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Tax Section

Report on New York Draft Combined Return Regulations

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I. INTRODUCTION

This Report[1] reviews draft amendments to regulations under New York State Tax Law Article 9-A prepared by the New York State Department of Taxation and Finance (the "**Department**"), relating to combined reports for business corporations. The amendments are intended to provide guidance in interpreting the amendments to New York State Tax Law Section 210-C enacted as part of the 2014 budget legislation (L2014, ch59, §18 (Part A)) (the "**Budget Bill**"). The Budget Bill substantially changed the prior framework under Article 9-A for combined reporting in New York, by adopting mandatory combined reporting for all unitary corporations that meet certain ownership requirements, and by providing taxpayers with the ability to elect to file a combined return with a commonly owned group of corporations. The Department has requested comments on the draft amendments by April 21, 2016.

The Tax Section appreciates the Department's openness in making the draft amendments available for comment before they are formally proposed pursuant to Article 2 of the State Administrative Procedures Act. We commend the Department for having prepared detailed and comprehensive guidance for businesses and practitioners with respect to the substantial changes made by the Budget Bill in an area of the tax law that has been the source of significant audit and litigation activity. As discussed further below, we believe that the guidance with respect to the unitary business requirement—in particular the proposal that the taxpayer or the Commissioner may overcome the presumption by the presentation of evidence that corporations are engaged in a unitary business—should substantially reduce the number of controversies in this area. This report offers the Tax Section's comments and recommendations on some of the draft amendments.

II. SUMMARY OF LAW

The Budget Bill overhauled New York's combined reporting regime. Under the prior rules, corporations satisfying a relatedness test were required to file a combined report if there were "substantial intercorporate transactions" among the related corporations, regardless of the existence of transfer pricing for those intercorporate transactions. In addition, even if there were

[1] The principal drafters of this report were Joshua E. Gewolb, Maria T. Jones, Leah Robinson, Arthur R. Rosen, Irwin M. Slomka, Jack Trachtenberg and Jennifer S. White. Helpful comments were received from Kimberly Blanchard, Peter J. Connors, Peter Faber, Stephen B. Land and Michael Schler. This report reflects solely the views of the Tax Section and not those of the NYSBA Executive Committee or House of Delegates.

no substantial intercorporate transactions among related corporations, the Department could permit or require a combined report if the Department deemed this necessary to properly reflect the tax liability because of intercompany transactions or some agreement, understanding or arrangement or transaction among the corporations, or, in other words, to correct "distortion."

Under Tax Law section 210-C as revised by the Budget Bill, the presence of intercorporate transactions or distortion is no longer relevant in determining whether combined reporting is required or permitted. A taxpayer is required to file a combined report with other corporations engaged in a unitary business with the taxpayer if, and only if:

1. The taxpayer owns or controls either directly or indirectly more than fifty percent of the voting power of the capital stock of one or more other corporations;
2. More than fifty percent of the voting power of the capital stock of the taxpayer is owned or controlled either directly or indirectly by one or more other corporations; or
3. More than fifty percent of the voting power of the capital stock of the taxpayer and the capital stock of one or more other corporations is owned or controlled directly or indirectly by the same interests.

The abolition of the intercorporate transactions and distortion concepts, and changes to the thresholds for determining if corporations are related, represent significant departures from the prior combined reporting regime.

In addition, the revised law introduces the concept of an elective combined group. Specifically, a taxpayer may elect to treat as its combined group all corporations that meet the related corporation test regardless of whether the corporations are part of a unitary business. The election is irrevocable and binding for the applicable tax year made and for the next six tax years. The election will automatically be renewed for another seven taxable years after it has been in effect for seven years unless it is affirmatively revoked.

III. Capital Stock Requirement

A. Draft Regulation

The draft amendments reflect the legislative changes to the capital stock ownership requirements for combined reporting. These ownership requirements also apply to the commonly-owned group election. The new stock ownership requirements for combination are triggered where: (1) a taxpayer owns or controls, directly or indirectly, more than fifty percent of the voting power of the capital stock of one or more other corporations; (2) more than fifty percent of the voting power of the taxpayer's capital stock is owned or controlled, directly or indirectly, by one or more other corporations; or (3) more than fifty percent of the voting power of capital

stock of the taxpayer and one or more other corporations is owned or controlled, directly or indirectly, by the same interests.[2]

B. Comments

In a report commenting on the 2014 corporate income tax reform proposed legislation, the Tax Section recommended that regulations provide for a general rule that the "voting power" requirement for such stock be based on the extent to which the stock confers voting rights for the election of the other corporation's board of directors.[3] This is consistent with the general federal income tax voting power requirement for consolidated returns under Internal Revenue Code section 1504(a)(2)(A). The draft amendments commendably adopt this approach, which provides important clarity in determining the type of "voting power" that will be considered for the capital stock requirement.

The draft amendments also provide that in determining the percentage of voting power of stock, "consideration will be given to all of the facts and circumstances in each case" and set out instances where formal voting rights will be disregarded or otherwise attributed to another stockholder.[4] The Tax Section agrees that the voting power requirement should not be limited exclusively to the right to elect directors where, for example, there are substantial restrictions on the board's actions that serve to reduce the shareholder's voting power.

We recommend that the Department consider having the regulations provide for a rebuttable presumption that the voting power requirement will be met where a corporation owns more than fifty percent of the voting stock for the election of the board of directors of another corporation. This would facilitate the filing and administration of combined returns under Article 9-A for most taxpayers, particularly since there are other significant differences between the federal stock ownership rules for consolidated returns and the Article 9-A related corporation test requirements for combined returns that make it impractical for a taxpayer (or the Department) to determine the voting power requirement based simply on the taxpayer's federal consolidated return.

We envision situations where such a presumption may be rebutted, for example, where actual voting power over a subsidiary's activities do not reside with its parent, or where the "real" power to elect the board of directors resides with someone other than the nominal holder of the voting stock. However, it would be difficult to set forth clear benchmarks in the regulations for ascertaining when voting rights for electing directors will not be the appropriate measure of

[2] N.Y. TAX LAW § 210-C.2(a).

[3] N.Y. ST. BA. ASS'N, TAX SEC., *Report No. 1301 on the Corporate Income Tax Reform Provisions of the New York State 2014-2015 Executive Budget* (Mar. 13, 2014)

[4] Draft Reg. § 6-2.2(f).

voting power. Accordingly, the Tax Section believes that the "facts and circumstances" standard contained in the draft amendments should be sufficient.

The draft amendments also contain several helpful examples—including examples of stock owned through a partnership—that illustrate how the statutory reference to "indirect" stock ownership should be applied. Overall, those examples are consistent with the Tax Section's previous recommendation that in the case of a multi-tiered ownership structure it be made clear that the more than fifty percent stock ownership test should be performed at each tier level. This approach insures that the voting power test for combination accurately takes into account ultimate control. We recommend that an additional example make clear that stock with contingent voting rights should not be treated as having voting power until the contingency is satisfied and the voting rights are effective.

IV. COMMONLY-OWNED GROUP ELECTION

A. Draft Regulation

Draft regulation section 6-2.7 addresses the commonly-owned group election authorized by Tax Law section 210-C(3). The commonly-owned group election permits a taxpayer to include in its combined group all corporations that meet the Tax Law's capital stock requirements, regardless of whether they are engaged in a unitary business.[5] Tax Law section 210-C provides that the commonly-owned group election must be made on an original, timely filed return and that the election shall be irrevocable and binding for seven years.

Draft regulation section 6-2.7(f) states that "the [legislative] purpose of the commonly owned group election is to simplify the filing of returns for commonly owned corporations by avoiding the fact-intensive analysis associated with determining the scope of the unitary business." The draft regulations acknowledge that the application of the election may result in a decrease in New York franchise tax liability, but that the election is for the purpose of simplification rather than "tax reduction." Based on this statement of the election's legislative purpose, the draft regulation proposes to authorize the Commissioner to disregard the election in certain circumstances. Specifically the draft regulation provides that "[a]lthough a commonly owned group election does not require the consent of the Commissioner, in light of this legislative purpose [to simplify the filing of returns] the Commissioner may disregard the tax effects of such an election, where it appears, from facts available at the time of the election, that the election will not have meaningful continuing application."

[5] The commonly owned group election cannot be used to combine an entity that is prohibited from filing on a combined basis. N.Y. TAX LAW §§ 210-C(3)(a), 210-C(2)(c).

As its sole example of when the Commissioner would exercise this proposed authority, the draft regulation provides that the Commissioner would disregard the election where it: (i) was made in anticipation of the sale of a New York business; (ii) would operate to reduce the amount of gain from the sale to be apportioned to New York; and (iii) would be anticipated to have no meaningful impact in New York following the sale:

> [T]he Commissioner would disregard the tax effects of a commonly owned group election made in anticipation of the sale of substantially all of a business conducted in New York where a material part of the anticipated gain from the disposition would be apportioned to New York in the absence of the election and where the sale results in the winding up of the seller's business in New York, such that the continued application of the commonly owned group election would be anticipated to have no meaningful continuing impact in New York.[6]

B. Comments

The Tax Section questions whether the Department has the statutory authority to adopt a rule that grants the Commissioner the authority to disregard an otherwise valid commonly-owned group election. In our view, the statute is void of any language that may be construed to permit either a taxpayer or the Commissioner to disregard the election under any circumstance. We believe that if the Department wants the authority to disregard a validly made commonly-owned group election, it must seek that authority through a statutory amendment.

Rather than relying on any statutory language, the Department appears to be grounding its proposed authority to disregard the commonly-owned group election on its interpretation of the purported intent of the Legislature in adopting the election. We do not think it is appropriate in this instance for the Department to assume a new discretionary power that is beyond the plain language of the statute and for which there is no indication that the Legislature had such an intent. Tax Law section 210-C unequivocally allows taxpayers to unilaterally make the commonly owned group election so long as the capital stock and other statutory requirements of the Tax Law are met. There is no statutory requirement that the election be used for purposes other than tax reduction or that the taxpayer must anticipate the election to have meaningful continuing impact in the years after the election is made. The only statutorily expressed consequence of the election is that it is binding on both the taxpayer and the Department—regardless of whether it increases or decreases the taxpayer's tax liability—for a period of seven years.

[6] Draft Reg. § 6-2.7(f).

According to the draft regulations, the purpose of the commonly-owned group election is simplification. Yet, allowing the Commissioner to disregard the election based on a facts and circumstances analysis (*i.e.*, whether the continued application of the commonly-owned group elec-election would be anticipated to have no meaningful continuing impact in New York at the time it is made) will undoubtedly lead to audit controversy and litigation, and is inconsistent with the certainty and simplicity that the election is intended to provide. Tax elections are designed to (i) provide the taxpayer a free choice between two or more alternatives, and (ii) result in an overt act by the taxpayer communicating the choice to the Commissioner.[7] The draft regulations contravene this purpose by introducing the element of uncertainty into the taxpayer's statutory right to make a choice that binds both it and the Commissioner.

On the other hand, the Tax Section does believe that the Commissioner has the authority to use common law anti-abuse tools, such as requiring economic substance, in determining whether the statutory prerequisites for the election have been satisfied. For example, if a shareholder voting agreement can be shown to be a sham, executed merely to gain eligibility for the election, the Commissioner should be permitted to disregard the election.

If the Commissioner's proposed authority to disregard the election is retained, the Tax Section believes additional guidance is needed as to how the discretionary power will be administered. The single example provided does not offer sufficient guidance. For example, even using the Department's own example, what would happen if at the time the election is made, the taxpayer anticipates the sale of substantially all of the business in year three of the election period? What if the sale is anticipated in year five or year six? In each of these scenarios, would the election be respected in all taxable years prior to the year of the sale or would it be disregarded for all years? What factors would be considered in determining the years for which the election would be respected? And when will taxpayers be viewed as having been able to anticipate that the election will not have a meaningful future impact?

V. UNITARY BUSINESS REQUIREMENT

A. Introductory Remarks

The draft regulation would provide guidance implementing the unitary business requirement as set forth in Tax Law section 201-C. The draft has five subsections: (a) general; (b) attributes of a unitary business; (c) presumptions; (d) examples; and (e) passive holding companies. The draft regulations instruct that unitary determinations be made to the broadest extent permitted by law.

[7] *See* T.A.M. 2002-59-059 (Sept. 10, 2002); *see also* Aubree L. Helvey & Beth Stetson, *The Doctrine of Election*, 62 TAX LAW. 335 (2009).

It is essential to keep in mind that a finding of a unitary business in the context of the new Tax Law provision and the draft regulation is a prerequisite to reaching the conclusion that the filing of a combined return is appropriate.[8] The draft regulation, due to its wide use of rebuttable presumptions, seems to acknowledge that unitary determinations should not be made in an automatic, mechanical manner, but rather with the underlying purpose of combined reporting being paramount. That ultimate purpose—determining the amount of income properly attributable to a taxing jurisdiction—should be kept in mind when arriving at the intermediate conclusion as to whether corporations are conducting a unitary business.

In other words, the determination of whether a unitary business exists should not be made in isolation without considering the ramifications. A number of court decisions from various states seem to reflect this approach. For example, quite recently, the Vermont Supreme Court, in *AIG Insurance Management Services, Inc. v. Vermont Department of Taxes*,[9] rather than merely using a "checklist" of the common unitary indicia, undertook a detailed examination of specific instances (or a lack thereof) of centralized management in the form of operation control, functional integration in the form of corporate goals (investment versus operational), and whether economies of scale could be identified where there were no or minimal intercompany transactions. Similarly, in the Arizona cases of *Arizona Department of Revenue v. Talley Industries, Inc.*[10] and *Arizona Department of Revenue v. Home Depot, Inc.*,[11] the Arizona Court of Appeals determined that a comprehensive review of a wide array of facts and circumstances was necessary to make a unitary business determination.

As noted below, a greater use of examples that demonstrate how the presumptions may be rebutted would ensure that this underlying philosophy will be respected. Since the underlying purpose of combined reporting should be paramount, it appears worthwhile to review the history and purpose of combined reporting.

The unitary business concept can be stated quite simply: when income arises from the operation of a single business enterprise, any state in which some of that enterprise's business activity occurs may seek to tax a portion of such income. It does not matter whether the enterprise operates solely within a single legal entity or across several legal entities.[12] As a result,

[8] We note that the unitary business concept is not confined to the combined reporting provisions. It is relevant, for example, in determining whether stock owned by another corporation is investment capital of the shareholder under Tax Law § 208.5(a). In our view, the definition of "unitary business" should not vary from provision to provision and we recommend that the Department amend other sections of the regulations to incorporate the definition set forth in § 6-2.3.

[9] 2015 Vt. 137 (2015).

[10] 893 P.2d 17 (App. 1994).

[11] 314 P.3d 576 (App. 2013)

[12] A corollary is that even within a single legal entity, there could be multiple separate unitary enterprises.

where the enterprise in fact occurs across several legal entities, combined reporting is a generally accepted method for measuring the enterprise's income.

The unitary business principle arose in the 1800s in the property tax arena. Railroads operated across several states. There was concern that the amount of physical property, such as rails and ties, in a particular state was not representative of the in-state portion of the value of the railroad enterprise. The U.S. Supreme Court determined that it would be appropriate to view the entire railroad as a "unit"[13] and hence the unitary business principle was born.

The next major development in the unitary business principle was extending it to income taxes. In *Underwood Typewriter Co. v. Chamberlain*,[14] the U.S. Supreme Court relied on the unitary business principle for purposes of capturing the out-of-state activities of the taxpayer in the taxpayer's in-state income tax computations. Instead of limiting the state's reach to just those activities occurring within the state's borders, the Court allowed for a "method of apportionment" that looked at "a series of transactions beginning with manufacture in Connecticut and ending with sales in other states." Just four years later, the Supreme Court took a similar position but where the out-of-state operations were largely foreign.[15]

Throughout the 1900s and into the 2000s, the Supreme Court has repeated the principle that a state may tax a portion of the income of a unitary enterprise, whether the enterprise is conducted across states or across entities or both.[16]

In reaction to the unitary principle developments described above, many state revenue agencies and several state courts began adopting somewhat mechanical tests to determine whether two or more legal persons, usually corporations, were jointly engaged in conducting a unitary business and thus should have their state income tax liability computed on the basis of a combined report. For example, California courts developed a "three unities" test[17] and later an interdependency test.[18]

However, the modern jurisprudence, as first articulated in *Mobil Oil Corp. v. Vermont*,[19] and repeated in each of the six subsequent U.S. Supreme Court decisions touching the subject,

[13] *In Re* State R.R. Tax Cases, 92 U.S. 575, 608 (1875); Union Pac. Ry. Co. v. Ryan, 113 U.S. 516 (1884); *see also* Adam's Express v. Ohio St. Auditor, 165 U.S. 194 (1897).

[14] 254 U.S. 113 (1920).

[15] Bass, Ratcliff & Gretton v. State Tax Comm'n, 266 U.S. 271 (1924).

[16] *See, e.g.,* Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983); Allied-Signal, Inc. v. Director, Div. of Tax'n, 504 U.S. 768 (1992); MeadWestVaco Corp. v. Illinois, 553 U.S. 16 (2008).

[17] *See* Butler Bros. v. McGolgan, 315 U.S. 501 (1942).

[18] Edison California Stores, Inc. v. McGolgan, 30 Cal. 2d 472 (1947).

[19] 445 U.S. 425, 438–40 (1980).

and followed by the New York State Tax Appeals Tribunal,[20] is that there is no "test"; rather, there are indicia that can lead to the conclusion that a unitary business is being conducted.[21] These indicia are centralized management, functional integration, and economies of scale between or among activities or entities for a unitary enterprise to exist. Indicia are circumstantial evidence from which a conclusion can be inferred. They are not direct evidence from which a conclusion is inevitable. The inferences drawn from circumstantial evidence can be disputed and overcome, either by other inferences, additional circumstantial evidence, or direct evidence. As such, it is appropriate that the Department treats the presumptions in the draft regulation as rebuttable.

B. Attributes of a Unitary Business

Draft regulation subsection 6-2.3(b) defines a unitary business as one "characterized by a flow of value as evidenced by functional integration, centralized management and economies of scale." Those are the indicia of a unitary business, used by the U.S. Supreme Court in *Mobil Oil*, supra, and other decisions, including those rendered by the Tax Appeals Tribunal as noted above. The draft regulation then provides descriptions of each term**.**

Functional integration would be based on "transfers between, or pooling among, business activities that significantly affect the operation of the business activities." The draft regulation specifies that the use of arm's length pricing does not negate the presence of functional integration.

Centralized management would be based on joint participation by personnel in the "management decisions that affect the respective business activities and that also operate to the benefit of the entire economic enterprise." The focus would be on whether management has "an operational role with respect to the business activities" and not day-to-day management.

"Economies of scale" would be based on a "significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size." It may be based on the inherent cost savings arising from functional integration and centralized management.

[20] SunGard Capital Corp., N.Y. Div. of Tax App., Tax Appeals Tribunal, DTA Nos. 823631, 823632, 823680, 824167, and 824256, May 19, 2015, *rev'g* Administrative Law Judge decision, dated April 3, 2014; Heidelberg Eastern, Inc.; East Asiatic Company, Inc, N.Y. Div. of Tax App., Tax Appeals Tribunal, DTA Nos. 806890, 807829 (May 5, 1994).

[21] Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207 (1980); ASARCO Inc. v. Idaho St. Tax Comm'n, 458 U.S. 307 (1982); Woolworth Co. v. Taxation Dep't, 458 U.S. 354 (1982); Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983); Allied-Signal Inc. v. Director, Div. of Tax'n, 504 U.S. 768 (1992); MeadWestvaco Corp. v. Illinois Dept. of Revenue, 553 U.S. 16 (2008).

The draft indicates that the three indicia should be analyzed in conjunction with one another "for their cumulative effect."

We applaud the Department for providing meaningful definitions of the various indicia of a unitary business and for recognizing that they are, indeed, mere indicia. Those definitions could be supplemented with examples, perhaps using fact patterns from New York's leading cases in this area. It would be particularly helpful if examples demonstrated the types and amount of evidence that would be acceptable.

C. Presumptions

The draft regulation provides five presumptions in draft regulation subsection 6-2.3(c), with examples in draft subsection 6-2.3(d). The presumptions are described as being rebuttable by either the taxpayer or the Department upon presentation of clear and convincing evidence that the corporations are not engaged in a unitary business. If some or none of the presumptions are triggered, the unitary determination will be based on all of the facts and circumstances with no presumption in place.

Each presumption presumes that the capital stock requirement described in draft regulation subsection 6-2.2 has been satisfied. For ease of discussion here, corporations that satisfy the capital stock requirement will be described as "related corporations."

We applaud the Department for including numerous examples in its draft regulation.

Below we provide a general comment on the presumptions and then discuss each presumption and separately comment on each.

1. General Comments on the Presumptions

In a report containing recommendations regarding the 2014 corporate tax reform legislation, the Tax Section recommended that the Department consider establishing a list of factors that if present would create a rebuttable presumption of the existence of a unitary business.[22] The Department commendably has adopted this approach in the draft amendments, which should help minimize audit and litigation activity in this area.

The draft regulation expressly indicates that the presumptions are rebuttable. As such, it would be very helpful if the draft provided a discussion of how the presumptions may be rebutted and provided examples of successfully rebutting each of the presumptions.[23] Specific

[22] N.Y. ST. BA. ASS'N, TAX SEC., *Report No. 1312 on Guidance Under the New York State Corporate Tax Reform Provisions* (Nov. 20, 2014).

[23] The draft regulation indicates that the standard of proof for rebutting a presumption by a taxpayer or the Department is "clear and convincing evidence." We suggest the Department consider the lower standard of

discussion of the types of proof also would be helpful. As there is no generally accepted definition of a unitary business, in contrast to the commonly acknowledged indicia of such a business, as noted above, the ultimate determination of whether there is a unitary business should focus on achieving the proper reflection of income attributable to New York.

2. Horizontal Integration

(a) Presumption and Example

The first presumption relates to "horizontal integration."[24] A unitary group is presumed to exist among related corporations "when all of their activities are in the same general line of business." Example #1 demonstrates this presumption. Corporations *A* and *B* sell specialty foods in the United States; Corporation *C* sells specialty foods in Canada. Because *A*, *B*, and *C* are in the same general line of business, the horizontal integration presumption has been triggered.

(b) Comments

We are not aware of any controlling case law in which a corporation engaged in the same general line of business, but not demonstrating functional integration, centralized management, and economies of scale, was found to be engaged in a unitary business. [25] Thus, we question the efficacy of this presumption as a standalone factor.

It is unclear what is meant by "*all*" of the related corporations' activities being in the same general line of business. Does this mean that if, in Example #1, Corporation *A* sold specialty food and also engaged in various intercompany services but that Corporations *B* and *C* only sold specialty food that the presumption would not be triggered between *A* and the others but would still be triggered between *B* and *C*?

"preponderance of the evidence." Because the presumptions relate to mere indicia of a unitary business conclusion (*i.e.*, circumstantial evidence), disproving the conclusion by a preponderance of evidence—that is, by a showing that there is a greater than fifty percent chance that the conclusion is not true—should be sufficient. Once the presumption has been overcome, the side urging combination could still provide direct evidence of the unitary business.

[24] Draft Reg. § 6-2.3(c)(1).

[25] In Woolworth Co. v. Tax'n Dep't, 485 U.S. 354 (1982), the U.S Supreme Court found that a horizontally integrated business was not unitary.

3. Vertical Integration

(a) Presumption and Example

The second presumption relates to "vertical integration." A unitary group is presumed to exist among related corporations that "are engaged in different steps in a vertically structured enterprise." Example #2 demonstrates this presumption. Corporations *A*, *B*, *C*, and *D* are each engaged in a different step in the oil extraction process. Because *A*, *B*, *C*, and *D* are engaged in different steps of a vertically-structured enterprise, the vertical integration presumption has been triggered.

(b) Comments

Traditionally, being engaged in the same vertical structure has often been considered characteristic of functional integration and may imply centralized management and economies of scale (but not always).[26] Thus, it is clear to see how this example is rooted in the underlying principles of the unitary business concept. It would be helpful to include a discussion of how this presumption could be rebutted, as well as an example.

4. Strong Centralized Management

(a) Presumption and Example

The third presumption relates to "strong centralized management." A unitary group is presumed to exist among related corporations "that might otherwise be considered as engaged in more than one unitary business … where there is strong centralized management coupled with the existence of centralized departments or affiliates for such functions as financing, advertising, research and development, or purchasing."

Example #3 describes Corporations *A*, *B*, and *C* being engaged in one line of business (clothing sales) and Corporations *D* and *E* being engaged in another line of business (restaurants). Corporation *F* provides centralized services and its officers are "actively engaged in the operations" of the other corporations. The example presumes that *A*, *B*, and *C* are unitary with each other, and that *D* and *E* are unitary with each other (based on horizontal integration, as discussed above). Because *F* provides centralized functions and operational management to the others, the strong centralized management presumption is triggered.

[26] ASARCO Inc. v. Idaho St. Tax Comm'n, 458 U.S. 307 (1982); Woolworth Co. v. Tax'n Dep't, 458 U.S. 354 (1982).

(b) Comments

We applaud the Department for hinging its presumption on something more than a mere overlap in the slate of directors or officers. However, the term "strong centralized management," while used in case law elsewhere,[27] does not provide clear guidance. For example, it has been established that only actual control—as opposed to a mere potential to control—the operations of an entity or asset is required for entities or assets to be unitary.[28] If the Department intends "strong centralized management" to mean "actual operational control," it would be helpful for that point to be clarified. In fact, it would be helpful if the two separate concepts—(1) actual control versus the potential to control, and (2) operational control versus corporate governance—were each clearly enunciated in the draft regulation. *ASARCO* dictates that actual control is required for there to be a unitary business and that the mere potential to control is insufficient. *Woolworth Co. v. Taxation Department* dictates that meaningful operational control beyond the normal corporate governance any parent corporation would be expected to perform for its subsidiaries is required for there to be a unitary business.

5. Newly-Formed Corporations

(a) Presumption and Example

The fourth presumption relates to newly-formed corporations. A newly-formed corporation is presumed to be engaged in a unitary business with the forming corporation or corporations from the date the capital stock requirement described in draft subsection 6-2.2 is satisfied. There is no example demonstrating this presumption.

(b) Comments

This presumption appears to reflect the position that mere ownership without any other factors could result in a unitary relationship between corporations. We question whether this is the view the Department should adopt. Unlike several of other presumptions, this presumption does not appear to be rooted in the underlying principles of the unitary business concept. For example, if a corporation forms a subsidiary to pursue a new line of business that is to be operated relatively independently and is staffed with newly hired individuals, then none of the indicia of a unitary enterprise would seem to exist.

[27] *See, e.g.*, AIG, *supra* note 9.

[28] ASARCO, *supra* note 26.

6. Newly-Acquired Corporations

(a) Presumption and Examples

The fifth presumption relates to newly-acquired corporations. A newly-acquired corporation is presumed to be engaged in a unitary business with the acquiring corporation during the "first taxable year" that the corporations satisfy the capital stock requirement described in draft subsection 6-2.2 but only if the corporations also trigger one or more of the first through third presumptions described above.

Example #6 describes Corporation *A* and its newly-acquired subsidiary, Corporation *B*. Corporations *A* and *B* are engaged in a vertically-integrated business. Because the stock ownership requirement and another presumption were satisfied, the newly-acquired corporation presumption was triggered.

(b) Comments

To the extent this presumption relies upon triggering another presumption, the comments relating to the other presumptions are incorporated herein by reference.

In addition, our experience is that the Department's prior audit approach reflected the position that it takes a while for previously independent entities to integrate enough to comprise a unitary business. While there are certainly exceptions, particularly among companies that routinely acquire existing business, the prior audit position seemed well grounded. The draft regulation presumption, however, takes the opposite approach indicating that instant unity is presumed. We urge the Department to reconsider including this presumption in the draft regulation, instead leaving each new entity acquisition to stand on its particular facts and circumstances alone, without any presumption.

7. Additional Example #4

(a) Example

Example #4 is not clearly associated with any of the presumptions listed in subsection 6-2.3(c). Example #4 describes Corporation *A* as providing centralized cash management services to Corporations *B*, *C*, and *D*. This includes a cash sweep and routine interest-free lending from a centralized account managed by Corporation *A*. Corporation *A* does not have any other interaction with Corporations *B*, *C*, or *D*. Corporations *A*, *B*, *C*, and *D* are presumed to be engaged in a unitary business.

(b) Comment

Example #4 does not appear to trigger any of the presumptions listed in subsection 6-2.3(c). We recommend that the example be removed or that the list of presumptions be altered to reflect the presumption underlying this example.

In addition, the example specifies the intercompany pricing for the loan activity (zero percent interest). The purpose of specifying the price, particularly since distortion is no longer a controlling concept, is not clear in the example.

8. Additional Example #5

(a) Example

Example #5 describes Corporation *A* transferring all of its intellectual property to Corporation *B* in exchange for its stock. The corporations are presumed to be engaged in a unitary business.

(b) Comment

Example #5 does not appear to trigger any of the presumptions listed in subsection 6-2.3(c). We recommend that the list of presumptions be altered to reflect the presumption underlying this example. To the extent that the conclusion is based on the newly-formed corporation presumption, we believe that our comments above regarding instant unity should be taken into consideration. Alternatively, this example may not be needed at all since it should be covered by the presumptions related to the treatment of newly created corporations.

In a discussion of how to rebut this presumption, it would be helpful to include guidance on such topics as, for example, what if the intellectual property is not used by Corporation *A* or other corporations in the combined group?

9. Passive Holding Companies

(a) Presumption

The draft regulation discusses the role of passive holding companies separately from its discussion of the attributes of a unitary business, presumptions regarding a unitary business, and examples thereof. Under a separate subheading, the draft indicates that if "a passive holding company" meets the capital stock requirement described in section 6-2.2 then it shall be deemed to be engaged in a unitary business with the related corporation or corporations.

(b) Comments

The Tax Section believes that a separate regulation on passive holding companies is unnecessary. In our view, the determination as to whether a passive holding company should or should not be included in a combined report should be made using the same unitary business analysis and presumptions applied to any other corporation. This eliminates any controversy over whether a particular corporation is or is not a "passive" holding company, which has been an audit issue in the past.

We note that the placement of the passive holding company language in subsection 6-2.3(e) makes it unclear as to whether the rebuttability discussed in subsection 6-2.3(c) applies. Because mere ownership has not traditionally been enough to create a unitary business (as discussed above), we encourage the Department to treat this presumption as rebuttable, if a separate regulation on passive holding companies is retained.

Further, as noted above, it is unclear what is meant by a "passive" holding company has been an issue on audits. How much activity conducted by the corporation would cause it not to be "passive"? An example reflecting a passive holding company and an example where the holding company's activities are not considered to be passive would be very helpful.

VI. PUBLIC LAW 86-272 CORPORATIONS

The proposed regulations do not address corporations covered by Public Law 86-272,[29] which restricts a state from imposing a net income tax on the income of an entity whose only business activities within the state consist of no more than the solicitation of orders for sales of tangible personal property provided that the orders are sent outside the state for approval and the goods are delivered from outside the state.[30]

The regulations should state that corporations protected by P.L. 86-272 are not considered taxpayers as defined in the regulations. They should further clarify that if all the members of the unitary group are protected by P. L. 86-272, no members of the unitary group are considered taxpayers and that the unitary group would not be required to file a combined report. This is consistent with the informal "FAQ" guidance currently posted on the Department's website, which should be formalized in the regulations.[31]

[29] 15 U.S.C. §§ 381–384.

[30] *See* N.Y. ST. BA. ASS'N, TAX SEC., *Report No. 1334 on Draft Amendments to Regulations Regarding Corporations Subject to Article 9-A Tax* (Dec. 3, 2015), at 17 *et. seq.* for a discussion of draft Reg. § 1-3.2(a)(3) relating to nexus determinations with respect to corporations protected under P.L. 86-272.

[31] https://www.tax.ny.gov/bus/ct/corp_tax_reform_faqs.htm.