the appeal of *Catalyst*.

method because the proof is provided at a time other than when the return is submitted.[11] There is neither a requirement for a taxpayer to first seek permission to use some other reasonable method nor a requirement to show that the default method (COP) would reach an unreasonable result.

In fact, pretty much all one must show is that the other method is reasonable. The department's own guidance supports this conclusion: At least four advisory opinions (that is, letter rulings) addressing article 9-A (general corporate tax) matters and one addressing an article 32 (bank) matter reflect the agency's position that some other reasonable method was available to taxpayers without requiring that they demonstrate that the COP method would be distortive, unfair, or unreasonable.[12] In each case, the only requirement was that the method used be reasonable.[13]

In fact, we found no regulations or publications with any such requirement to demonstrate that the default method is not reasonable before using some other reasonable method.[14]

And Then New York City

The New York City Department of Finance, which often walks to the beat of its own drummer, has never officially adopted or litigated the same approach as its state sibling. Rather, it has remained conspicuously quiet regarding receipts from automated and electronic transactions. For the most part, it has opposed customer sourcing for companies and receipts that do not qualify under the frameworks that apply to tax years beginning before January 1, 2015, when the city's version of tax reform took effect. Its statutory framework for both corporations and unincorporated entities nevertheless mirrors the New York state framework and permits apportionment using some other reasonable method.[15]

Thus, the same ability to use some other reasonable method exists, and the same proof of reasonableness should be available — a method the State Department of Taxation and Finance has required for decades. Surely the City Department of Finance would not argue that the state's method was unreasonable.

Conclusion

Even though the OBR line of cases suggests that receipts from highly automated services are to be assigned based on costs, companies with high in-state costs should consider using some other reasonable method. The department has told us for quite some time how those receipts should be assigned (by market), so it would be hard-pressed to now say that position was unreasonable. ■

[11] While the department could deny the use of some other reasonable method if the taxpayer has not provided the details with its return, we would seriously question the propriety of that position. If the taxpayer can establish that the method is reasonable, since the proper reflection of the taxpayer's income attributable to New York is the goal, rejection of a reasonable method because of a foot fault would be inherently arbitrary and capricious. *See, e.g.*, *In re Autotote Ltd.*, TSB-D-90(4)C (N.Y.S. Tax Appeals Tribunal, Apr. 12, 1990) (rejecting the regulatory requirement that a corporation seeking permission to file on a combined basis must do so within 30 days before the end of the tax year, and holding that if the criteria for combined reporting are met, the corporation must be allowed to do so. Note that the "goal is to require a report which is an accurate reflection of the income which should be subjected to taxation in New York State." Also note that to decide otherwise "would give credence to an 'unwritten fourth rule,' that is, that the discretion accorded to the Division under section 211(4) is to be exercised only when the result will be a larger tax. Surely, that is not the proper result").

[12] Article 9-A: *In re Advisory Opin.*, TSB-A-12(2)C (N.Y.S. Department of Taxation and Finance, Mar. 2, 2012) (receipts from providing tours could be assigned by some other reasonable method); *In re PricewaterhouseCoopers* (Advisory Opin.), TSB-A-02(2)C (N.Y.S. Department of Taxation and Finance, Apr. 8, 2002) (receipts from licensing intellectual property could be assigned by some other reasonable method); *In re Hodgson, Russ, Andrews, Woods & Goodyear* (Advisory Opin.), TSB-A-95(11)C (N.Y.S. Department of Taxation and Finance, July 26, 1995) (receipts from diversified marketing services could be assigned by some other reasonable method); *In re Insight Management Inc.* (Advisory Opin.), TSB-A-95(5)C (N.Y.S. Department of Taxation and Finance, Mar. 29, 1995) (receipts from investment consulting could be assigned by some other reasonable method). Article 32: *In re Sumitomo Trust & Banking Co.* (Advisory Opin.), TSB-A-01(18)C (N.Y.S. Department of Taxation and Finance, May 30, 2001) (receipts from investment custodial services could be assigned by some other reasonable method).

[13] *Id.*

[14] For the department to begin requiring such a showing as a perquisite would likely violate the State Administrative Procedure Act.

[15] 19 R.C.N.Y. sections 3-04(f)(7)(iii), 11-65(b)(3)(i), and 28-07(e)(4). Note, however, that a taxpayer must request permission to use some other reasonable method under the unincorporated business tax, like an alternative allocation method. Also, the unincorporated business tax regulations have not been updated for the place-of-performance standard that now applies to receipts from services under N.Y.C. Admin. Code section 11-508(c)(3).