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A Royal Opportunity: Amendments to New York's Royalty Expense Add-back Statute Leave the Income Exclusion Intact for Prior Years

On March 28, 2013, the New York State Legislature passed budget legislation (S.2609D/A.3009D) that replaces the existing New York State and City related-party royalty add-back requirements with provisions based on the Multistate Tax Commission's model add-back statute. In addition, the legislation repeals the New York State and City royalty income exclusions, which permitted taxpayers to exclude royalty income from taxable income when the royalty income would have been subject to the related party add-back requirement. The amendments apply to the New York State corporate franchise tax, bank franchise tax, tax on unrelated business income, personal income tax, and insurance company tax. The amendments also apply to the New York City general corporation tax, unincorporated business tax, banking corporation tax, and resident individual income tax. The legislation, which is expected to be signed by Governor Cuomo, will take effect immediately and will apply to tax years beginning on or after January 1, 2013.

Background

In 2003, the New York tax law was amended to impose a related-party add-back provision for otherwise deductible royalty expenses received from a related party, subject to a few exceptions. First, a taxpayer was generally not subject to the royalty expense add-back if the royalty payments were made to a related party that paid the amounts to an unrelated entity (i.e., the "conduit" exception). Additionally, the royalty expense add-back generally did not apply if the royalty payments were made to a related foreign entity that was subject to a comprehensive tax treaty with the United States (the "treaty" exception). In 2007, an additional exception to the add-back requirement was adopted for combined filers.

In addition, the New York tax law was amended to provide a royalty exclusion in computing taxable income for royalty income that was included in federal taxable income and received from related members. The royalty exclusion applied when the related-party payor would be subject to the related party add-back requirement for the royalty expense. In certain circumstances, this statutory language arguably allowed taxpayers to claim the royalty income exclusion even if the related-party payor was not actually a New York taxpayer that was subject to tax on the royalty expense add-back. For example, taxpayers have a strong position that royalty income received from alien corporations not doing business in New York may be excluded from income, so long as the conduit, treaty or combined reporting exceptions do not apply.

Sutherland Observation: The opportunity to claim the royalty income exclusion, even where the related-member payor is not subject to tax in New York on the royalty expense add-back, is not only supported by the statute, but is also arguably required under the U.S. Constitution. New York's failure to grant the royalty income exclusion in such circumstances likely violates the Commerce Clause of the U.S. Constitution pursuant to U.S. Supreme Court precedent holding that a state cannot enact a tax statute that burdens an out-of-state entity compared to an in-state entity based on the entity's level of activity in the state.

The New Legislation

The new legislation provides for the elimination of the royalty income exclusion and substantially changes the operation of the existing royalty expense add-back exception. The royalty expense add-back will not be required if the taxpayer can establish by clear and convincing evidence that it meets the new “subject to tax” exception or the amended “conduit” and “treaty” exceptions:

1. *Subject to Tax Exception.* The royalty expense add-back will not be required if: (i) the related member was subject to tax on, or measured by, net income in New York or another state or possession of the United States; (ii) the tax base for the tax paid in the other jurisdiction included the royalty payment; and (iii) the aggregate effective tax rate applied to the related member in the other jurisdiction is not less than 80% of the statutory rate applied to the taxpayer in New York for the taxable year.
2. *Conduit Exception.* The royalty expense add-back will not be required if: (i) the related member was subject to tax on the royalty income in New York, another state or possession of the United States, or a foreign nation; (ii) the related member, during the same taxable year, directly or indirectly paid, accrued or incurred such portion to a person that is not a related member; and (iii) the transaction giving rise to the royalty payment was undertaken for valid business purposes.
3. *Treaty Exception.* The royalty expense add-back will not be required if: (i) the royalty payment was paid, accrued or incurred to a related member organized under the laws of a country other than the United States; (ii) the related member’s income from the transaction was subject to a comprehensive income tax treaty between the other country and the United States; (iii) the related member was subject to tax in a foreign nation on the royalty income; (iv) the related member’s income from the transaction was taxed in the foreign nation at an effective rate at least equal to that imposed by New York; (v) the royalty payment was paid, accrued or incurred in a transaction that was undertaken for a valid business purpose and using terms that reflect an arm’s-length relationship.

Additionally, the new legislation provides that the royalty expense add-back will not be required if the taxpayer and the Commissioner of Taxation and Finance agree in writing to the application or use of alternative adjustments or computations.

Sutherland Observation: The new legislation is prospective, applying only to tax years beginning on or after January 1, 2013. This leaves intact the royalty income exclusion regime adopted by the Legislature in 2003. For taxable years prior to January 1, 2013, taxpayers engaged in royalty expense transactions should review the applicability of the royalty income exclusion—including in circumstances where the related-party payor is not subject to tax in New York on the expense add-back—and file refund claims where appropriate.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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