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New York: Corporate Franchise Tax Regulations Finalized

On December 27, 2023, the New York Department of Taxation and Finance (Department) adopted regulations to implement the sweeping Article 9-A corporate franchise tax reforms first enacted almost a decade ago. As adopted, the regulations are 417 pages and can be accessed here. It is likely that almost every New York business taxpayer will be affected by some aspect of the final regulations. Most of the significant changes are in Parts 1 through 9 of Subchapter A of Chapter I of Title 20 of the Codes, Rules and Regulations of the State of New York, which are repealed and replaced with entirely new language.

The regulations had been in draft form for some time, and the Department had solicited feedback from the taxpayer community before the regulations were officially proposed in the New York Register. In its "Assessment of Public Comment" document, which it posted on the Department's website, it notes that a majority of the written comments submitted in response to the proposed rule duplicated feedback submitted to it during the development of the proposed rule. The Department also addresses the substantive comments received during the formal comment period and explains its reasons for rejecting suggested changes.

The regulations were adopted without any specific effective date and in the "Assessment of Public Comment," the Department notes that by law the regulations are technically in effect when they were signed as final. The Department's Assessment of Public Comment" then addressed what it correctly understood the question of "effective date" to mean, which is the extent to which the regulations would be retroactively applied. The Department's answer to that is that, since the regulations interpret the statutory amendments of tax reform, they therefore will be applied to the same periods, *i.e.*, as far back as to the 2015 tax year of the tax reform to the extent a tax reform year is still open under the statute of limitations. However, the Department notes, it may choose not to apply penalties in cases where taxpayers took a position in their tax filings prior to adoption of the proposed rule in reliance upon prior article 9-A regulations or prior drafts of the proposed rule. Below is a summary of what is covered in Parts 1 through 9 of the adopted regulations.

Part 1 addresses when corporations are subject to New York tax and incorporates the state's post-reform economic nexus standard whereby a corporation or combined group will be subject to New York tax if it derives receipts from activity in New York that equals or exceeds $1 million (adjusted periodically for inflation and set at $1.283 million for the 2024 tax year).

This part also provides examples of activities that are, and are not, protected under P.L. 86-272. These examples cover situations where a foreign corporation will be subject to New York tax, and the regulations incorporate aspects of the Multistate Tax Commission's revised Statement on P.L. 86-272. Notably, a business that provides post-sales assistance to customers via email or chat will not be protected under P.L. 86-272 because these activities are not entirely ancillary to solicitation of orders for sales of tangible personal property. Other activities that exceed the scope of P.L. 86-272 protection include a corporation receiving branded credit card applications over its website and allowing prospective employees to submit an electronic application over a website for non-sales positions. The regulations also incorporate the MTC's guidance on the use of cookies by Internet sellers. Cookies placed on customer devises to gather information that will be used to adjust production schedules and inventory amounts, develop new products, or identify new items to offer customers are not protected activities under P.L. 86-272.

Part 2 addresses accounting periods and methods and is largely unchanged from its predecessor regulations.

Part 3 provides guidelines for the computation of tax on the business income base, capital base and the fixed dollar minimum tax. This part is substantially revised and, in addition to capturing the New York tax reform related changes to computing the business income tax base, the regulation also addresses certain federal tax reform items, such as 163(j). Post-reform, New York NOLs are computed on an apportioned basis and are no longer limited to the allowed federal NOL amount. The regulation addresses the post-reform NOL computation, and provides guidance on computing the prior net operating loss conversion subtraction used to convert pre-reform NOLs into a new subtraction to be used in post-reform years.

Part 4: New York's tax reform bills significantly overhauled the state's apportionment rules, including generally adopting customer-based sourcing rules for service receipts in lieu of sourcing service receipts to the location where services were performed. Under the sourcing rules, there is a hierarchy that must be applied to determine a customer's location. The first step in the hierarchy is to look to the location where the customer receives the benefit of the service.

While the general rule sources service receipts to customer location, specific statutory provisions address various types of service receipts. In fact, per the Department's summary of the changes to the Article 9-A regulations, post-reform, there are over 50 categories of receipts and income addressed in the statutory apportionment provisions. The regulation does not address each and every category but, per the Department, provides guidance "where needed." For each category of receipts addressed in the regulation, there are numerous illustrative examples.

The statute was silent with respect to sourcing asset management fees. Of interest to those in the non-real estate asset management industry, the regulation provides a hierarchy to determine where the benefit of a service is received if services are provided to a "passive investment customer" (including a passive corporation or passive partnership, among other business entities), as opposed to an individual customer or a business customer that is an active business. The benefit of management, distribution, and administration services provided to a passive investment customer is presumed to be received at the location of the investors in such passive investment customer unless the investor is holding the interest in the passive investment customer for a beneficial owner. If the investor is holding the interest in the passive investment customer for a beneficial owner, the benefit of the services is presumed to be received at the beneficial owner's location. The location of an individual investor or beneficial owner is its billing address; the location of a non-individual is its principal place of business. Management, distribution and administration services provided to a passive investment customer are apportioned to New York in proportion to the average value of the interests in the passive investment customer held by the passive investment customer's investors and beneficial owners located in New York. To calculate the average value of the interests in, taxpayers are instructed to add the percentage of the value of the interests held by investors and beneficial owners located in New York at the beginning of the taxable year to the percentage of the value of the interests held by investors and beneficial owners located in New York at the end of the taxable year and divide by two. If a corporation cannot determine the location under the general rule, the benefit of management, distribution, and administration services provided to a passive investment customer is presumed to be received at the location where the contract for such services is managed by the passive investment customer. Apparently, that default approach would consider the location of where the contract is managed to be the corporate taxpayer's location of performing such management if it has been delegated with trading authority in that regard. Moreover, the Department rejected public comments on the proposed regulations, which had requested a bifurcated approach to applying this two-step hierarchy, *i.e.*, source to the location of where the passive business entity customer's owners are located to the extent that is known, and source to the default "contract managed location" to the extent such look-thru owners' locations are not known. The Department's explanation for rejecting such bifurcation is that it could pose administrative complexities, and also set up potential tax avoidance "manipulation" strategies for the sourcing. The Department's decision thereby could often lead to the situation where the default approach swallows up the primary approach, if the taxpayer does not have 100 percent knowledge of the locations of the underlying investors of the business entity being managed.

Another point to note is that the regulation recognizes the increasing use of intermediaries to facilitate sales and adopts specific rules for "intermediary transactions." An intermediary transaction means a transaction where the business customer derives value from a product or service (digital or otherwise) at the location of the consumer rather than the location of the business customer itself. Various examples illustrate what, in the Department's view, is and is not considered an intermediary transaction.

Part 5 addresses tax credits and makes minimal changes to its predecessor regulations.

Part 6 provides guidance on New York's reporting requirements. Importantly, Subpart 6-2 implements the tax change to mandatory unitary combined reporting by defining terms, providing explicit guidance, and presenting illustrative examples of the application of the new combined reporting rules in specific circumstances.

Part 7 relates to the payment of tax and estimated tax, as well as collection. It is largely unchanged.

Part 8 is dedicated to the computation of the Metropolitan Transportation Business Tax Surcharge and Part 9 provides definitions of terms and rules pertaining to the following special entities: qualified New York manufacturers, corporate partners, New York S corporations, real estate investment trusts and regulated investment companies, and domestic international sales corporations.

The New York City Department of Finance is expected soon to propose and then enact its own corporate tax reform regulations. It is expected that virtually all of those will be in conformity with those of the State as the State and City tax reform laws were enacted in virtually a parallel manner. However, may be a few areas where the City, nonetheless, diverts from the State. Please contact Russ Levitt or Aaron Balken with questions.