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NEW YORK TAX INSIGHTS

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STATE TAX DEPARTMENT RELEASES NEW DRAFT ARTICLE 9-A COMBINED REPORTING REGULATIONS

By Michael J. Hilkin

The New York State Department of Taxation and Finance has released draft amendments to the Article 9-A corporate franchise tax regulations to address significant changes relating to combined reporting under New York State corporate tax reform legislation enacted in 2014 and 2015. Corporate Tax Reform Draft Regulations, Combined Reports, (N.Y.S. Dep't of Taxation & Fin., Jan. 22, 2016).

Under corporate tax reform legislation, which went into effect for tax years beginning on or after January 1, 2015, a taxpayer is required to file combined returns including unitary corporations in which it has more than 50% of the voting power. The distortion test for mandatory combination under prior law, including the substantial intercorporate transactions test, is eliminated. The law includes several exceptions to unitary combined filing, including an exception for alien corporations that have no federal effectively connected income and that are not classified as "domestic" corporations for federal tax purposes. Notably, the new law also allows commonly owned corporations to make a binding seven-year election to file on a combined basis if the 50% voting power test is met, whether or not a unitary relationship exists. Except with respect to eligibility for tax credits, the combined group will generally be treated as if it were a single entity.

The draft amendments contain several potentially significant proposals:

- The term "unitary business" would be "construed to the broadest extent permitted under the U.S. Constitution," as interpreted by the U.S. Supreme Court, New York State courts and the New York State Tax Appeals Tribunal.
- The 50% voting power test would be satisfied by a corporation based on direct or indirect ownership, or direct or indirect control, of more than 50% of the voting power of another company. "Voting power" would be defined to mean the power to elect board members of a company, and the calculation of a company's total combined voting power would exclude formal voting rights held by stockholders in circumstances where there is any express or implied agreement that the stockholder will not vote its stock in the company.

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- "Ownership" of voting power would be defined to include actual or beneficial ownership of stock, meaning that the stockholder must have the right to vote and the right to receive any declared dividends. "Control" of voting power would be defined to apply to circumstances where a company "directly or indirectly possesses the power to dictate or influence the management and policies" of another company through the direct or indirect ownership of more than 50% of the voting power in the other company, or where a company has been given the right to vote the stock of another company "by proxy or otherwise."

- Companies satisfying the 50% voting power test would be presumed to have a unitary relationship when they: (1) are horizontally integrated, meaning that all of the companies' "activities are in the same general line of business"; (2) are vertically integrated, meaning that all of the companies "are engaged in different steps in a vertically structured enterprise"; or (3) share "strong centralized management" along with "centralized departments or affiliates" for certain functions such as financing, advertising, research and development or purchasing.

- Newly formed corporations would be presumed to have a unitary relationship with their forming company as long as the 50% voting power test is met, and newly acquired corporations would be presumed to have a unitary relationship with their acquiring company as long as the 50% voting power test is met and the corporations are horizontally integrated, vertically integrated or have strong centralized management (as defined by the draft regulations and discussed above).

- Either a business or the Department may nonetheless refute one of the regulatory presumptions that a group is unitary by "clear and convincing evidence." If no regulatory presumption applies, the presence of a unitary business would be determined based on all of the facts and circumstances of the case without any presumption in favor of or against a unitary business finding.

- If a passive holding company and one or more operating companies satisfied the 50% voting power test, the passive holding company would be "deemed" (rather than merely presumed) to be engaged in a unitary business with such operating company or companies.

- While companies would generally be allowed to make a seven-year election to file on a combined basis if the 50% voting power test is met, the Department would have the right to disregard such election if it appears to the Department, based on the facts at the time of the election, that "the election will not have meaningful continuing application." As an example of an election lacking meaningful continuing application, the Department describes a situation where an election is "made in anticipation of the sale of substantially all of a business conducted in New York" when a "material part" of any gain from such disposition would be apportioned to New York in the absence of the election and the sale results in the winding up of the seller's New York business activities. On the other hand, an election would not lack meaningful continuing application merely because the election reduces New York tax liability, as long as the company making the election anticipates "continuing material business operations in New York" that will be subject to and affected by the election. The Department claims to have the power to disregard elections lacking meaningful continuing application because the election is intended to simplify tax filings, rather than allow for a reduction in tax, and, in the example given, the taxpayer making the election would know that it is winding up business in New York and that the election would have no meaningful continuing application.

The regulations also provide a variety of examples applying the 50% voting power test and unitary business requirement.

The regulations are in draft form and have not yet been formally proposed by the Department under the State Administrative Procedure Act. The Department is inviting comments on the draft amendments by April 21, 2016.

STATE TAX DEPARTMENT EXTENDS INVESTMENT CAPITAL IDENTIFICATION PERIODS FOR NON-DEALERS

By Kara M. Kraman

The New York State Department of Taxation and Finance has issued helpful guidance extending the additional investment capital identification periods for non-dealers under certain circumstances. *Technical Memorandum*,

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"Additional Investment Capital Identification Periods for Certain Non-Dealers for Specified Circumstances that Occur on or After October 1, 2015," TSB-M-15(4.1)C, (5.1)I (N.Y.S. Dep't of Taxation & Fin., Jan. 7, 2016).

Recent New York State and City corporate tax reform legislation narrowed the definition of investment capital but made investment income entirely exempt from corporate income tax. In order to qualify as investment capital, however, stock must satisfy five separate criteria, one of which is that the stock must be "clearly identified" in the taxpayer's records as being held for investment. Although the corporate tax reform legislation implementing this change is effective for tax years beginning on or after January 1, 2015, transition rules allowed all corporations subject to New York State and City corporate tax (other than securities dealers) until October 1, 2015, to clearly identify stock being held for investment for purposes of receiving investment capital treatment.

This new Technical Memorandum supplements the investment capital identification requirements contained in a previous Department memorandum, "Investment Capital Identification Requirements for Article 9-A Taxpayers, TSB-M-15(4)C, (5)I (N.Y.S. Dep't of Taxation & Fin., July 7, 2015). Specifically, the new Memorandum provides an additional investment capital identification period beyond October 1, 2015, for certain non dealers for stock that otherwise satisfies the criteria for investment capital. The additional identification period begins on the later of the "measurement date" or January 7, 2016 (the date the Technical Memorandum was released), and ends at the close of business of the 90th day thereafter:

- In the case of a corporation that first becomes subject to tax under Article 9-A on or after October 1, 2015, the "measurement date" is the date that the corporation begins doing business, employing capital, owning or leasing property or maintaining an office in the state (collectively, "doing business").
- In the case of a corporation or unitary group that becomes subject to tax on or after October 1, 2015, solely because it has New York receipts of $1 million or more ("economic nexus"), the measurement date from which the 90 days run is the date on which the corporation or unitary group first had $1 million or more of New York receipts.
- In the case of a corporation that is not a New York taxpayer, has not been included in a New York combined return, and that first meets the capital stock requirement to be included in a combined return on or after October 1, 2015, the measurement date is the day the corporation first meets the capital stock requirement.
- In the case of a partnership that on or after October 1, 2015, first begins doing business in the state, the measurement date is the date the partnership first begins doing business in the State. In the case of a partnership that becomes subject to tax solely because it has New York receipts of $1 million or more, the measurement date is the date on which the partnership first has $1 million or more of New York receipts.
- In the case of a partnership that is not itself doing business in the State, but on or after October 1, 2015, first has as a partner a corporation subject to tax under Article 9-A, the measurement date is the first date that the partnership has a corporate partner that is subject to tax in the State.
- In the case of a partnership that is not itself doing business in the state, and prior to October 1, 2015, none of its corporate partners were subject to tax in the state, but on or after October 1, 2015, one or more of its partners becomes subject to tax in the state, the measurement date is the first date that one of its existing partners becomes subject to tax in the State.

The Technical Memorandum also clarifies that for non-dealers any stock purchased after the additional identification period described above has expired, and that was purchased pursuant to an option acquired by those corporations before the expiration date, may not be identified as investment capital unless the corporation or partnership clearly identified the option as held for investment prior to the expiration of the additional identification period.

Additional Insights

In its earlier Technical Memorandum addressing investment capital identification requirements, the Department allowed corporations and partnerships that were not securities dealers a nine-month grace period – from January 1, 2015, to September 30, 2015 – to identify stock held for investment, regardless of when the stock was purchased. This new Memorandum creates an additional, and ongoing, 90-day grace period for certain corporations and partnerships that become subject to Article 9-A on or after October 1, 2015. Pursuant to the Memorandum, a qualifying corporation which first finds itself subject to tax in New York State will receive a 90 day grace period to identify stock as held for investment, whether it becomes subject to tax in January 2016 or January 2019. The Department's new policy is commendable and ensures that non-dealer corporations have a workable grace period in which to identify stock held for investment, even for those that first become subject to New York tax in the future.

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NEW ARTICLE 9-A GUIDANCE ON ATTRIBUTION OF INTEREST DEDUCTIONS TO NONTAXABLE INCOME

By Irwin M. Slomka

Among the many changes under New York corporate tax reform is the exclusion from tax of a corporation's investment income and the creation of a new category of "other exempt income." A related change is that nonbusiness expenses are now fully attributable to a corporation's business income (and thus fully deductible), leaving only interest expense to be attributed to nontaxable investment income and other exempt income. The New York State Department of Taxation and Finance has now released important guidance through a Technical Memorandum on how taxpayers should directly and indirectly attribute interest deductions, as well as how taxpayers may claim the new "safe harbor" election in lieu of such interest expense attribution for tax years beginning after 2014. *Technical Memorandum*, "Direct and Indirect Attribution of Interest Deductions for Article 9-A Taxpayers," TSB-M-15(8)C, (7)I, (N.Y.S. Dep't of Taxation & Fin., Dec. 31, 2015).

Prior to corporate tax reform, one of the more contentious – and unpredictable – audit adjustments under Article 9-A was the direct and indirect attribution of interest expense deductions (and sometimes non-interest deductions) to subsidiary and investment capital. This often resulted in substantial tax deficiencies resulting from the expense disallowance. Although under corporate tax reform the exclusion for income from subsidiary capital has been eliminated, and the definition of investment income has been scaled back significantly, the new law does provide a more taxpayer-friendly expense attribution methodology.

A corporate taxpayer or New York combined group with interest expenses now has two options. First, it can directly and indirectly (by formula) attribute a portion of its interest expenses to investment income and other exempt income and add back the resulting attributed interest expense. Alternatively, a taxpayer can now make a "safe harbor" election to reduce its gross investment income and other exempt income by 40% in lieu of any direct and indirect interest expense attribution. Since investment income and other exempt income are subtracted from entire net income in computing a corporation's business income, the election will typically result in increased business income. However, by making the election the taxpayer will not be subject to any interest expense attribution adjustments on audit by the Department. Moreover, the taxpayer may claim or revoke the election at any time within the statute of limitations period. The Department cannot revoke the election.

The new Technical Memorandum sets out a three step process for interest expense attribution. This involves (i) determining the total amount of interest expense subject to attribution; (ii) then determining the portion of interest expenses that are directly attributable to such nontaxable income (for example, interest incurred to purchase or carry investment capital); and, finally, (iii) indirectly attributing the amount of such interest expense (not otherwise directly traced in step (ii) above) to investment income and other exempt income using an asset-based formula. The detailed mechanics of the three-step process are set out in the Technical Memorandum.

[A] taxpayer can now make a "safe harbor" election to reduce its gross investment income and other exempt income by 40% in lieu of any direct and indirect interest expense attribution.

In lieu of being subject to such expense attribution, a taxpayer may instead make the annual election on Form CT-3.1 to reduce its investment income and other exempt income by 40%. The election can be made by a taxpayer or New York combined group member that reports no investment capital or other exempt income. The election applies to the taxpayer and all members of its New York combined group.

Those familiar with the Department's pre-2015 interest expense attribution policy will find that the mechanics of the new direct and indirect attribution are not meaningfully different. However, the availability of the "safe harbor" election in lieu of attribution is completely new, and offers much-needed certainty to taxpayers. Since the election is fully revocable by the taxpayer, and can be claimed even if the taxpayer reports no investment capital, it is expected that some corporations will make the election preemptively as protection against expense attribution on audit.

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2016-17 NEW YORK STATE EXECUTIVE BUDGET RELEASED

By Irwin M. Slomka

New York State Governor Andrew M. Cuomo has released the 2016-2017 Executive Budget. Among the relatively low-key tax proposals being made this year are the following:

1. Conform the New York State and City tax filing deadlines for corporations and partnerships to the new deadlines put in place for federal income tax purposes. (Part Q)
2. Reduce the Article 9-A income tax rate for small businesses from 6.5% to 4% beginning in 2017, and expand the personal income tax small business subtraction modification for members, partners or shareholders of LLCs, partnerships and S corporations that meet the definition of a "small business." (Part R)
3. Amend the definition of "qualified financial instruments" ("QFIs") for New York State and City corporate income tax purposes to ensure that taxpayers are able to claim the exemption for "other exempt income" with respect to stock in subsidiaries that are not included in a New York combined return, even though the taxpayer makes a fixed 8% sourcing election for its QFI income. (Part P)
4. Provide a non-refundable tax credit of 50% of NYS Thruway tolls paid through E-ZPass accounts for both businesses and individuals (in the case of individuals who pay at least $50 annually in NYS Thruway tolls), with a 100% credit available for farm vehicles. (Part T)
5. Permit hotel room remarketers to claim an exemption from New York State sales tax and New York City hotel room occupancy tax for their purchases of hotel room occupancies that in turn are supplied to the remarketers' customers. Currently, room remarketers must seek a credit or refund of the tax paid to the hotel operators. (Part X)
6. Eliminate charitable contributions and activities as a factor in determining domicile for estate tax purposes (similar to the rule for State and City personal income tax purposes). (Part Y)

The deadline for enactment of the budget is April 1, 2016.

NO REFUND IS AVAILABLE OF TAX PAID ON OUTSET OF CAR LEASE EVEN IF CAR IS REMOVED FROM THE STATE

By Hollis L. Hyans

The New York State Department of Taxation and Finance has issued an Advisory Opinion finding that sales tax collected at the outset of a car lease on the total lease payments will not be refunded if the leased vehicle moves out of the state. *Advisory Opinion*, TSB-A-15(50)S (N.Y.S. Dep't of Taxation & Fin., Dec. 11, 2015).

[S]ales tax collected at the outset of a car lease on the total lease payments will not be refunded if the leased vehicle moves out of the state.

The Petitioner, while a New York resident, leased a new car in May 2011 and paid New York State and local sales tax on the total amount of the lease stream payments for the car. In February 2012, he moved to Florida. He registered the car with the Florida Department of Motor Vehicles, and since May 2012 was charged Florida sales tax on each monthly lease payment.

The Department's analysis starts with recognition that New York law requires sales tax on leases of cars to be paid at the inception of the lease, on the total amount of the lease payments for the entire term of the lease, rather than requiring the tax to be paid with each periodic lease payment. Tax Law § 1111(i). The Department also notes that the tax is legally imposed on the lessee, while the lessor is required to collect the tax and pay it over to the Department. Tax Law §§ 1131 and 1132.

The Department then went on to find that no New York statute or regulation allows a refund even if the remaining lease payments are not made, citing three decisions from the Tax Appeals Tribunal: *Matter of Moerdler*, DTA No. 816969 (N.Y.S. Tax App. Trib., Apr. 26, 2001); *Matter of Torquato*, DTA No. 816973 (N.Y.S. Tax App. Trib., Oct. 12, 2000); and *Matter of Miehle*, DTA No. 816201 (N.YS. Tax App. Trib., Aug. 24, 2000).

The Department also went on to find that, although the tax is legally imposed on the Petitioner as the lessee, because the dealer is responsible for collecting and remitting the tax, New York tax secrecy provisions

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prevent the Department from disclosing the dealer's sales tax information, including whether the tax on the customer's vehicle was remitted to the Department.

Additional Insights

While this Advisory Opinion appears to leave the lessee with a double tax burden – paying tax on 100% of the lease payments to New York at the outset of the lease and then paying tax to Florida each month on the same lease payments for the remaining length of the lease – there is no doubt that it is consistent with decisions from the Tax Appeals Tribunal. These cases included circumstances where not only was the car moved out of state (*Matter of Torquato*), but also where the vehicle was stolen (*Matter of Moerdler*) or so badly damaged to be a total loss (*Matter of Miehle*).

In *Matter of Miehle*, the Tribunal reviewed Tax Law § 1139 and found no provision for a refund of any portion of the sales tax properly paid at the inception of the lease. The Tribunal noted that the Legislature was not unaware of the statute's failure to provide for a refund, and that bills that would have allowed refunds or credits in the case of early termination or non-renewal of a motor vehicle lease, or allowed a refund if the vehicle was destroyed, had been introduced but never enacted. The legislature did allow, in Tax Law § 1139(f), for a refund of sales tax paid at the inception of a lease when the car was found to be a "lemon" under General Business Law §§ 198-a and 396-p(5), which the Tribunal determined provided further support for the Department's position that no refund was allowed in other circumstances.

Absent some future modification of the statute, claims for refund of tax paid at the inception of leases are unlikely to succeed.

CHARGES FOR USE OF "DARK" FIBER OPTIC CABLES FURNISHED THROUGH CROSS CONNECT SERVICES ARE NOT SUBJECT TO SALES TAX

By Irwin M. Slomka

A recent Advisory Opinion issued by the Department of Taxation and Finance addresses several interesting New York sales tax questions relating to the furnishing of interconnection, managed IT infrastructure services and co-location services at data centers in New York State. Advisory Opinion, TSB-A-15(53)S (N.Y.S. Dep't of Taxation & Fin., Dec. 31, 2015). The Advisory Opinion concludes, among other things, that the furnishing of so-called "dark" fiber optic cables through what are known as "cross connect" services does not constitute the sale of taxable telephone or telegraph services and is not subject to sales tax.

The service provider ("Seller") provides options for customers to choose various ways of interconnecting with their business partners. Through these "cross connect" services, the Seller's customers are able to directly connect to various bandwidth providers, including carriers, Internet service providers ("ISPs") and broadband access networks. This is done through the Seller's co-location centers in New York, called International Business Exchanges ("IBXs"). The Seller's customers co-locate their own equipment in the Seller's IBX facility in order to utilize the technology available at that facility, which in turn enables the customer to connect with business providers, service providers and networks.

The Department's ruling on the taxability of each of the enumerated services is summarized below:

1. **Charges for "dark fiber."** The Seller provides access to a bundle of fiber optic cables through its cross connect service that allow a customer to connect its equipment with its business partners' equipment. The customer's equipment must be co-located at the Seller's IBX facility in order to access the fiber optic cable. The cable is commonly referred to as "dark fiber," which means that it remains "dark" until the customer "lights" the cable by establishing service with a third party provider. The Seller does not transmit data, sounds or signals through the cables. The Seller separately states its cross connect service charges on invoices with customers.

   Ruling: Because customers use their own equipment to connect to the Seller's cables, and the third party or ISP transmits the customers' data or other signals to their destination, the Seller is deemed to be providing "dark cable" only, which means it is not providing taxable telephony or telegraphy services under Tax Law § 1105(b). The charges are also not considered to be for the sale or use of the cables as tangible personal property because the cables as installed constitute capital improvements to real property.

2. **Co-location charges.** Customers contract to co-locate their equipment in "cages" or "suites" at the Seller's IBX facility in order to utilize the technology at that facility. Customers are given exclusive possession of the space, which can be accessed 24 hours a day, seven days a week.

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Ruling: The furnishing of cages or suites at the Seller's IBX facility is considered a nontaxable lease of real property and is not a taxable storage service. The Department analyzed five indicators of a rental or lease of real property and concluded that the co-location services constituted the rental of real property and therefore was not subject to sales tax.

3. **Maintenance/operation of the customer's equipment.** Some of the Seller's customers will choose to have the Seller maintain and/or operate the customer's equipment that is co-located at the Seller's IBX facility.

   Ruling: Charges for the installation, maintenance, service or repair of the customer's equipment will be subject to sales tax. Tax Law § 1105(c)(3). If there is a single charge for the maintenance and operation of customer equipment, the entire charge (not just the maintenance portion) will be taxable.

4. **Electrical power.** The Seller purchases electrical power from its power suppliers in order to provide its overall service to customers. Currently, the Seller charges customers for electrical power not based on their actual consumption, but based on each customer's general usage requirements, such as the number of servers co-located at the Seller's facility.

   The Seller is contemplating providing metered electrical power to its customers, and will separately charge customers based on the customer's actual usage plus a negotiated administrative fee intended to cover the Seller's related costs. Each customer would be required to purchase a "minimum commitment" amount of electricity, regardless of its actual usage.

   Ruling: The Department ruled that the Seller's current charges for fixed electrical power not based on actual consumption are incidental to the customer's rental of the cage or suite and therefore are not for the taxable sale of electricity, citing *Empire State Building Co. v. New York State Department of Taxation & Finance*. 81 N.Y.2d 1002 (1993). If the Seller meters the electricity that it furnishes to its customers, however, it would be required to collect sales tax on the charges. In that case, the Seller will be able to purchase the electricity from its electrical power suppliers for resale, without having to pay sales tax on those purchases.

Additional Insights

The Advisory Opinion's conclusion that the Seller's separate charges for cross connect services are not for a taxable telephone service is consistent with earlier Department pronouncements. The fact that the Seller provides other ancillary services, at least some of which (such as the furnishing of sub-metered electricity) may be subject to sales tax, does not change this outcome. The Advisory Opinion also addresses the important related question of whether the charges are for the taxable sale or use of tangible personal property, correctly concluding that the cables, as installed, constitute capital improvements to real property. Although the Department has previously ruled that co-location charges are for the rental of real property, this ruling also disposes of the ancillary question of whether the charges are taxable storage charges under Tax Law § 1105(c)(4), concluding that they are not.

INSIGHTS IN BRIEF

New York State Tax Department Determines That a Corporate Partner May Aggregate Activities of Two Partnerships for Purposes of the Investment Tax Credit

The New York State Department of Taxation and Finance issued an Advisory Opinion finding that a corporate partner may aggregate the activities and employees of two majority-owned partnerships, and other single member limited liability companies ("SMLLCs") directly or indirectly owned, for purposes of satisfying the "principally used" and "employment" tests for the New York State Investment Tax Credit ("ITC"). *Advisory Opinion*, TSB-A-16(1)C (N.Y.S. Dep't of Taxation & Fin., Jan. 11, 2016). The Department found, first, that the Petitioner corporation, while not itself a registered broker dealer, was entitled to such treatment based on the broker-dealer status of the partnerships and SMLLCs that it owned and thus qualified for the ITC available to broker dealers under Tax Law § 210(12)(b)(i). The Petitioner also was considered to have purchased the property placed in service by a partnership it owned for purposes of qualifying for the ITC under the aggregate principle. Finally, the Petitioner was permitted to aggregate the property and activities of the employees of two SMLLCs, to the extent they were qualifying uses under the ITC statute, to satisfy one of the three employment tests in the statute.

Charges for Downloading Software to Access Marketplace Website is Subject to Sales Tax

The Department of Taxation and Finance has ruled that a marketplace website operator's charges to customers to download and use its software in order to access its website and place orders for goods sold by third party vendors through the website are from the lease or license to use prewritten software, and therefore

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are subject to sales tax if "delivered" in New York. *Advisory Opinion*, TSB-A-15(51)S (N.Y.S. Dep't of Taxation & Fin., Dec. 11, 2015). An additional monthly fee denominated as "usage/maintenance," entitling customers to software updates, technology support and training, are excludable from tax only if both reasonable and separately stated in invoices or other pricing statements given to the customer. Finally, fixed fees paid by the vendors to the website operator for each order placed through the website are not subject to sales tax because they constitute charges for the furnishing of Internet-based advertising.
