# This Week in State Tax (TWIST)

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## New York: Application of Broker-Dealer Sourcing Rule Results in Distortion

In a non-precedential decision, an Administrative Law Judge for the New York Division of Tax Appeals recently ruled in a broker-dealer taxpayer's favor in a dispute involving the application of the customer-based sourcing rules for such entities, which remained in place after the state's 2015 tax reform and continue to apply for the New York State and City corporate taxes and the New York City Unincorporated Business Tax purposes[1]. The taxpayer's clients were primarily institutional investors and not retail clients (i.e., individuals). On amended returns, the taxpayer took the position that brokerage commissions, gross income from principal transactions including accrued interest, margin interest, clearing fees and management fees should be sourced based on an approximation of the locations of the underlying investors of the institutional intermediaries, and not based upon the locations of the institutional intermediaries themselves. In other words, the underlying investors were the relevant customers. The auditor disagreed and adjusted the taxpayer's apportionment based on treating the institutional intermediaries as the relevant customer. Under this approach, receipts were attributed to New York if the institutional intermediaries' address in the taxpayer's records was in New York. The taxpayer disagreed with the adjustment and the matter eventually made it to the administrative law judge level of the New York State Division of Tax Appeals.

As support for its position, the taxpayer argued that because the payment of the commissions and fees came from the institutional investor's custodial account, which contained the funds of the underlying investors, the commissions were "paid" by the underlying investors and not the institutional investors. In the taxpayer's view, the term "customer should be interpreted to mean the customer responsible for paying." The ALJ disagreed. Although the facts showed that the underlying investors of the institutional intermediaries were the customers responsible for paying the taxpayer, the tax law's broker-dealer "customer sourcing" statute did not operate to allow the taxpayer to look through to the underlying investors' location. The taxpayer next asserted that the Division should be required to exercise its discretionary authority, provided for in a general sense under the corporate tax law, to correct a distortive apportionment result, so as to source its receipts based upon a reasonable approximation of the locations of the underlying investors of the institutional intermediaries. An expert testifying on behalf of the taxpayer established that from an economic perspective, the customers in the securities industry who paid the securities transactions costs were the individual investors, whether they invest in securities directly or indirectly. The expert further examined various ways to approximate the locations of those individual underlying investors when their locations are unknown and concluded that using New York's U.S. Census percentage to source the taxpayer's receipts was the most reasonable method because population is a direct

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[1] *Jefferies Group LLC & Subsidiaries* (August 31, 2023.) The decision also addressed, and resolved in the taxpayer's favor, disputes over the taxpayer's investment capital "cash" election and claimed financial services investment tax credits, which are not addressed in this summary. Note, however, that the ALJ held that certain guidance published by the State had too narrowly applied the financial services ITC, and the financial services ITC and its associated "employment incentive credit" expired for property placed in service on or after October 1, 2015, though some taxpayers might still have their amended return statutes of limitation still open for filing refund claims

and reliable measure of where individual investors are likely to be located. The ALJ agreed. In her view, given the expert's "cogent analysis," it was clear the Division's method to allocate the receipts factor grossly overstated, by a factor of three or four times, the results reached using an allocation method that reasonably approximated the location of the individual investors, i.e., the customers from an economic perspective. As such, the ALJ concluded that using New York's share of the U.S. Census, i.e., 6.48 percent, was appropriate in this case.

Citing to the U.S. Supreme Court's decision in *Hans Rees*, the taxpayer also asserted that the Division's method of allocating its receipts violated the Commerce and Due Process Clauses because it attributed income to New York State that was out of all proportion to the income generated in the state. Although the ALJ had already determined that use of New York's census percentage (6.48%) was appropriate, she went on to hold that the Division's calculation of the receipts allocation factor (at 22.44% and 20.65% for the tax years at issue) was grossly overstated, by a factor of three or four times, which resulted in an unconstitutional distortion of the taxpayer's income.

As an ALJ decision, the case is not binding precedent. If an appeal is filed with the State's Tax Appeals Tribunal, then the Tribunal's decision would constitute binding precedent (including for the parallel New York City corporate tax regime and the City's UBT; see NYC Charter section 170.d), though the Tribunal's decision could potentially be subject to further appeal to New York's appellate court (always the right of a taxpayer, and recently extended as well to the State but for this matter only to the extent that the Tribunal's decision is grounded in New York State or Federal constitutional law). The timeframe for appealing to the Tribunal is within 30 days of the August 31st decision, though, on motion, the Tribunal often grants an additional 30 days. Please contact Russ Levitt with questions on *Jefferies Group LLC & Subsidiaries.*

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