

On the Subject

State & Local Tax

March 6, 2014

This is the third installment of a series that takes an inside look at the corporate tax reform proposals in Governor Andrew Cuomo's 2014–15 New York Budget Bill. This proposed reform is sweeping and, if enacted, is likely to result in major changes for many New York corporate taxpayers. This installment of *Inside the New York Budget Bill* examines proposed changes to apportionment, discussing how the proposals vary from current law and how they will affect New York taxpayers. The next installment will explore proposed changes to New York's traditional nexus standards.

Inside the New York Budget Bill Part Three: Apportionment

This installment of *Inside the New York Budget Bill* examines the Budget Bill's proposed changes to apportionment and discusses how those proposals vary from current law and how they will affect New York taxpayers. **A chart comparing the most significant apportionment sourcing provisions of the Budget Bill to the current sourcing provisions in Articles 9-A and 32 appears at the end of this installment.**

Current Law

Article 9-A

Part two of this series addressed the need for apportionment under the entire net income (ENI) base and the capital base of Article 9-A, and can be found at <http://bit.ly/1lwq2qU>. Business income and capital is apportioned by the taxpayer's business allocation percentage (BAP), and investment income and capital is apportioned by the taxpayer's investment allocation percentage (IAP). Since the Budget Bill would exempt newly defined "investment income" and eliminate the need for an IAP, only the BAP is addressed here.

The BAP is the ratio of the taxpayer's New York receipts to its total receipts. In general, New York receipts are those generated from (1) sales of tangible personal property shipped or delivered to the taxpayer's customers in New York, (2) sales of services to the extent the services were performed in New York and (3) other business receipts to the extent "earned" in New York.

Determining proper receipts sourcing has become a very contentious audit issue, particularly given the evolution of corporate business transactions. For example, difficulties have arisen under current law regarding the sourcing of receipts earned from performing services that are delivered or made available through the Internet. Is revenue derived therefrom more properly classified as from the performance of services or from "other"? If services, where are those services performed, and if "other," where are those receipts "earned"?

Article 32

Under Article 32, in computing the portion of a banking corporation's ENI that will be subject to tax by New York (if the resulting tax amount is greater than the amount computed under the gross assets base or under the alternative ENI base), ENI is multiplied by a three-factor formula consisting of the deposits factor, the payroll factor and the receipts factor. The three factors are averaged, with the deposits and receipts factors being double-weighted. The same formula generally applies in apportioning the Article 32 gross assets base.

Much audit controversy has developed in the context of determining the deposits factor under current law (which requires taxpayers to source deposits to the extent that those deposits are "maintained" by the taxpayer at a "branch" location). These controversies largely involve whether any office of the taxpayer constitutes a "branch" and what it means, in today's world, to "maintain" a deposit at a particular "branch" location.

Proposed Changes

The Budget Bill retains the current receipts-only apportionment scheme under Article 9-A but would eliminate the disparate apportionment schemes applied to general business corporations and banking corporations; the same rules would apply to both

categories of corporations (thus, for example, ending deposit factor controversies).

In general, the Budget Bill would expand the market-based sourcing regime that currently applies to sales of tangible personal property and certain asset management and investment advisory services to all receipts “that are included in the computation of the taxpayer’s business income for the taxable year.” The Budget Bill also expands the categories of receipts for which sourcing is specifically addressed by law and provides guidance on how to apply the sourcing rules, for example, by including hierarchies for determining where to assign particular receipts, likely eliminating much of the current controversy. Under this hierarchical approach, a taxpayer would be required to exercise due diligence under each method before rejecting it and moving to the next method in the hierarchy.

While the Budget Bill’s approach to categorization is commendable, and while it may be argued that the regime provides clarity and uniformity in its “market” focus, many taxpayers may be adversely affected by such changes, particularly those in the service industry that benefit from the current performance-focused method, and those with receipts in the “other business receipts” category that “earn” those receipts outside of New York. In addition, several provisions in the Budget Bill would allow for use of the customer billing or mailing address as the determination of where the customer is located. However, billing and mailing addresses can often be moved (particularly in business-to-business transactions) and often reflect only the location of a customer’s back-office functions, not the location where a customer really benefits from goods or services purchased. An alternative, such as commercial domicile (which is used in the Budget Bill for some sourcing), may provide a better indication of where the “market” for a good or service really is (of course, commercial domicile has its own drawbacks in that sellers do not always know their customers’ commercial domicile location).

As in current law, the Budget Bill would provide the Commissioner with discretion to apply alternative methods “to effect a fair and proper apportionment of the business income and capital reasonably attributed to the state” when the standard statutory scheme “does not result in a proper reflection of the taxpayer’s business income or capital within the state.” While the Budget Bill does not address which party would have the burden of proof in this instance, the majority (and better) view in the country is that the party seeking alternative apportionment should bear the burden of proof.

New York City

Currently, New York City’s apportionment regime is substantially similar to the State’s current regime (although New

York City will not fully phase in a single receipts factor for tax years beginning after 2017). The Budget Bill’s apportionment provisions would not automatically affect New York City’s regime, resulting in vastly different treatment of certain categories of receipts. This will add to compliance difficulties when filing returns.

Effective Date

If enacted, the apportionment provisions would apply to taxable years beginning on or after January 1, 2015.

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Appendix: Comparison of Receipts Sourcing Provisions

This chart addresses the significant categories of receipts in the New York Budget Bill. There are other sourcing rules applicable to certain industries (e.g., aviation and railroad) that are not addressed herein. Under current Article 9-A, certain categories of receipts discussed below might be included in investment income subject to IAP apportionment, but in certain situations and for certain taxpayers those same receipts might be business income subject to BAP apportionment. This chart discusses the sourcing rules for all such receipts assuming that they are included in business income subject to BAP apportionment.

Receipts	Budget Bill's Proposed Receipts Factor Sourcing Method	Current Article 9-A Receipts Factor Sourcing Method	Current Article 32 Receipts Factor Sourcing Method
Tangible personal property	Shipping address or destination (presumably the current rules regarding the customer's ultimate destination would continue to apply)	Customer's ultimate destination	Subject to controversy, likely customer's ultimate destination
Rentals of tangible personal property	Property location	Property location	Subject to controversy, likely property location
Licensing intangible property	Location of use	If royalties from the use of patents or copyrights, location of use Otherwise, likely Other Business Receipts (see below)	Subject to controversy, likely location of use
Digital products (defined as any property or service, or combination thereof, of whatever nature delivered by various electronic media; specific examples include games, information or entertainment services, storage of digital products, and computer software by whatever means delivered or accessed)	Pursuant to the following hierarchy: 1. Actual location where used or accessed (may be demonstrated by using destination IP address, the location of receiving equipment, or bill of lading or invoice) 2. Customer's billing address 3. Zip code or other geographic locator of customer's location 4. The taxpayer's apportionment fraction for receipts from sales of digital products used for the preceding year (If delivered to multiple locations, delivered to New York to the extent accessed or used in New York)	Hotly contested issue; taxpayers often classify as services assigned to where performed, whereas the Department generally classifies as Other Business Receipts assigned to where the customer accesses the vendor's network (e.g., modem) (See NYMEX, TSB-A-99(16)C; Insurance Services Office, Inc., TSB-A-00(15)C; Deloitte & Touche LLP, TSB-A-02(3)C)	Subject to controversy, likely classified as "other" (see below)

Receipts	Budget Bill's Proposed Receipts Factor Sourcing Method	Current Article 9-A Receipts Factor Sourcing Method	Current Article 32 Receipts Factor Sourcing Method
Advertising	Location of the audience (where print media is delivered; where listeners or viewers of electronic media, such as television or radio, are located)	<p>If in newspapers or other periodicals, to the extent that such newspapers and periodicals are delivered to points within the state</p> <p>If televised commercials, to the extent of the viewing audience in the state</p> <p>Otherwise, see Other Business Receipts</p>	Subject to controversy, likely classified as "other" (see below)
Other Services Not Specifically Addressed	<p>Location of the customer as determined under the following hierarchy:</p> <ol style="list-style-type: none"> 1. Delivery destination (receipts for services performed for a customer's particular location, such as where a delivery is made to that location, as may be indicated on an invoice or bill of lading) 2. Customer's billing address 3. Zip code or other geographic indicator of customer's location 4. The percentage used by the taxpayer for the preceding year to apportion Other Business Receipts 	To the extent the service is performed in New York	To the extent the service is performed in New York

Receipts	Budget Bill's Proposed Receipts Factor Sourcing Method	Current Article 9-A Receipts Factor Sourcing Method	Current Article 32 Receipts Factor Sourcing Method
Other Business Receipts	Location of the customer as determined under the following hierarchy: 1. Delivery destination (receipts for services performed for a customer's particular location, such as where a delivery is made to that location, as may be indicated on an invoice or bill of lading) 2. Customer's billing address 3. Zip code or other geographic indicator of customer's location 4. The percentage used by the taxpayer for the preceding year to apportion Other Business Receipts	To the extent "earned" by the taxpayer in New York	To the extent "earned" by the taxpayer in New York
"Receipts from Financial Transactions" ***Special rules may apply to registered brokers or dealers under Article 9-A***			
Interest on loans secured by real property (Secured Loans)	Location of the real property	Where the taxpayer performs its activities related to the loans generating the interest (relevant activities include financing, accounting, calculation of foreign exchange rates, and general support and stewardship services) (<i>Matter of Siemens Corp. v. Tax Appeal Tribunal</i> , 89 N.Y.2d 1020 (N.Y. 1997))	Where the greater portion of income producing activity related to the loan occurred (to determine where the greater portion of income producing activity relating to a loan occurred, consider such activities as the solicitation, investigation, negotiation, final approval and administration of the loan (SINAA))
Interest on other loans	Location of the borrower	<i>Matter of Siemens Corp.</i> (see above)	Where the greater portion of income producing activity related to the loan occurred (SINAA)
Net gains from sales of Secured Loans	Use ratio of gross proceeds from sales of New York Secured Loans over all Secured Loans	Subject to controversy, likely Other Business Receipts (see above)	Where the greater portion of income producing activity related to the loan occurred (SINAA)
Net gains from sales of other loans	Use ratio of gross proceeds of such loans to purchasers located in New York to all such loan sales	Subject to controversy, likely Other Business Receipts (see above)	Where the greater portion of income producing activity related to the loan occurred (SINAA)

Receipts	Budget Bill's Proposed Receipts Factor Sourcing Method	Current Article 9-A Receipts Factor Sourcing Method	Current Article 32 Receipts Factor Sourcing Method
Interest from asset-backed securities	8 percent of such receipts are sourced to New York (8 percent rule)	Subject to controversy, likely Other Business Receipts (see above)	If from "trading or investment activities," based on the percentage that the average value of trading assets and investment assets attributable to New York bears to the average value of all such assets (a trading asset or investment asset is attributable to the state where the greater portion of income producing activity related to the trading or investment asset occurs) (trading or investment costs of performance rule) Otherwise, likely "other" (see above)
Net gains from sales of asset-backed securities	If government-issued or sold through a securities broker or dealer or through a licensed exchange, 8 percent rule Otherwise, use ratio of gross proceeds from such sales to purchasers located in New York to gross proceeds of all such purchasers	Subject to controversy, likely Other Business Receipts (see above)	If from "trading or investment activities," based on the trading or investment costs of performance rule Otherwise, likely "other" (see above)
Interest from corporate bonds	Commercial domicile of the issuing corporation determined pursuant to the following hierarchy: 1. Treasury function 2. Seat of management or control	Subject to controversy, likely Other Business Receipts (see above)	If from "trading or investment activities," based on the trading or investment costs of performance rule Otherwise, likely "other" (see above)
Net gains from sale of corporate bonds	1. Sold through a securities broker or dealer or through a licensed exchange: 8 percent rule 2. Other: use ratio of gross proceeds from such sales to purchasers located in New York to gross proceeds of all such sales	Subject to controversy, likely Other Business Receipts (see above)	If from "trading or investment activities," based on the trading or investment costs of performance rule Otherwise, likely "other" (see above)

Receipts	Budget Bill's Proposed Receipts Factor Sourcing Method	Current Article 9-A Receipts Factor Sourcing Method	Current Article 32 Receipts Factor Sourcing Method
Net interest income from reverse repurchase agreements and securities borrowing agreements	8 percent rule	Subject to controversy, likely where the taxpayer performs its activities related to the "loans" generating the interest; <i>Matter of Siemens Corp.</i> (see above)	If from "trading or investment activities," based on the trading or investment costs of performance rule Otherwise, likely "other" (see above)
Stock dividends and net gains from sales of stock	Generally excluded from apportionment computation, although Commissioner retains the discretion to require inclusion	Subject to controversy, likely Other Business Receipts (see above)	If from "trading or investment activities," based on the trading or investment costs of performance rule Otherwise, likely "other" (see above)
Receipts from sale of physical commodities	Net receipts are sourced to New York based on the ratio of net receipts from physical commodities actually delivered to a point in New York (when no delivery, then to customer's location in New York) to all such net receipts	To the customer's ultimate destination (see "tangible personal property" above)	Subject to controversy, likely gross receipts sourced to customer's ultimate destination (see "tangible personal property" above)
"Other financial instruments"	Location of payor	Subject to controversy, likely Other Business Receipts (see above)	Subject to controversy, likely "other" (see above)
Net gains from sale of "other financial instruments"	Location of purchaser or payor, except if the purchaser or payor is a registered securities broker or dealer or the transaction is made through a licensed exchange, 8 percent rule	Subject to controversy, likely Other Business Receipts (see above)	Subject to controversy, likely "other" (see above)
Rendering management, advisory, distribution (including selling) and administrative services to investment companies	On a monthly basis, to the domicile of the investment company's shareholders; individuals, estates and trusts are deemed "located" at his or her mailing address, and business entities are deemed located at their commercial domiciles, determined pursuant to the following hierarchy: 1. Treasury function 2. Seat of management or control	On a monthly basis, to the domicile of the investment company's shareholders (Dreyfus rule)	On a monthly basis, to the domicile of the investment company's shareholders (Dreyfus rule)

Receipts	Budget Bill's Proposed Receipts Factor Sourcing Method	Current Article 9-A Receipts Factor Sourcing Method	Current Article 32 Receipts Factor Sourcing Method
"Other Receipts from Broker or Dealer Activities"			
Commissions, margin interest, securities, underwriting fees, account maintenance fees, management and advisory fees (except those rendered to investment companies)	Address of customer responsible for payment	Address of customer responsible for payment	Traditionally, broker-dealers are subject to tax under Article 9-A, but, to the extent relevant, subject to controversy, likely "other" (see above)
Primary spread from underwriting securities	Location of customer	<ol style="list-style-type: none"> 1. Retained securities: 100 percent to New York where the underwritten securities that have been retained by the taxpayer are sold wholly at or through a New York office of the taxpayer 2. Group sales: 100 percent to New York when the principal office of the managing underwriter is located in New York 3. Directed or designated sales: to New York when the office of such member that is responsible for the sale is located within New York 	Traditionally, broker-dealers are subject to tax under Article 9-A, but, to the extent relevant, likely "other" (see above)
"Receipts from Credit Card and Similar Activities"			
Interest, fees, penalties and service charges	Cardholder's mailing address	Generally, most card issuers are banks (subject to Article 32); however, if relevant, interest equivalents would likely be assigned based on <i>Matter of Siemens Corp.</i> or as Other Business Receipts (see above)	Cardholder's mailing address
Merchant discount	Location of merchant's related sales (<i>i.e.</i> , transaction location) with the presumption that all sales are made at the merchant's address shown on the invoice (likely billing address)	Generally, receipts from merchant discount are received by acquirer banks (subject to Article 32); however, if relevant, subject to controversy, likely "other services" or Other Business Receipts (see above)	State where the merchant is located

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