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December 22, 1995

FEDERAL EXPRESS

The Honorable Michael H. Urbach
Commissioner
Department of Taxation & Finance
W.A. Harriman Campus, Building 9
Albany, NY 12227

The Honorable Alfred C. Cerullo, III
New York City Department of Finance
1 Centre Street, Room 500
New York, NY 10007

Re: Corporate Expense Attribution

Dear Commissioner Urbach and Commissioner Cerullo:

I am pleased to enclose a report of the New York State Bar Association Tax Section on the recent New York State and City noninterest expense attribution proposals. We are most pleased by the unprecedented degree of State/City cooperation evident in these proposals. This kind of joint effort to reduce complexity, confusion and the burden of multiple audits is most needed and most welcome.

Our report sets forth a number of issues and questions raised by the proposals. Some of these issues are relatively minor, while others, such as the treatment of combined groups under the proposals, reflect fundamental issues that must be addressed for the proposals to be meaningfully applied to those taxpayers.

We recognize your interest in promulgating guidance quickly, so that taxpayers can use these proposals in preparing their 1995 returns. We also believe that a test period is needed, for the actual application of the proposals to corporate returns will likely flush out additional questions. We believe that

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the promulgation of the proposals as a State TSB-M and a City SAP is a very useful approach, for this both serves to provide guidance quickly, and leaves the State and City sufficient flexibility to refine the proposals as issues arise. After these proposals have been tested in use, we urge that they be finalized as a State Regulation and a City Rule, so that the final guidance will be provided in a formal and binding form.

We are pleased with the proposals and with the joint effort they reflect, and we thank you for including the Tax Section in the development of these proposals.

Very truly yours,

A handwritten signature in cursive script, appearing to read "Carolyn Joy Lee". The signature is written in black ink and is positioned above the typed name.

Carolyn Joy Lee
Chair

**REPORT ON NEW YORK STATE AND
NEW YORK CITY CORPORATION TAX PROPOSALS
REGARDING ATTRIBUTION OF NONINTEREST EXPENSES¹**

The New York State Department of Taxation and Finance and the New York City Department of Finance have jointly proposed major changes in the method utilized to attribute expenses other than interest to the three categories of income; the same changes would apply in attributing liabilities other than debt (i.e., liabilities that do not primarily generate interest payments) to the three categories of capital. This report examines the proposed changes and, while generally supporting the changes because their adoption would certainly improve the current situation which is rife with uncertainty and controversy, raises some conceptual issues and notes some technical problems. The Tax Section is mindful of the public statements made by various State and City tax officials that these proposals are intended to reduce substantially taxpayers' administrative and economic burdens imposed by the current situation.

Most significant is the collaborative process by which the proposals were developed; the cooperation and coordination between and among the State, the City, taxpayer groups, and professional organization merits extreme commendation. The Tax Section is pleased to have been able to participate in the development of the proposals. The expeditious process that was implemented so that the proposals could be effective for taxable years beginning in 1995 is also to be commended because all parties are obviously best served when contentious areas, such as this, are addressed

¹ The author of this report was Arthur R. Rosen. Helpful comments were contributed by Robert Brown, Paul Butler, James Fisher, Carolyn Lee, James Locke, and William Randolph.

quickly, as well as fairly.

BACKGROUND

General. In determining a general business corporation's liability for the New York State corporation franchise tax imposed by Article 9-A of the Tax Law and for the New York City general corporation tax imposed by Title 11 of the New York City Administrative Code, the corporation must compute its tentative tax pursuant to each of four alternative bases; whichever base yields the greatest amount of tax is then utilized to determine the actual tax due.² Two of the State tax bases, "entire net income" and "capital," are virtually identical to two of the City tax bases. The proposed changes would affect both these bases. Inasmuch as the ultimate liability of a large majority of corporate taxpayers is computed pursuant to the entire net income base, the proposal will likely have a far-reaching impact.

The first conceptual step in computing a corporation's tax based on entire net income is to trifurcate its federal taxable income into (1) "subsidiary income," (2) "investment income," and the residual category of (3) "business income." Subsidiary income (i.e., dividends, gains and certain interest from subsidiary investments) is nontaxable and is simply excluded from the tax computation.³ Investment income (i.e., dividends, gains, and interest from nonsubsidiary investments) is apportioned to New York utilizing the taxpayer's Investment Allocation Percentage, which is a weighted average of the portion of each investment issuer's total capital that

² N.Y. Tax Law § 210.1; N.Y.C. Administrative Code § 11-604.1.E.

³ Tax Law § 208.9(a)(1); Admin. Code § 11-602.8(a)(1).

is employed in New York.⁴ Business income (i.e., federal taxable income less subsidiary and investment income) is apportioned to New York utilizing the taxpayer's Business Allocation Percentage, which is an average of the taxpayer's property, payroll, and receipts that are assignable to New York.⁵ A substantial tax rate is then applied to the sum of apportioned business income and apportioned investment income.⁶

Computing a corporation's tax based on capital requires a similar trifurcation. Subsidiary capital is apportioned to New York by multiplying each investment in and advance to a subsidiary by a fraction representing the portion of the respective subsidiary's capital (i.e., the subsidiary's own business, investment and subsidiary capital) that is apportioned to New York.⁷ Investment capital and business capital are apportioned to New York utilizing the same Investment Allocation Percentage and Business Allocation Percentage described above.⁸ An extremely small tax rate is applied to apportioned subsidiary capital⁹ and relatively low tax rate is applied to the sum of apportioned investment capital and business capital.¹⁰

Implications. As a consequence of apportioned subsidiary income being excluded from tax and apportioned subsidiary capital being taxed at an extremely low rate, attributing income and capital to the subsidiary category has the

⁴ Tax Law §210.3(b); Admin. Code § 11-604.3(b).

⁵ Tax Law §210.3(a); Admin. Code § 11-604.3(a).

⁶ Tax Law §210.1(a); Admin. Code § 11-604.1.E.

⁷ Tax Law §210.7; Admin. Code § 11-604.7.

⁸ Tax Law §210.4 and .5; Admin. Code § 11-604.4 and .5.

⁹ Tax Law §210.1(e); Admin. Code § 11-604.1.E.

¹⁰ Tax Law §210(b); Admin. Code § 11-604.1.E.

effect of reducing corporate tax liabilities. And because most taxpayers have an Investment Allocation Percentage substantially lower than their Business Allocation Percentage, attributing more income and capital to the investment category and accordingly less to the business category will usually reduce taxes as well. Thus, in terms of deductions, taxes are reduced by attributing a minimum portion or no expenses and liabilities to subsidiary income and capital, respectively, and also are generally reduced by minimizing the portion of expenses and liabilities to investment income and capital, respectively. Stated differently, attributing expenses and liabilities to business income and capital, respectively, generally reduces taxes. Given these implications of attributing expenses and liabilities, there has been considerable tension and controversy between taxpayers and the State and City regarding the appropriate allocation of expenses and liabilities.

Prior Law. Prior to statutory changes made in 1987 and 1988, the Tax Law and the Administrative Code gave the State Commissioner and the City Commissioner, respectively, the discretion to modify federal taxable income by disallowing deductions for noninterest expenses that were *directly* attributable to subsidiary capital (in contrast, deductions for interest expenses that were *directly or indirectly* attributable to subsidiary capital were subject to such treatment).¹¹ In computing the capital bases, only liabilities that were due and payable within one year from their creation were deductible.¹² While this scheme generated some controversy

¹¹ Former Tax Law § 208.9(b)(6), amended, Laws of 1987, ch. 817; Former Admin. Code § 602.8(b)(6), amended, Laws of 1988, ch. 525.

¹² Former Tax Law § 208.5, .6 and .7; amended, Laws of 1987, ch 817; Former Admin. Code § 602.3, .4 and .5, amended, Laws of 1988, ch. 525.

in connection with the deductibility of interest expenses,¹³ little controversy arose in connection with noninterest expenses because only those noninterest expenses that were very clearly and directly related to subsidiary capital were disallowed.

Current Law. As part of New York's reaction to the federal tax changes enacted in 1986, the State and City corporation tax statutes were amended in 1987 and 1988, respectively, to give the Commissioners discretion to attribute expenses indirectly to the three categories of income and capital. The Department of Taxation and Finance reacted by issuing a TSB-M in 1988¹⁴ requiring (a) attribution of all direct expenses to each of the three categories and (b) attribution of any remaining expenses by an asset formula (although taxpayers could suggest other formulas). The Department of Finance reacted by issuing an SAP¹⁵ strongly encouraging direct attribution and providing for indirect attribution by formula (and stating that in the absence of any more reasonable formula, an asset formula was to be used).

¹³ See, e.g. Unimax Corp. v. Tax Appeals Tribunal, 79 NY 2d 139 (1992); F.W. Woolworth Co. v. State Tax Comm'n, 126 AD 2d 876 (3d Dep't 1987); Matter of Volt Information Sciences, Inc., NYS Tax Appeals Tribunal (Oct. 15, 1992); Matter of Siemens Capital Corp., NYS Tax Appeals Tribunal (Nov. 3, 1994).

¹⁴ TSB-M-88(5)C (Oct. 14, 1988)

¹⁵ SAP 93-1-GCT (Mar. 1, 1993)

THE PROPOSALS

The proposals address the direct and indirect attribution of noninterest expenses (and liabilities) to income (and capital) to the three categories of business, investment, and subsidiary.¹⁶ Specifically, the proposals (1) indicate that certain categories of noninterest expenses will irrebuttably be presumed to be attributed to business income, (2) provide guidelines for directly attributing other noninterest expense, and (3) set forth two alternative formulas for indirectly attributing any remaining noninterest expense.¹⁷

Automatic Attribution to Business. Under the proposals, many common corporate overhead and operating expenses are irrebuttably assumed to be attributable to business income, irrespective of the relevant facts and circumstances. Included in the list of such expenses are:

- (a) cost of goods sold;
- (b) bad debts other than items properly classified as subsidiary or investment capital;
- (c) property, excise and sales and use taxes;
- (d) real estate rents, depreciation and repairs;

¹⁶ In the balance of this report, any discussion of the attribution of expenses to income should be read to include an analogous discussion of the attribution of liabilities to capital.

¹⁷ The current policies regarding the attribution of interest expense (and debt liabilities) remain unaffected.

- (e) utilities, including telecommunications costs;
- (f) amortization of real property leasehold costs and improvements;
- (g) depletion;
- (h) advertising;
- (i) noninterest expenses for which reimbursement is received in the form of a management fee treated on the return as business income;
- (j) research and development expenses;
- (k) marketing expenses;
- (l) property and casualty and product liability insurance;
- (m) compensation packages of the chief executive officer, chief financial officer and chief operating officer;
- (n) directors' fees, expenses and indemnity insurance;
- (o) charitable contributions;
- (p) stationery, printing, postage and other similar distribution costs;
- (q) noninterest costs and expenses relating to communication and interaction with the taxpayer's shareholders and investors;
- (r) noninterest costs and expenses relating to routine reporting

requirements of the Securities and Exchange Commission, routine financial statements and tax filings;

- (s) travel and entertainment expenses;
- (t) noninterest costs and expenses incurred in connection with an unsuccessful acquisition;
- (u) noninterest costs and expenses of developing company- or group-wide administrative procedures; and
- (v) internal auditing costs and expenses.

Direct Attribution. The proposals encourage direct attribution of noninterest expenses and envision the use of indirect attribution only as a last resort. Each noninterest expense “that proximately and not incidentally benefits” one or more categories of income is to be directly attributed to that or those categories. The proposals permit direct attribution of noninterest expense to more than one category of income through the use of indirect formulas that incorporate factors such as time, space, payroll, and headcount.

If 95% or more of the noninterest expenses of an “operating division” are directly attributable to a single category of income, the balance of that division’s noninterest expense also may be attributed to that same category. An “operating division” is defined as a sub-unit of a corporation the activities of which “constitute a trade or business” and for which a “separate set of books and records is maintained.”

Indirect Attribution. Unless a taxpayer elects to utilize the alternative formula described below, all noninterest expenses that have not been attributed directly to one or more categories of income are to be indirectly attributed through the use of a two-factor formula consisting of a single-weighted asset factor and a double-weighted income factor. The income factor is the taxpayer's gross income from each category divided by the taxpayer's total gross income (as defined in Internal Revenue Code section 61, as adjusted pursuant to New York statutory modifications). The asset factor is the average value of each category of the taxpayer's capital divided by the average value of the taxpayer's total capital (average value is computed without any reduction for liabilities and is determined as follows: real property and marketable securities at fair market value; other property as shown on the taxpayer's books and records maintained in accordance with generally accepted accounting principles). Pursuant to this formula, for example, a corporation with \$20 of noninterest expenses remaining after direct attribution has been completed, subsidiary income of \$1, gross income of \$3, investments in subsidiaries of \$5, and total assets of \$10 would indirectly attribute its noninterest expense to subsidiary capital as follows: $\$20 \times \left\{ \left[\left(\frac{2}{3} \right) + \frac{5}{10} \right] \div 3 \right\}$, or \$7.78.

In the alternative, taxpayers could irrevocably elect to utilize a single-factor asset formula for the indirect attribution of noninterest expenses (assets will be valued in the same manner as in the 2-factor formula discussed above; this formula is the current method generally followed by the State and City for the indirect attribution of noninterest, as well as interest, expenses. In the example above, this alternative would result in the attribution of noninterest expense to subsidiary capital as follows:

\$20 x (5/10), or \$10.00.

State and City Conformity. The proposals state that each jurisdiction will abide by the other jurisdiction's audit findings. This conformity will be effective only if the first jurisdiction's audit of expense attribution for the year at issue has been "completed" prior to the "commencement" of the second jurisdiction's audit. The City's proposal states that the City and the State have agreed to confer if the two jurisdictions' audits are proceeding simultaneously; the State's proposal is silent on this point.

COMMENTS

General. The State proposal is in the form of a draft Taxpayer Services Bureau Memorandum (a "TSB-M"); the City proposal is in the form of a draft Statement of Audit Procedure (an "SAP").¹⁸ We understand that the proposals are intended to be adopted utilizing these relatively informal (i.e., not statutorily sanctioned nor legally binding) but expeditious vehicles so that the proposals can, as a practical matter, be implemented for taxable years beginning during or after 1995. We wholeheartedly support this approach for two reasons.

First, the concept of indirect expense attribution, when initially proposed in 1987, was viewed by us as a provision that "would compound the confusion in an already troublesome area in order to produce what we would judge to be relatively

¹⁸ A thorough review of the draft is needed to identify and correct typographical/clerical errors. For example, the State proposal's sections are as follows: "I", "II", "III", "(V)" and "(VI)". Similarly, the cross-reference in the final paragraph on page 14 of the State proposal is to a nonexistent section.

small amounts of revenue.”¹⁹ Experience since enactment seems to have validated this thought. Therefore, because these proposals would simplify the area and reduce the tax and administrative burdens on taxpayers, we believe expeditious implementation is extremely desirable.

Second, utilizing a TSB-M and an SAP will allow for the new attribution scheme to be tested for a short period while permitting refinements to be made easily. As noted in the balance of this report, there are a number of such refinements that we believe are warranted. Further, the complexity and far-reaching implications of the proposals will surely result in the identification of other items that will also need addressing.

We strongly recommend that after the expiration of this “test period,” the State and City adopt the proposals, with any needed changes, as formal regulations and rules, respectively (we note that the City’s proposal announces such a plan). Such formal, legally binding promulgation will provide additional comfort and security for taxpayers, an announced goal of the proposals.

The proposals state that “discretionary adjustments” is a separate issue from expense attribution. The potential interplay between such adjustments and noninterest expense should be explained fully.

Effective Date. The proposals state that they are to be applied for tax years beginning after 1994. We believe that the proposals’ provisions should be

¹⁹ “Report on Proposals to Amend New York Corporate Taxation,” New York State Bar Association Tax Section, Report #566, July, 1987.

utilized as guidelines in connection with audits of prior years. Inasmuch as there were no related statutory changes effective in 1995 nor any relevant adjudicatory decisions that generated the proposals, and because no formal regulations or rules have ever been promulgated to address indirect attribution, there appears to be no reason to restrict the applicability of the proposals to years after 1994. The proposals' objective announced in the preamble -- improving the New York business climate (i.e., easing taxpayer burdens) in an effort to maintain and enhance New York's attractiveness as a location for corporate headquarters -- is just as relevant to audits of years prior to 1995 as to subsequent years.

Combined Reporting. The interplay between these proposals and combined reporting is unclear. Currently, for example, the City auditors usually attribute expenses on a combined basis while State auditors often perform attribution on a separate company basis. To make the proposals' goal of State and City conformity achievable, there needs to be uniformity in this area; otherwise, the application of identical principles to different numbers will result in inconsistent results. In addition, provisions permitting elections under the proposals would need to be explicit regarding whether the election can be made independently by each member of a combined group or whether all members must make the same election. While we understand that the State is currently considering a more plenary position regarding when a combined group of corporations is to be treated as a single taxpayer for various franchise tax purposes (an issue on which we have not yet developed a position), we believe that the pendency of such a project should not delay a decision with reference to noninterest expense attribution (because implementation of the instant

proposals can be successful only if the issue has been resolved).

Direct Attribution.

A. The irrebuttable direct attribution of certain categories of expenses to business capital is, we understand, intended to benefit taxpayers. For taxpayers whose income is largely derived from investments, however, this could be harmful because a large portion of their expenses that are attributed to business income could exceed business income (before expenses), and therefore would effectively be nondeductible. Similarly, the ultimate benefit of deductions could be substantially diluted for a corporation with an investment allocation percentage that is larger than its business allocation percentage. Accordingly, consideration should be given to making the proposed “automatic attribution” an election or a safe harbor, rather than an irrebuttable presumption, at least in those cases where a substantial portion of a taxpayer’s activities relates to investment and/or subsidiary income and capital.

B. The list of officers whose compensation will be irrebuttably presumed to be attributable to business capital should indicate that the list is intended to identify duties, not official titles. Otherwise, mere nomenclature (i.e., “form”) would be determinative. Perhaps the alternative of “the three highest-compensated individuals” should be considered.

C. Under the proposals, expenses related to SEC-required reports would be irrebuttably presumed to be attributable to business income. We believe that the intent of this provision would be met, and confusion would be reduced, if reports and

statements required by other regulatory agencies and by securities exchanges were treated in the same manner as SEC-required reports.

D. The proposals state that costs of shipping goods to customers may, if the facts so warrant, be directly attributable to business. It would seem that such costs are more clearly related to business income than many of the items included in the list of expenses that are to be irrebuttably presumed attributed to business income (see “Automatic Attribution to Business,” above). Accordingly, we recommend that such shipping costs be added to the “irrebuttable presumption” list.

E. The proposals state that if 95% or more of an operating division’s non-interest expenses are attributable to a certain category of income, the balance of such expenses “may” also be so attributed. We understand that this provision was intended to reduce the compliance burdens of many taxpayers. The manner in which the provision is worded (i.e. there is no indication regarding *who* may make the attribution of the remaining 5%-or-less of expenses) could be interpreted as meaning that the auditors may attribute the balance. We suggest that the proposals make clear that it is taxpayers who have the option of utilizing this provision.

F. As noted above, the 95% rule applicable to operating divisions is intended to ease taxpayer compliance burdens. In this vein, perhaps consideration should be given to adopting a comparable provision in terms of a specific dollar amount so as to ease the compliance burden on smaller businesses. For example, if a taxpayer’s total expenses are less than a certain amount (or if an operating division’s expenses are less than that amount), all noninterest expenses of the taxpayer (or its

division) could, at the taxpayer's option, be attributed to business income.

G. Although the proposals attempt to provide a comprehensive definition of an operating division that would qualify for the 95% rule, further clarification is needed. This is especially true in the context of the requirement that the division's activities "must ordinarily include every operation that forms a part of, or is a step in, an income producing or profit making process, including the collection of income and the payment of expenses." Does this mean that if otherwise independent divisions jointly utilize an affiliate for factoring, those divisions will not qualify? Would the use of a common paymaster disqualify otherwise independent divisions? We believe that such an interpretation would be overly restrictive and inconsistent with the goal of reducing compliance burdens. Consequently, we suggest that examples be provided that make clear that certain activities, such as those just described, need not be conducted by a division for it to qualify for the 95% rule.

H. Arguments could be propounded supporting classifying financing costs either as noninterest expense or as interest expense. Such costs, which may include commitment fees and appraisals, for example, are sometimes substantial. We suggest that the proposals make clear whether such items are to be attributed as noninterest or as interest.

I. The proposals use the term "officers" in connection with attributing costs related to specified activities conducted by certain individuals. Inasmuch as the nature of the activity, rather than the title of the actor, is relevant in determining to which category an activity is related, the term "employee" may be more appropriate.

J. The proposals provide a list of examples of noninterest deductions that are attributable to subsidiary capital. Excepted from this list are deductions “in subparagraph (i)(A)”, which are the items that are irrebuttably presumed to be attributable to business. In addition, items that have been directly attributed, due to the facts and circumstances, to business or investment (such as some of the items listed in subparagraph (i)(B)) should also be excepted.

K. Additional examples of alternative approaches that are acceptable for directly attributing certain “overhead” expenses would be very helpful. For example, what are the conceivable options for apportioning the depreciation of a computer used by an accounting department?

L. In the examples of expenses that may be directly attributed to business income, “(c)” should state “. . . such as certain costs. . . .” This should help to eliminate confusion caused by the proposals’ reference to costs that are often capitalized. For example, the proposals state that deductible legal expenses incurred to acquire a patent used in the taxpayer’s business would be directly attributed to business income. This may be confusing to some readers because, although the proposals do state that deductible expenses are being addressed, the described expenditures are usually capitalized.

M. The discussion of management fees needs to be expanded. For examples, it is not clear how “lump sum” management fees are to be handled (see Colt

Industries ²⁰). The proposals' apparent goal in the reimbursed management fee area would seem to be met if the respective books and records reflected appropriate treatment so that the correct tax liability can be ultimately computed. We therefore believe that the necessary accounting entries should be able to be made at any time. Similarly, we see no need for the management fee arrangement to be memorialized in writing.

N. The proposals include the comment that the nature of the income generated is merely a single factor in determining to which category an expense should be attributed. We believe, consistent with the proposals' introductory remarks, that the category of income to be generated by the expense should be the overriding consideration in this context. The proposals should clearly disavow the City's so-called "but for" rule (whereby, for example, the costs of integrating the operations of a former subsidiary into the parent's business operation so as to generate business income are attributed to subsidiary capital because, "but for" the erstwhile existence of the subsidiary, no such expenses would have been necessary).

O. Elaboration regarding when corporate activities are undertaken in the role of a shareholder rather than in another role (such as a lender) would be extremely helpful. Perhaps referring to federal authority regarding stewardship expenses would be helpful.

²⁰ Colt Industries, Inc. v. N.Y.C. Dep't of Finance, 66 NY 2d 466 (1985).

Indirect Attribution.

A. The requirement that the asset-only indirect apportionment formula election be binding eternally seems quite extreme. We suggest instead that there be a multi-year binding period, with the ability to request permission from the Commissioner for an earlier "election out" upon a showing of a substantial change in the relevant facts and circumstances. We recognize the need for the governments to be protected from the whipsawing that can occur by, for example, a parent taking dividends from a subsidiary every other year and utilizing the capital-only alternative only for the years that dividends are paid. On the other hand, the election is not comparable to a change in an accounting method such as switching from LIFO to FIFO where such a change can result in certain costs being deducted more than once. The attribution formula is merely a means to attribute each year's specific expenses, and is not intended to characterize amounts accumulated over several years. Providing some flexibility, so that elections could be changed as circumstances change or after a sufficiently long period of time, is a sounder approach than requiring the permanent use of the same allocation methodology.

B. The availability of the asset-only indirect apportionment formula election only in the first taxable year after 1994 seems unnecessary and unduly restrictive, for many of the same reasons as presented in connection with requiring the election to be eternally binding. Perhaps the election should also be available in any taxable year (albeit binding for that year as well as several subsequent years). This is an especially crucial concern because of the many unaddressed issues raised by the

proposals, some of which are identified in this report.

C. For many of the reasons set forth above, the asset-only indirect apportionment formula election should also be available after the due date (including extensions) of the return (i.e., in an amended return). This is especially warranted when, as a result of audit adjustments, a substantial portion of expenses that were directly attributed by a taxpayer on its return are attributed differently (either directly or indirectly to a different category or categories).

D. An alternative income-only indirect apportionment formula should be considered so as to reflect the economics relating to service businesses. Such businesses, which are clearly prevalent in New York, may have investments or subsidiaries with a high value relative to the value of the assets used in producing business income, while the preponderance of their income is business income. To require such businesses to attribute expenses utilizing an asset-based formula can skew the computation of their business income.

E. The City proposal says that field auditors must respect any reasonable attribution. How does this jibe with the requirement of using the formulas for indirect attribution? Is the reference intended to apply to direct attribution only? Or may the auditors disregard the proposals' formulas?

F. Similar to the statutory provisions regarding the valuation of capital, the proposals require valuing capital (other than real estate and marketable securities), including subsidiary capital, in accordance with generally accepted accounting

principles. There is a great deal of confusion regarding this because under GAAP, consolidated reporting of subsidiaries is required and there would be no value (except for certain assets) reflected. Alternatively, if it is assumed that the parent and the subsidiary are independent, the parent's original cost would be reflected. Finally, equity accounting might apply. We understand that the drafters of the bill regarding capital valuation anticipated, as did many practitioners, that original cost would apply.

G. On the fourth line of page 15 of the State proposal, "\$3,000" should be "\$3,500."

State and City Conformity.

A. It is highly commendable that the State and City have agreed to be bound by the other's audit findings in this area. The Tax Section has long been troubled by the complexities and problems caused by dual audits, and we are encouraged by this significant step towards State and City conformity. Limiting such conformity only to situations where the first audit is "concluded" before the other audit "commences," however, seems unduly restrictive. Perhaps the conformity should occur once the issue has been "fully developed" in the first audit if the issue has not been "comprehensively addressed" in the second audit.

B. Does one jurisdiction's binding itself to other's audit findings in this area mean that taxpayers cannot seek different treatment? In other words, are taxpayers estopped from challenging the first jurisdiction's audit conclusions in the context of audit adjustments of the second jurisdiction's tax? We do not think that

there is any statutory authority that could be used to restrict such challenges.

Accordingly, it should be made clear that the reference to “audit findings” means only conclusions made by the respective audit divisions. Moreover, there may be a need for a clear definition of “audit findings;” does the term refer to the initial “30-day letter” or to the signed Consent or statutory notice?

C. The State proposal should conform to the City proposal in announcing that the respective auditors will confer with each other in the event of simultaneous audits of noninterest expense attribution.

D. The proposals do not state whether the elections permitted in this area must be made with regard to both jurisdictions (when applicable). The resolution of this issue should be clearly announced in the TSB-M and the SAP.

E. We understand that the City is considering amending its rules’ definition of “subsidiary” to conform to the State regulations’ definition. As with combined reporting, such conformity is vitally necessary to make overall expense attribution conformity meaningful.

CONCLUSION

We commend the State and the City for their efforts and for working together to address the pervasive, contentious issue of noninterest expense attribution. We recommend that the proposals be issued quickly, incorporating as many of our suggested changes as possible. We suggest that the proposals not be promulgated as formal regulations and rules until the proposals have been initially tested by being applied to actual corporate filings.

October 30, 1995

I. Background

Article 9-A of the Tax Law, along with applicable regulations, requires certain amounts deducted for federal income tax or New York State corporation franchise tax purposes that are directly or indirectly attributable to subsidiary capital or to income, gains or losses from subsidiary capital, as a carrying charge or otherwise, to be added back to federal taxable income for purposes of computing entire net income. In addition, investment income is required to be reduced by deductions directly or indirectly attributable to investment capital or to income, gains or losses from investment capital.

Consistent with the State's longstanding tradition as a headquarters state, under the Franchise Tax investment income generally is allocated to the State at a lower percentage than business income, and income, gains and losses from subsidiary capital are excluded from entire net income. There is, however, a tax on subsidiary capital, but one imposed at a very low rate. The purpose of expense attribution is to avoid a double tax benefit resulting from giving favorable tax treatment to income from investment and subsidiary capital while simultaneously allowing a deduction against business income for expenses related to investment or subsidiary capital. In accordance with New York's headquarters state tradition, the expense attribution rules are to be construed so as not to alter a system designed and intended to enable New York to attract and retain corporate activity by attracting capital and offering a unique and certain set of structures for the favorable treatment of various business activities, such as the holding of subsidiaries and investments.

This TSB-M provides guidance on the direct and indirect attribution of **noninterest** deductions among the various classes of capital and income. This TSB-M is effective for tax years beginning on or after January 1, 1995, and supersedes TSB-M-88(5)C for those years. This TSB-M does not address the issue of attribution of **interest** expenses, to

which TSB-M-88(5)C continues to apply.

This TSB-M is the product of a coordinated effort by the New York State Department of Taxation and Finance and the New York City Department of Finance. Pursuant to such coordination, it is the policy of the Department of Taxation and Finance that if a taxpayer has previously been the subject of an audit by the New York City Department of Finance on the issue of expense attribution for a tax period with respect to which a State audit is being conducted, and the City audit has been concluded prior to the commencement of the State audit, State auditors will not propose expense attribution adjustments that are inconsistent with the audit findings of the Department of Finance, except to the extent necessitated by differences between applicable City and State law.

References in this memorandum to subsidiary "capital" should be understood to refer also to income (including gains and losses) from that type of capital, and references to investment "capital" should be understood to refer also to investment income.

Expenses subject to discretionary adjustment. Tax Law sections 208.9(d) and 211.5 authorize the Commissioner of Taxation and Finance to make certain adjustments to items of income, deduction, capital or assets where necessary to properly and accurately reflect income of a taxpayer in the State. The Commissioner may determine that the taxpayer has improperly reported its federal taxable income and that gross income, deductions, credits or allowances should be redistributed, apportioned or allocated between the taxpayer and certain related entities, pursuant to the principles applicable under section 482 of the Internal Revenue Code. In any case where the Commissioner of Taxation and Finance has exercised his or her discretion by adjusting a deduction, that deduction is subject to attribution after any such adjustment. However, an expense may not be attributed to a class of capital or income in lieu of making a discretionary adjustment, as described above, of all or any part of an expense.

II. Attribution - General

Article 9-A requires taxpayers to characterize most deductions (see below) as either (1) directly attributable to subsidiary, investment or business capital, or (2) not directly attributable to subsidiary, investment or business capital. Deductions which are directly attributable to subsidiary capital are required to be added back to federal taxable income in computing entire net income. (Tax Law § 208.9(b)(6)). Deductions which are directly attributable to investment capital are subtracted from income derived from investment capital in computing investment income (Tax Law, § 208.6). Deductions which are directly attributable to business capital require no special treatment.

The taxpayer's deductions which are not directly attributable to one of the three types of capital are treated as indirectly attributable to the three types of capital. The sum of such indirectly attributable deductions is apportioned among the three types of capital by formula. The portion thus directly attributable to subsidiary capital is required to be added back to federal taxable income in computing entire net income (Tax Law, § 208.9(b)(6)). The portion thus indirectly attributable to investment capital is subtracted from income derived from investment capital in computing investment income (Tax Law, § 208.6). The portion thus indirectly attributable to business capital is automatically reflected in the computation of business income and requires no special treatment.

The deductions subject to such direct and indirect attribution are those includible on line E of Schedule B included in the instructions for line 5b of Form CT-3. Noninterest expenses incurred by a taxpayer for the benefit of, or on behalf of, an affiliated corporation or other affiliated entity that are either charged back to that corporation or other entity or offset on the books and records of the taxpayer, other than through a reimbursement arrangement described in (i)(B)(d) below, or through a management fee described in (i)(B)(e) below, are not subject to attribution, provided a deduction for such expenses is not claimed by the taxpayer.

III. Direct attribution of noninterest deductions.

Where possible, the taxpayer must directly attribute to the

appropriate class of capital those noninterest deductions which are for expenses that proximately, and not incidentally, benefit that class of capital. The determination of the appropriate classes of capital to which particular deductions must be attributed should be made on the basis of all of the facts and circumstances including, but not limited to, the nature of the income that would be generated by the expenditures that are the basis for the deduction. Taxpayers should maintain books and records sufficient to support the direct attribution of expenses among the three classes of capital.

Except as provided in subparagraph (i) (A), below, if a deduction is attributable to more than one class of capital, the deduction must be apportioned among those classes of capital.

(i) Direct attribution of noninterest deductions to business capital.

(A) The following noninterest deductions are irrebuttably presumed to be attributable to business capital and should be directly attributed thereto.¹ The taxpayer need only substantiate the nature and amount of each item on this list; the taxpayer is not required to separately establish the basis for direct attribution to business capital:

- (a) cost of goods sold;
- (b) bad debts other than items properly classified as subsidiary or investment capital;
- (c) property, excise and sales and use taxes;
- (d) real estate rents, depreciation and repairs;
- (e) utilities, including telecommunications costs;
- (f) amortization of real property leasehold costs and improvements;
- (g) depletion;
- (h) advertising;
- (i) noninterest expenses for which reimbursement is

¹This does not preclude as a separate issue a discretionary adjustment, as described above, to any expense on this list.

received in the form of a management fee treated on the return as business income;

- (j) research and development expenses;
- (k) marketing expenses;
- (l) property and casualty and product liability insurance;
- (m) compensation packages of the chief executive officer, chief financial officer and chief operating officer;
- (n) directors' fees, expenses and indemnity insurance;
- (o) charitable contributions;
- (p) stationery, printing, postage and other similar distribution costs;
- (q) noninterest costs and expenses relating to communication and interaction with the taxpayer's shareholders and investors;
- (r) noninterest costs and expenses relating to routine reporting requirements of the Securities and Exchange Commission, routine financial statements and tax filings;
- (s) travel and entertainment expenses;
- (t) noninterest costs and expenses incurred in connection with an unsuccessful acquisition;
- (u) noninterest costs and expenses of developing company or group-wide administrative procedures; and
- (v) internal auditing costs and expenses.

(B) Taxpayers shall directly attribute to business capital those noninterest deductions which are for expenses that proximately, and not incidentally, benefit business capital. The following are examples of noninterest deductions that under appropriate facts and circumstances may be directly attributed to business capital:

- (a) deductible costs of shipping goods to customers;
- (b) compensation and other benefits of officers, other than officers described in subparagraph (i) (A) (m) above, and employees engaged in manufacturing, sales, services, or other activities directly producing business capital or income;
- (c) deductible legal expenses incurred in conducting

the taxpayer's business, such as costs incurred to acquire or protect a copyright or patent used in the taxpayer's business, or legal expenses incurred in negotiating contracts or resolving labor disputes with employees engaged directly in manufacturing, sales, services, or other activities directly producing business capital or income.

(d) reimbursed noninterest expense, as follows: where a taxpayer is reimbursed in whole or in part for noninterest expenses incurred on behalf of another person or entity, the amount of reimbursement must be treated as business income, and deductions for expenses for which, and to the extent, such reimbursement is received must be directly attributed to business capital. Noninterest expenses will be treated as reimbursed provided that on or before the due date, excluding extensions, for its corporation franchise tax return for the taxable year, reimbursement is made pursuant to a written agreement between the parties, or the taxpayer receives payment of an amount equal to the amount of the expense incurred either as a direct cash payment or through offsets to other accounts receivable or payable and the payment or adjustment is identified as a reimbursement on the books and records of the taxpayer and the payor. Absent a written agreement or timely reimbursement, the nature of the transaction as one involving reimbursed expenses must be proven by the taxpayer. Amounts incurred by a taxpayer for expenses charged back to another person or entity for which no reimbursement is received will not be considered reimbursed for these purposes; and (e) noninterest expenses compensated for by a management fee, as follows: compensation received through a management or similar fee arrangement between the taxpayer and a corporation or other entity, whether or not affiliated with the taxpayer, must be treated as business income, and deductions for noninterest expenses compensated for by such management or similar fee must be directly attributed to business capital. Noninterest expenses will be treated as compensated for through a management or similar fee provided the fee is paid pursuant to a

written agreement. Absent a written agreement the nature of the transaction as one involving compensation through a management or similar fee must be proven by the taxpayer.

(ii) Direct attribution of noninterest deductions to subsidiary capital.

Taxpayers shall directly attribute to subsidiary capital those noninterest deductions which are for expenses that proximately, and not incidentally, benefit subsidiary capital. The following are examples of noninterest deductions that, except as provided in subparagraph (i)(A), above, should be directly attributed to subsidiary capital:

- (A) compensation and other benefits of officers, other than officers described in subparagraph (i)(A)(m) above, and employees engaged in the acquisition, management or disposition of subsidiary capital or income therefrom;
- (B) legal and accounting expense deductions relating to the management of subsidiary capital or income therefrom;
- (C) computer expense deductions relating to the management of subsidiary capital or income therefrom;
- (D) other deductible fees and expenses incurred in connection with the successful purchase of subsidiary capital, or the sale, whether or not successful, of subsidiary capital;
- (E) other deductible expenses incurred by the taxpayer for its own benefit in its role as a shareholder of the subsidiary, including but not limited to;

- (a) deductible expenses incurred in reviewing information prepared by the subsidiary, where such review is undertaken by the taxpayer in its role as a shareholder of the subsidiary;
- (b) deductible expenses incurred in connection with the general supervision of a subsidiary by the taxpayer's employees (stewardship expenses). These expenses do not include expenses relating to the day-to-day operation of the subsidiary;
- (c) deductible expenses incurred by the taxpayer to preserve its investment in a subsidiary; and

(d) deductible expenses incurred in meeting reporting requirements or other legal obligations imposed on the taxpayer in its role as a shareholder of the subsidiary, other than expenses described in subparagraph (i) (A) (r) of this paragraph.

(iii) Direct attribution of noninterest deductions to investment capital.

Taxpayers shall directly attribute to investment capital those noninterest deductions which are for expenses that proximately, and not incidentally, benefit investment capital. The following are examples of noninterest deductions that, except as provided in subparagraph (i) (A), above, should be directly attributed to investment capital:

(A) safe deposit box rentals for safekeeping of certificates or other documents relating to investment capital;

(B) financial news subscriptions utilized exclusively by employees engaged in the acquisition, management or disposition of investment capital or the income therefrom;

(C) compensation and other benefits of officers, other than officers described in subparagraph (i) (A) (m), above, and employees engaged in the acquisition, management or disposition of investment capital or the income therefrom;

(D) the deductible cost of insurance and fidelity bonds covering investment capital;

(E) deductible custodian fees, investment advisory fees and legal and accounting costs and fees relating to the management of investment capital or the income therefrom;

(F) deductible computer expenses relating to the management of investment capital or the income therefrom;

(G) deductible fees and expenses incurred in connection with the successful purchase of investment capital, or the sale, whether or not successful, of investment capital; and

(H) other deductible expenses incurred by the

taxpayer for its own benefit in its role as a holder of the investment in the corporation, including but not limited to;

- (a) deductible expenses incurred in reviewing information prepared by the corporation, where such review is undertaken by the taxpayer in its role as an investor in the corporation;
- (b) deductible expenses incurred in connection with the general supervision of the corporation by the taxpayer's employees, excluding expenses relating to the day-to-day operation of the corporation;
- (c) deductible expenses incurred by the taxpayer to preserve its investment; and
- (d) deductible expenses incurred in meeting reporting requirements or other legal obligations imposed on the taxpayer in its role as an investor in the corporation, other than expenses described in subparagraph (i) (A) (r), above.

(iv) Direct attribution to more than one class of capital.

A particular noninterest deduction may be attributable to more than one class of capital. In that case, the taxpayer should directly attribute a portion of that deduction to each class of capital proximately benefitted by the expense which gave rise to that deduction, using a method that is reasonable for that particular deduction. Such a method can be based on one or more factors appropriate given the nature of the deduction. Such factors may include, but are not limited to, time, space, payroll, and numbers of personnel. See examples below. Deductions listed in subparagraph (i) (A), above, are irrebuttably presumed to be attributable to business capital and, therefore, are directly attributed entirely to business capital.

(V) Special rule for operating division.

(A) If the taxpayer can substantiate that at least 95 percent of the noninterest expenses of an operating division are directly attributable to a particular class of

capital, 100 percent of the noninterest expenses of that operating division may be directly attributed to that class of capital. Noninterest expenses subject to this rule include expenses listed in subparagraph (i) (A), above, and all other noninterest expenses of that operating division.

(B) For purposes of this subparagraph, the term "operating division" shall mean a subunit of a corporation that meets the following criteria:

- (a) the activities of the subunit constitute a trade or business; and
- (b) a separate set of books and records is maintained with respect to the subunit

The determination as to whether activities constitute a trade or business is dependent on all of the facts and circumstances. Generally a trade or business is a specific set of activities that constitutes or would constitute an independent economic enterprise carried on for profit if carried on by a separate entity. To constitute a trade or business, a group of activities must ordinarily include every operation that forms a part of, or a step in, an income producing or profit making process, including the collection of income and the payment of expenses. It is not necessary that the activities carried out by a subunit constitute a different trade or business from those carried out by other subunits of the taxpayer. A vertical, functional or geographic division of the same trade or business may be a trade or business for this purpose, provided that the activities otherwise qualify as a trade or business under this paragraph. However, activities that are merely ancillary to a trade or business do not constitute a trade or business. For example, financing activities or legal, accounting or other administrative activities will generally be considered ancillary and will not constitute a trade or business for this purpose.

To meet the separate set of books and records requirement the subunit must maintain, at a minimum, a separate set of ledger accounts (i.e., cash receipts, cash disbursements, accounts receivable, and accounts payable) and a general journal or similar book of original entry.

(VI) Indirect attribution of residual noninterest deductions.

(i) General. Noninterest deductions that cannot be directly attributed as provided in section III, termed "residual noninterest deductions", must be attributed to subsidiary and investment capital using combined asset and income percentages or, if an election is made as described below, by an asset percentage. The amount of residual noninterest deductions is determined by subtracting the amount of noninterest deductions attributed directly under section III from the total amount of noninterest deductions.

To make attributions based on the asset percentage, the amount of residual noninterest deductions is multiplied by the asset percentage computed with respect to subsidiary capital or investment capital, as the case may be. To use the combined asset and income percentage, the amount of residual noninterest deductions is multiplied by the combined asset and income percentage with respect to subsidiary capital or investment capital, as the case may be. The result in either case represents the amount of noninterest deductions indirectly attributable to subsidiary or investment capital, respectively. The portion of residual noninterest deductions not so indirectly attributed must be indirectly attributed to business capital.

In order to use asset percentages to allocate residual noninterest deductions, the taxpayer must elect to do so on a timely return (including extensions) for its first taxable year beginning on or after January 1, 1995 on which the taxpayer reports subsidiary or investment capital. This election is irrevocable, and applies to all subsequent taxable years. The taxpayer may not elect the alternative method on a late or amended return.

(ii) Asset percentage:

The asset percentage with respect to subsidiary capital is determined by dividing the average value of the taxpayer's subsidiary capital, without reduction for liabilities, by the total average value of all the taxpayer's assets, without reduction for liabilities. The asset percentage with respect to investment capital

is determined by dividing the average value of the taxpayer's investment capital, without reduction for liabilities, by the total average value of all the taxpayer's assets, without reduction for liabilities. For these purposes, real property and marketable securities must be valued at fair market value and the value of personal property other than marketable securities must be the value thereof shown on the books and records of the taxpayer in accordance with generally acceptable accounting principles.

(iii) Income percentage:

The income percentage for subsidiary capital is determined by dividing the taxpayer's gross income from subsidiary capital by its total gross income. The income percentage with respect to investment capital is determined by dividing the taxpayer's gross income from investment capital by its total gross income. For these purposes:

(A) total gross income is the amount determined under Internal Revenue Code section 61, modified by the adjustments provided in the Tax Law;

(B) gross income from subsidiary capital is that portion of total gross income consisting of dividends, interest, and gains from subsidiary capital; and

(C) gross income from investment capital is that portion of total gross income consisting of dividends, interest, and gains from investment capital as well as items of gross income described in section 4-8.3(2)-(5) of the Franchise Tax Regulations.

(iv) Combined asset and income percentage. The combined asset and income percentage is computed by adding together two times the taxpayer's income percentage for subsidiary or investment capital and the taxpayer's asset percentage for subsidiary or investment capital, and dividing the total by three. If total gross income is zero, the combined asset and income percentage is equal to the asset percentage. If total assets is zero, the combined asset and income percentage is equal to the income percentage.

B. Examples

The following examples illustrate the direct and indirect attribution of noninterest deductions to subsidiary, investment and business capital.

Example 1: Each member of a taxpayer's accounting staff spends 40% of his or her time analyzing whether the taxpayer should restructure its subsidiaries. Each member of the accounting staff spends 20% of his or her time analyzing the taxpayer's investment portfolio. The accounting staff does not spend any other time on issues relating to subsidiary or investment capital or income. The taxpayer attributes 40% of the accounting staff's salaries and related expenses to subsidiary capital and 20% to investment capital. This method is acceptable.

Example 2: The facts are the same as in example 1. In addition, the accounting staff occupies 10% of a building rented by the taxpayer. The other 90% is used for the taxpayer's service business. All rental expense should be directly attributed to business capital pursuant to subparagraph (i) (A) (d). None of the rental expense should be attributed to subsidiary or investment capital or income.

Example 3: The facts are the same as in example 1. The taxpayer has a total of 100 employees. Ten employees are in the accounting department. Ten employees are in the personnel department. They are responsible for managing the hiring, salaries, pension and medical benefits of all employees. Of the remaining 80 employees, five spend 20% of their time on activities related to investment capital and 40% of their time on activities related to subsidiary capital. The 15 employees engaged in activities relating to investment and subsidiary capital represent 25% of the total payroll of the taxpayer.

The taxpayer attributes 5% (25% X 20%) of the salaries and related expenses of the personnel department employees to investment capital and 10%

(25% X 40%) to subsidiary capital. This method, based on time and payroll, is reasonable under the circumstances and is acceptable.

Example 4: The CEO of a corporation does not maintain detailed time records. However, she does maintain a diary that shows that she spends approximately 20% of her time in planning the corporation's strategy for investment in subsidiaries and 80% of her time in planning the corporation's strategy for developing, manufacturing and marketing its products. The taxpayer should attribute the CEO's salary to business capital pursuant to subparagraph (i) (A) (m) of this paragraph. None of the CEO's salary should be attributed to subsidiary (or investment) capital. ✓

Example 5: Income and assets. Corp. X has \$10,000 of business income, \$4,000 of business capital, \$300 of income from subsidiary capital, \$1,000 of subsidiary capital, \$500 of investment income and \$2000 of investment capital. (Capital is here computed without reduction for liabilities.)

Expenses. Corp. X has \$6,000 in noninterest expenses, of which \$3,500 is directly attributable to business capital and properly substantiated, including items on the list of expenses presumed attributable to business capital under paragraph (b) (i) (A) above.

Separate Operating Division. Corp. X has a manufacturing plant that has its own human resources department, keeps separate books and records of expenses and qualifies as an "operating division". \$1,000 of the \$6,000 of noninterest expenses are attributable to that plant and are not included in the \$3,500. Of that \$1,000, \$400 is wages and salaries, \$100 is for equipment rental and depreciation, and \$500 consists of items on the list in section IV.A. (3) (b) (1) (A) above. Corp. X can substantiate that at least \$950 of the \$1,000 is directly attributable to business capital. Therefore, all \$1,000 of the expenses of that plant

are considered directly attributable to business capital.

The total of directly attributable expenses⁵ is \$4,500 (\$1,000 from the division and \$3,000 from the corporation as a whole).

Subsidiary and Investment Capital Percentages

Subsidiary: $[\$300/\$10,800 \text{ (income)} + \$300/\$10,800 \text{ (income)} + \$1,000/\$7,000 \text{ (capital)}] / 3 = 6.61\%$

Investment: $[\$500/\$10,800 \text{ (income)} + \$500/\$10,800 \text{ (income)} + \$2,000/\$7,000 \text{ (capital)}] / 3 = 12.61\%$

Indirect residual noninterest deductions of \$1,500 (\$6,000 less the \$4,500 directly attributed to business capital) are attributed, 6.61% (\$99.15) to subsidiary capital and 12.61% (\$189.15) to investment capital. The remainder, \$1211.70 (\$1500-[\$99.15+\$189.15]) is attributed to business capital.

The total direct and indirect noninterest expense attribution is \$5711.70 to business, \$99.15 to subsidiary and \$189.15 to investment capital. (Capital is here determined without the deduction of liabilities.)

Example 6: Income and Assets. Corp. X has \$10,000 of business income, \$4,000 of business capital, \$300 of income from subsidiary capital, \$1,000 of subsidiary capital, \$500 of investment income and \$2000 of investment capital. (Capital is here determined without the deduction of liabilities.)

Expenses. Corp. Y, a broker dealer, has \$5,000 in noninterest expenses, of which \$2,000 is substantiated as compensation of account representatives, \$1,000 is substantiated as for computer equipment and software and wire services used exclusively to manage customer accounts and

execute customer transactions, \$1,000 consists of items on the list in section IV.A.(3)(b)(1)(A) above and \$500 is substantiated as directly attributable to investment capital.

The total of directly attributable expenses is \$4,500 (\$4,000 to business capital and \$500 to investment capital).

Subsidiary and Investment Capital Percentages.

Subsidiary: $[\$300/\$10,800 + \$300/\$10,800 + \$1,000/\$7,000]/3 = 6.61\%$

Investment: $[\$500/\$10,800 + \$500/\$10,800 + \$2,000/\$7,000]/3 = 12.61\%$

Indirect residual noninterest expenses of \$500 are attributed 6.61% (\$33.05) to subsidiary capital and 12.61% (\$63.05) to investment capital. The remainder, \$403.90, ($\$500 - [\$33.05 + \$63.05]$) is attributed to business capital.

The total direct and indirect noninterest expense attribution is \$4403.90 to business, \$33.05 to subsidiary and \$563.05 to investment capital.

APPENDIX A
1995 CT-3 INSTRUCTIONS
For lines 4 and 5

Lines 4a and 4b -

Complete lines 4a and 4b if you have subsidiary capital includable on Form CT-3-ATT, line 51, column C (otherwise, enter "0" on lines 4a and 4b).

Line 4a- Enter the amount of **interest** deductions allowed in the computation of entire net income (i.e. includable in the amount on worksheet A, line E) that are **directly** attributable to subsidiary capital (or to income, losses or gains from subsidiary capital).

Line 4b- Enter the amount of **non-interest** deductions allowed in the computation of entire net income (i.e. includable in the amount on worksheet B, line E) that are **directly** attributable to subsidiary capital (or to income, losses or gains from subsidiary capital).

The direct attribution of deductions is based on an analysis of facts and circumstances. Deductions directly attributable to subsidiary capital or income include but are not limited to the following:

- interest on debt incurred to buy subsidiary capital;
- salaries of employees engaged in the management, supervision or conservation of subsidiary capital;
- expenses for legal advice relating to the acquisition of subsidiary capital; and
- stewardship deductions relating to subsidiary capital.

Do not include on lines 4a or 4b interest deductions or non-interest deductions that are directly attributable to:

- investment capital (or to income, losses or gains from investment capital); see Form CT-3-ATT, line 43a or line 43b; or
- business capital (or income, losses or gains from business capital). Note: For tax years beginning in 1995 or after, certain expenses are deemed to be directly attributable to business capital (or income, losses or gains from business capital). These expenses include, among others: depletion, advertising, research and development expenses, compensation packages of chief executive officer, chief financial officer and chief operating officer, charitable contributions and internal auditing expenses. For a complete listing of deductions deemed attributable to business capital, and for a full discussion of the attribution of deductions, see TSB-M-95(2)C.

If at least 95% of the non-interest deductions of an operating division are directly attributable to a particular class of capital or income, 100% of the non-interest deductions of that division may be directly attributed to that class of capital or income.

Lines 5a and 5b -

Complete lines 5a and 5b if you have subsidiary capital includable on Form CT-3-ATT, line 51, column C (otherwise, enter "0" on lines 5a and 5b).

Line 5a

Enter the amount of **interest** deductions that are **indirectly** attributable to subsidiary capital (or to income gains or losses from subsidiary capital) (from worksheet A, line N).

Use worksheet A to determine the amount of interest deductions indirectly attributable to subsidiary capital.

Worksheet A

- A. Enter federal interest deductions shown on federal Form 1120, line 18 _____
- B. Enter amounts of interest deductions which are required to be added back to federal taxable income in computing entire net income (other than the amount on Form CT-3, line 5a)
Enter the line number and amount below .
Line # ___ Amount _____
Line # ___ Amount _____
Line # ___ Amount _____ **Total** _____
- C. Total- subtract line B from line A _____
- D. Enter amounts of interest deductions which are required to be subtracted from federal taxable income in computing entire net income (for example the interest deductions taken in computing the amount on Form CT-3, line 2 or amounts related to foreign source income not included on Federal Form 1120).
Enter the line number and amount below.
Line # ___ Amount _____
Line # ___ Amount _____
Line # ___ Amount _____ **Total** _____
- E. Total New York interest deductions included in entire net income -add lines C and D _____
- F. Enter any interest deductions directly attributable to subsidiary capital included on Form CT-3, line 4a _____
- G Enter any interest deductions directly attributable to investment capital included on Form CT-3-ATT, line 43a _____
- H. Enter any interest deductions directly attributable to business capital _____
- I. Subtotal- add lines F, G and H _____
- J Interest deductions subject to indirect attribution- subtract line I from line E _____
- K. Enter the amount from Form CT-3-ATT, line 51, column C _____

- L. Enter the amount from Form CT-3, line 30, column C _____
- M. Percentage - Divide line K by line L _____ %
- N. Amount of interest deductions indirectly attributable to subsidiary capital _____
 - multiply line J by line M. Enter this amount on line 5a. _____

Line 5b-

Enter the amount of **non-interest** deductions that are **indirectly** attributable to subsidiary capital (or to income, gains or losses from subsidiary capital) (from worksheet B, line R).

Use worksheet B to determine the amount of noninterest deductions indirectly attributable to subsidiary capital.

Worksheet B

- A. Enter federal noninterest deductions included on federal Form 1120, line 27 (excluding the amount from federal Form 1120, line 18) _____
- B. Enter amounts of noninterest deductions which are required to be added back to federal taxable income in computing entire net income. _____
 . Include the New York excess depreciation amount described in Tax Law section 208.9(b)(11) to the extent that such amount was subtracted in computing entire net income for prior taxable years which began on or after January 1, 1987. Enter the line number and amount below.
 Line # ___ Amount _____
 Line # ___ Amount _____
 Line # ___ Amount _____ Total _____
- C. Total- subtract line B from line A _____
- D. Enter amounts of noninterest deductions listed below which are required to be subtracted from federal taxable income in computing entire net income. _____

- In the case of a taxpayer organized outside the United States, deductions attributable to income which is not included in federal taxable income but is required to be included in entire net income (e.g., foreign source income) (Tax Law, section 208.9(c); see also Franchise Tax Regulations, 20 NYCRR 3-2.3(a)(9)).
- The portion of wages and salaries paid or incurred for the tax year for which a deduction is not allowed pursuant to section 280C of the IRC(Tax Law, Section 208.9(a)(7)).
- Depreciation deductions permitted under Article 9-A with respect to **decoupled** property pursuant to Tax Law, section 208.9(a)(11) and (12).
- Deductions arising from **decoupling** from federal safe harbor lease provisions pursuant to Tax Law, section 208.9(a)(10).
- The noninterest deductions taken in computing the amount on Form CT-3, line 2.

Enter the line number and amount below.

- Line # ___ Amount _____
- Line # ___ Amount _____

Line #	Amount	Total
E.	Total New York noninterest deductions included in entire net income -add lines C and D	_____
F.	Enter non-interest deductions directly attributable to subsidiary capital from Form CT-3, line 4b	_____
G.	Enter non-interest deductions directly attributable to investment capital, from Form CT-3-ATT, line 43b	_____
H.	Enter noninterest deductions directly attributable to business capital	_____
I.	Subtotal- add lines F, G and H	_____
J.	Noninterest deductions subject to indirect attribution-subtract line I from line E (see instructions for line R)	_____
K.	Enter gross income attributable to subsidiary capital from Form CT-3-ATT, line 50	_____
L.	Enter gross income (the amount shown on federal Form 1120, line 11, with lines 8 and 9 recomputed to exclude losses, plus New York State Tax Law section 208.9(c) gross income items.)	_____
M.	Income percentage - divide line K by line L	_____%
N.	Enter amount from Form CT-3-ATT, line 51, column C	_____
O.	Enter amount from Form CT-3, line 30, column C	_____
P.	Asset percentage - divide line N by line O	_____%
Q.	Subsidiary capital percentage (If line L is -0- the subsidiary capital percentage is equal to the asset percentage. If line O is -0- the subsidiary capital percentage is equal to the income percentage.)	
a.	Enter percentage from line M _____; multiply by 2 _____	
b.	Enter percentage from line P _____	
c.	Total- add lines a and b _____	
d.	Subsidiary capital percentage- divide line c by 3 _____%	
R.	Amount of noninterest deductions indirectly attributable to subsidiary capital - multiply line J by the percentage from line Q or, if an election has been made to use the asset percentage, by the percentage from line P. Enter this amount on line 5b	_____

CT-3-ATT Instructions
For line 43

Lines 43a and 43b-

Complete lines 43a and 43b if you have investment capital includable on Form CT-ATT, line 35, column C (otherwise, enter "0" on lines 43a and 43b).

Line 43a

Enter the amount of **interest** deductions allowable in the computation of entire net income (i.e., includable in the amount on worksheet A, line E) that are **directly** attributable to investment capital (or to income, losses or gains from investment capital).

Line 43b

Enter the amount of **noninterest** deductions allowed in the computation of entire net income (i.e., includable in the amount on worksheet B, line E) that are **directly** attributable to investment capital (or to income, losses or gains from investment capital).

The direct attribution of deductions is based on an analysis of the facts and circumstances. Deductions directly attributable to investment capital or income include but are not limited to the following:

- interest on debt incurred to buy investment capital
- safe deposit box rentals
- financial news subscriptions
- salaries of employees engaged in the management and conservation of stocks, bonds and other securities included in investment capital
- investment counsel fees
- custodian fees
- the cost of insurance and fidelity bonds covering investment capital
- expenses for legal advice relating to the acquisition of investment capital

Do not include on lines 43a or 43b interest deductions or noninterest deductions that are directly attributable to:

- subsidiary capital (or ~~to~~ income, losses or gains from subsidiary capital) see Form CT-3, lines 4a and 4b; or
- business capital (or ~~to~~ income, losses or gains from business capital). **Note:** For tax years beginning in 1995 or after, certain expenses are deemed to be directly attributable to business capital (or income, losses or gains from business capital). These expenses include, among others: depletion, advertising, research and development expenses, compensation packages of chief executive officer, chief financial officer and chief operating officer, charitable contributions and internal auditing expenses. For a complete listing of deductions deemed attributable to business capital and for a full discussion of the attribution of deductions, see TSB-M-95(2)C.

If at least 95% of the noninterest deductions of an operating division are directly attributable to a particular class of capital or income, 100% of the noninterest deductions of that division may be directly attributed to that class of capital or income.

Lines 44a and 44b-

Complete line 44a and 44b if you have investment capital includable on Form CT-3-ATT, line 35, column C (otherwise, enter "0" on lines 44a and 44b).

Line 44a

Enter the amount of **interest** deductions that are **indirectly** attributable to investment capital (or to income, gains or losses from investment capital) (from worksheet A, line N).

Use worksheet A to determine the amount of interest deductions indirectly attributable to investment capital.

Worksheet A

- | | |
|--|-------------|
| A. Enter federal interest deductions included on federal Form 1120, line 18 | _____ |
| B. Enter amounts of interest deductions which are required to be added back to federal taxable income in computing entire net income (other than the amount on Form CT-3, line 5a).
Enter the line number and amount below. | |
| Line # ___ Amount _____ | |
| Line # ___ Amount _____ | |
| Line # ___ Amount _____ | Total _____ |
| C. Total-subtract line B from line A | _____ |
| D. Enter amounts of interest deductions which are required to be subtracted from federal taxable income in computing entire net income (for example the interest deductions taken in computing the amount on Form CT-3, line 2 or amounts related to foreign source income not included on Federal Form 1120).
Enter line number and amount | |
| Line # ___ Amount _____ | |
| Line # ___ Amount _____ | |
| Line # ___ Amount _____ | Total _____ |
| E. Total New York interest deductions included in entire net income
- add lines C and D | _____ |
| F. Enter any interest deductions directly attributable to subsidiary capital from Form CT-3, line 4a | _____ |
| G. Enter any interest deductions directly attributable to investment capital from Form CT-3-ATT, line 43a | _____ |
| H. Enter any interest deductions directly attributable to business capital | _____ |
| I. Subtotal-add lines F, G and H | |
| J. Interest deductions subject to indirect attribution-subtract line I from line E | _____ |

- K. Enter amount from Form CT-3-ATT, line 35, column C _____
- L. Enter amount from Form CT-3, line 30, column C _____
- M. Percentage-Divide line K by line L _____ %
- N. Amount of interest deductions indirectly attributable to investment capital. .
 -multiply line J by line M. Enter this amount on line 44a. _____

Line 44b-

Enter the amount of **noninterest** deductions that are **indirectly** attributable to investment capital (or to income, gains or losses from investment capital) (from worksheet B, line R).

Use worksheet B to determine the amount of noninterest deductions indirectly attributable to investment capital.

Worksheet B

- A. Enter federal noninterest deductions included on federal Form 1120, line 27 (excluding the amount from federal Form 1120, line 18) _____
- B. Enter amounts of noninterest deductions which are required to be added back to federal taxable income in computing entire net income. Include the New York excess depreciation amount described in Tax Law section 208.9(b)(11) to the extent that such amount was subtracted in computing entire net income for prior taxable years which began on or after January 1, 1987. Enter the line number and amount below.
- | | | |
|--------|--------|-------|
| Line # | Amount | _____ |
| Line # | Amount | _____ |
| Line # | Amount | _____ |
| | Total | _____ |
- C. Total-subtract line B from line A _____
- D. Enter amounts of non-interest deductions listed below which are required to be subtracted from federal taxable income in computing entire net income.

- In the case of a taxpayer organized outside the United States, deductions attributable to income which is not included in federal taxable income but is required to be included in entire net income (e.g., foreign source income) (Tax Law, section 208.9(c); see also Franchise Tax Regulations, 20 NYCRR 3-2.3(a)(9)).
- The portion of wages and salaries paid or incurred for the tax year for which a deduction is not allowed pursuant to section 280C of the IRC (Tax Law, Section 208.9(a)(7)).
- Depreciation deductions permitted under Article 9-A with respect to **decoupled** property pursuant to Tax Law, section 208.9(a)(11) and (12).
- Deductions arising from **decoupling** from federal safe harbor lease provisions pursuant to Tax Law, section 208.9(a)(10).
- The noninterest deductions taken in computing the amount on Form CT-3, line 2

Enter the line number and amount below.

Line #	Amount	Total
Line #	Amount	
Line #	Amount	
Line #	Amount	
E.	Total New York noninterest deductions included in entire net income -add lines C and D.	_____
F.	Enter noninterest deductions directly attributable to subsidiary capital from Form CT-3, line 4b	_____
G.	Enter noninterest deductions directly attributable to investment capital from Form CT-3-ATT, line 43b	_____
H.	Enter noninterest deductions directly attributable to business capital	_____
I.	Subtotal- add lines F, G and H	_____
J.	Noninterest deductions subject to indirect attribution-subtract line I from line E. (see instructions for line R)	_____
K.	Enter gross income attributable to investment capital from Form CT-3-ATT, line 42	_____
L.	Enter gross income (the amount included on federal Form 1120, line 11, with lines 8 and 9 recomputed to exclude losses, plus New York State Tax Law section 208.9(c) gross income items.)	_____
M.	Income percentage - divide line K by line L	_____
N.	Enter amount from Form CT-3-ATT, line 35, column C	_____
O.	Enter amount from Form CT-3, line 30, column C	_____
P.	Asset percentage-divide line N by line O	_____
Q.	Investment capital percentage (If line L is -0- the investment capital percentage is equal to the asset percentage. If line O is -0- the investment capital percentage is equal to the income percentage.)	_____
a.	Enter percentage from line M _____; multiply by 2 _____	
b.	Enter percentage from line P _____	
c.	Total - add lines a and b _____	
d.	Investment capital percentage-divide line c by 3 _____%	
R.	Amount of noninterest deductions indirectly attributable to investment capital - multiply line J by the percentage from line Q or, if an election has been made to use the asset percentage, by the percentage from line P. The taxpayer has the option of using either of the two percentages. Enter this amount on line 44b	_____




FINANCE
NEW • YORK
THE CITY OF NEW YORK
DEPARTMENT OF FINANCE

M E M O R A N D U M

October 31, 1995

TO: Joint State and City Expense Attribution Task Force

FROM: Ellen E. Hoffman 
Director, Tax Law Division
New York City Department of Finance

RE: Draft Statement of Audit Procedure

Attached for your review and comment is a draft of a Statement of Audit Procedure providing advise to Department desk and field auditors regarding the procedures for auditing entities subject to the General Corporation Tax and Unincorporated Business Tax on the issue of direct and indirect attribution of noninterest expense deductions. The State Department of Taxation and Finance is simultaneously sending you a draft Technical Services Bureau Memorandum on the same issue. As we have previously stated, these documents are intended to be effective for this filing season and we expect to incorporate these rules into regulations during the coming year.

While there are stylistic differences between the two documents necessitated by the different functions of Statements of Audit Procedure and Technical Services Bureau Memoranda, the substantive rules for attribution contained in the two documents are intended to be identical. Please give me your comments by November 22, 1995. Thank you for your continued cooperation in this project.

cc: Ron Ginsberg
Israel Schupper

DRAFT SAP ON NONINTEREST EXPENSE ATTRIBUTION

I. Background

For taxable years beginning after December 31, 1987, the Commissioner of Finance requires certain amounts deducted for federal income tax or New York City General Corporation Tax ("GCT") purposes that are directly or indirectly attributable to subsidiary capital or to income, gains or losses from subsidiary capital, as a carrying charge or otherwise, to be added back to federal taxable income for purposes of computing entire net income. In addition, investment income is required to be reduced by deductions directly or indirectly attributable to investment capital or to income, gains or losses from investment capital. Finally, for taxable years beginning after June 30, 1994, investment income of a taxpayer subject to the Unincorporated Business Tax ("UBT") is required to be reduced by deductions directly or indirectly attributable to investment income or capital.

Consistent with New York City's longstanding tradition as a center of corporate headquarters, under the GCT and UBT, investment income generally is allocated to the City at a lower percentage than business income, and, for GCT purposes, income, gains and losses from subsidiary capital are excluded from entire net income. There is, however, a tax on subsidiary capital, but it is imposed at a very low rate. The purpose of expense attribution is to avoid a double tax benefit resulting from giving favorable tax treatment to income from investment and subsidiary capital while simultaneously allowing a deduction against business income for expenses related to investment or subsidiary capital. In accordance with New York City's corporate headquarters tradition, the expense attribution rules are to be construed so as not to alter a system designed and intended to enable New York to attract and retain corporate activity by attracting capital and offering a unique and certain set of structures for the favorable treatment of many activities, such as the holding of subsidiaries and investments.

II. Scope

GCT and UBT returns affected by the attribution requirements described above are subject to both desk and field audits. This Statement of Audit Procedure is intended to give desk and field auditors guidance on how to review a return to determine whether an appropriate attribution of noninterest expenses has been made by a taxpayer. This SAP provides guidance on the direct and indirect attribution of noninterest deductions among the various classes of capital and income. This SAP is effective for tax

years beginning on or after January 1, 1995, and supersedes SAP 93-1-GCT (3/1/93) for those years. This SAP does not address the issue of attribution of interest expenses. SAP AP/GCT 2, March 22, 1991 will continue to be in effect with regard to the attribution of interest expenses.

III. Audit Procedures

A. Desk Audit

As part of the review of GCT and UBT returns, desk auditors should determine whether an attribution of expenses to the appropriate classes of capital or income has been made. If the GCT return reports investment or subsidiary capital or income, or a UBT return reports investment income and, in either case, it appears that the taxpayer's attribution of expenses to the respective forms of capital appears reasonable, no further examination should be made of the attribution of expenses as part of a desk audit. If the desk auditor is in doubt as to whether the taxpayer has made a reasonable effort to attribute expenses, the desk auditor should consult with the Desk Audit Unit Manager. If the taxpayer reports investment or subsidiary capital or income on the return but has attributed none of its expenses to those classes of capital or income, or the Desk Audit Manager determines that the taxpayer's attribution of expenses to investment or subsidiary capital or income is unreasonable, the following steps will be taken:

(1) The desk auditor will inform the taxpayer by letter that the issue of attribution of expenses is being examined. That letter will give the taxpayer a reasonable time to either submit corrected schedules to make an appropriate attribution, or to provide a detailed explanation as to why the position taken on its original return with regard to attribution was appropriate. The auditor will provide a reasonable additional amount of time to comply if requested by the taxpayer or its authorized representative.

(2) If the taxpayer neither submits corrected schedules nor provides a reasonable explanation for the position taken on its original return within the time allowed and the taxpayer has not attributed any expenses to investment or subsidiary income or capital, the auditor may attribute all the expenses shown on the return, other than those expenses listed at IV.A(3)(b)(i)(A) below that are readily identifiable from the return or from information provided by the taxpayer, to the various types of capital or income using the appropriate method of indirect

attribution described below.¹

(3) If, on the basis of the information provided on the return or in response to inquiries directed to the taxpayer described above, the Desk Audit Unit Manager determines that the taxpayer has not made a reasonable effort to attribute expenses to investment or subsidiary capital or income, the desk auditor may apply the appropriate method of indirect attribution to attribute to subsidiary, investment or business income or capital any expenses that, in his or her discretion, exercised in accordance with the standards set forth below, cannot readily be directly attributed based on the information provided.

B. Field Audit

Once a return has been selected for field audit, the taxpayer's attribution of expense may be examined as part of the audit. The field audit unit may examine this issue even if it has been examined as part of a desk audit. If the attribution of expenses is to be examined, an information document request will be sent to the taxpayer concerning this issue, giving the taxpayer a reasonable period of time to provide documentary support for the propriety of the attribution of expenses in its original return, or to submit corrected schedules making an appropriate attribution.

If the taxpayer provides acceptable documentation supporting the propriety of the attribution shown on the return or submits corrected schedules with acceptable supporting documentation, the auditor, subject to further review, will close his or her examination of this issue based upon the information or schedules submitted.

If the taxpayer makes a reasonable effort to respond to the auditors's request but the auditor determines that one or more particular expenses have not been properly attributed, the field auditor should make a reasonable effort to directly attribute the expenses if they are easily identifiable and the attribution is supported by acceptable documentation in accordance with the standards set forth below. If an expense cannot easily be directly attributed, the expense may be attributed by the appropriate method of indirect attribution as described below.

If the taxpayer does not make a reasonable effort to support its original return or submit corrected schedules, the auditor may apply the appropriate method of indirect attribution to attribute to subsidiary, investment or business income or

¹ The appropriate method will be the combined asset and income method unless the taxpayer has properly elected the alternative asset method as described below at IV.A(3)(c).

capital any expenses that, in his or her discretion, exercised in accordance with the standards set forth below, cannot readily be directly attributed based on the information provided.

C. Prior State Audit

This SAP is the product of a coordinated effort by the New York City Department of Finance and the New York State Department of Taxation and Finance. Pursuant to that effort, the Department of Finance has agreed that if the taxpayer has previously been the subject of a field audit by the New York State Department of Taxation and Finance on the issue of expense attribution for a tax period with respect to which a City audit is being conducted and the State audit has been concluded prior to the commencement of the City audit, City desk and field auditors will not propose expense attribution adjustments that are inconsistent with the audit findings of the Department of Taxation and Finance except to the extent necessitated by differences between applicable State and City law. In the case of simultaneous audits, the State and City have agreed to consult with each other on this issue. Auditors should ask taxpayers if they are being audited by the State on this issue.

IV. Attribution Standards

Desk and field auditors are required to apply the standards set forth below in determining whether a taxpayer has properly attributed noninterest expenses under the above procedures.

A. Deductions must be properly deducted by taxpayer.

(1) The deductions subject to attribution are limited to those deductions properly allowed to the taxpayer for GCT or UBT purposes adjusted as provided in (a).

(a) Expenses subject to discretionary adjustment. Administrative Code sections 11-605(5) and 11-602.8(d) authorize the Commissioner of Finance to make certain adjustments to items of income, deduction or capital where necessary to properly and accurately reflect income of a taxpayer in the City. Similarly, the Commissioner of Finance may determine that the taxpayer has improperly reported its federal taxable income and that gross income, deductions, credits or allowances should be redistributed, apportioned or allocated between the taxpayer and another entity owned or controlled directly or indirectly by the same interests under Internal Revenue Code section 482. In any case where the Commissioner of Finance has exercised his or her discretion described above by adjusting a deduction for all or part of any expense, that deduction is subject to attribution after any such adjustment. However, an expense may not be attributed to a class of capital or income in lieu of making

a discretionary adjustment, as described above, of all or any part of an expense.

(b) Reimbursed noninterest expenses. (i) Where a taxpayer is reimbursed in whole or in part for noninterest expenses incurred on behalf of another person or entity, the amount of reimbursement must be treated as business income, and deductions for expenses for which, and to the extent, such reimbursement is received must be directly attributed to business income and capital.

(ii) Noninterest expenses will be treated as reimbursed provided that on or before the due date, excluding extensions, for its GCT return for the taxable year, reimbursement is made pursuant to a written agreement between the parties, or the taxpayer receives payment of an amount equal to the amount of the expense incurred either as a direct cash payment or through offsets to other accounts receivable or payable and the payment or adjustment is identified as a reimbursement on the books and records of the taxpayer and the payor. Absent a written agreement or timely reimbursement, the nature of the transaction as one involving reimbursed expenses must be proven by the taxpayer. Amounts incurred by a taxpayer for expenses charged back to another person or entity for which no reimbursement is received cannot be considered reimbursed for these purposes.

(c) Noninterest expenses charged to another person or entity. Noninterest expenses incurred by a taxpayer for the benefit of, or on behalf of, an affiliated corporation or other affiliated entity that are either charged back to that corporation or other entity or offset on the books and records of the taxpayer, other than through a reimbursement arrangement described above or through a management fee described below, are not subject to attribution provided a deduction for such expenses is not claimed by the taxpayer.

(d) Management fees. Compensation received through a management or similar fee arrangement between the taxpayer and a corporation or other entity, whether or not affiliated with the taxpayer, must be treated as business income, and deductions for noninterest expenses compensated for by such management or similar fee must be directly attributed to business income and capital. Noninterest expenses can be treated as compensated for through a management or similar fee provided the fee is paid pursuant to a written agreement. Absent a written agreement, the nature of the transaction as one involving compensation through a management or similar fee must be proven by the taxpayer.

(2) Federal base modifications. In determining those deductions

subject to attribution, adjustments required by the Administrative Code must be taken into account.

(3) Attribution of noninterest deductions.

(a) The following rules must be applied in determining whether a taxpayer has properly attributed noninterest deductions directly and indirectly among classes of capital and the income, gains and losses therefrom. Deductions not directly attributed to one or more classes of capital or income under these rules must be included in the residual group of deductions that will be indirectly attributed as provided in paragraph (c).

(b) Direct attribution of noninterest deductions. Where possible, the taxpayer must directly attribute to the appropriate class of capital or income those noninterest deductions for expenses that proximately, and not incidentally, benefit that class of capital or income. The determination of which classes of capital or income are proximately benefitted must be made on the basis of all facts and circumstances, including but not limited to, the nature of the income that proximately relates to the expenses that are the basis for the deduction. Taxpayers should maintain books and records sufficient to support the direct attribution of expenses among the classes of capital and income.

Except as provided in subparagraph (i) (A), below, if a deduction is for an expense that proximately benefits more than one class of capital or the income therefrom, the deduction must be apportioned among those classes of capital or income that are benefitted.

(i) Direct attribution of noninterest deductions to business capital or income.

(A) The following noninterest deductions are irrebuttably presumed to benefit business income or capital and should be directly attributed thereto.² In response to any letter sent to the taxpayer as provided under the procedures set forth above, the taxpayer need only substantiate the nature and amount of each item on this list; the taxpayer is not required to separately establish the basis for direct attribution to business income or capital:

²This does not preclude as a separate issue a discretionary adjustment as described in section IV.A(1) (a) above, to any expense on this list.

- (a) cost of goods sold;
- (b) bad debts other than items properly classified as subsidiary or investment capital;
- (c) property, excise and sales and use taxes;
- (d) real estate rents, depreciation and repairs;
- (e) utilities including telecommunications costs;
- (f) amortization of real property leasehold costs and improvements;
- (g) depletion;
- (h) advertising;
- (i) noninterest expenses for which reimbursement is received in the form of a management fee treated on the report as business income;
- (j) research and development expenses;
- (k) marketing expenses;
- (l) property and casualty and product liability insurance;
- (m) compensation packages of the chief executive officer, chief financial officer and chief operating officer;
- (n) directors' fees, expenses and indemnity insurance;
- (o) charitable contributions;
- (p) stationery, printing, postage and other similar distribution costs;
- (q) noninterest costs and expenses relating to communication and interaction with the taxpayer's shareholders and investors;
- (r) noninterest costs and expenses relating to routine reporting requirements of the Securities and Exchange Commission, routine financial statements and tax filings;
- (s) travel and entertainment expenses;
- (t) noninterest costs and expenses incurred in

connection with an unsuccessful acquisition;

(u) noninterest costs and expenses of developing company or group-wide administrative procedures; and

(v) internal auditing costs and expenses.

(B) Taxpayers shall directly attribute to business capital or income those noninterest deductions for expenses that proximately benefit business capital or income. The following are examples of noninterest deductions that under appropriate facts and circumstances may be directly attributed to business capital or income. In response to any letter sent to the taxpayer as provided under the procedures set forth above, the taxpayer must substantiate the direct attribution of these deductions to business capital or income as well as the amount of the deduction:

(a) deductible costs of shipping goods to customers;

(b) compensation and other benefits of officers, other than officers described in subparagraph (A)(m) above, and employees engaged in manufacturing, sales, services, or other activities directly producing business capital or income; and

(c) deductible legal expenses incurred in conducting the taxpayer's business, such as costs incurred to acquire or protect a copyright or patent used in the taxpayer's business or legal expenses incurred in negotiating contracts or resolving labor disputes with employees engaged directly in manufacturing, sales, services, or other activities directly producing business capital or income.

(d) reimbursed noninterest expenses as provided in section IV.A(1)(b) above.

(e) noninterest expenses compensated for by a management fee, as provided in section IV.A(1)(d) above.

(ii) Direct attribution of noninterest deductions to subsidiary capital or income, gains or losses therefrom. Taxpayers shall directly attribute to subsidiary capital or income those noninterest deductions for expenses that proximately benefit subsidiary capital or income. The following are examples of noninterest deductions that, except as provided in subparagraph (i)(A), above, should be directly attributed to subsidiary capital or income from subsidiary capital:

(A) compensation and other benefits of officers, other than officers described in subparagraph (i) (A) (m) above, and employees engaged in the acquisition, management or disposition of subsidiary capital or income therefrom;

(B) legal and accounting expense deductions relating to the management of subsidiary capital or income therefrom;

(C) computer expense deductions relating to the management of subsidiary capital or income therefrom;

(D) other deductible fees and expenses incurred in connection with the successful purchase of subsidiary capital, or the sale, whether or not successful, of subsidiary capital;

(E) other deductible expenses incurred by the taxpayer for its own benefit in its role as a shareholder of the subsidiary, including but not limited to;

(a) deductible expenses incurred in reviewing information prepared by the subsidiary where such review is undertaken by the taxpayer in its role as a shareholder of the subsidiary;

(b) deductible expenses incurred in connection with the general supervision of a subsidiary by the taxpayer's employees (stewardship expenses). These expenses do not include expenses relating to the day-to-day operation of the subsidiary;

(c) deductible expenses incurred by the taxpayer to preserve its investment in a subsidiary; and

(d) deductible expenses incurred in meeting reporting requirements or other legal obligations imposed on the taxpayer in its role as a shareholder of the subsidiary, other than expenses described in subparagraph (i) (A) (r) of this paragraph.

(iii) Direct attribution of noninterest deductions to investment capital or income. Taxpayers shall directly attribute to investment capital or income those noninterest deductions for expenses that proximately benefit investment capital or income. The following are examples of noninterest deductions that, except as provided in subparagraph (i) (A), above, should be directly attributed to investment capital or income:

(A) safe deposit box rentals for safekeeping of certificates or other documents relating to investment capital;

(B) financial news subscriptions utilized exclusively by employees engaged in the acquisition, management or disposition of investment capital or the income therefrom;

(C) compensation and other benefits of officers, other than officers described in subparagraph (i) (A) (m) of this paragraph, and employees engaged in the acquisition, management or disposition of investment capital or the income therefrom;

(D) the deductible cost of insurance and fidelity bonds covering investment capital;

(E) deductible custodian fees, investment advisory fees and legal and accounting costs and fees relating to the management of investment capital or the income therefrom;

(F) deductible computer expenses relating to the, management of investment capital or the income therefrom;

(G) deductible fees and expenses incurred in connection with the successful purchase of investment capital, or the sale, whether or not successful, of investment capital; and

(H) other deductible expenses incurred by the taxpayer for its own benefit in its role as a holder of the investment in the corporation, including but not limited to;

(a) deductible expenses incurred in reviewing information prepared by the corporation, where such review is undertaken by the taxpayer in its role as an investor in the corporation;

(b) deductible expenses incurred in connection with the general supervision of the corporation by the taxpayer's employees. These expenses do not include expenses relating to the day-to-day operation of the corporation;

(c) deductible expenses incurred by the taxpayer to preserve its investment; and

(d) deductible expenses incurred in meeting reporting requirements or other legal obligations imposed on the taxpayer in its role as a investor in the corporation, other than expenses described in subparagraph (i) (A) (r), above.

(iv) Direct attribution to more than one class of capital. A specific noninterest deduction may represent an expense that proximately benefits more than one class of capital or

income. In that case, the taxpayer should directly attribute a portion of that deduction to each class of capital or income proximately benefitted by that expense using a method that is reasonable for that particular expense. Such a method can be based on one or more factors appropriate given the nature of the deduction. Such factors may include but are not limited to time, space, payroll, and numbers of personnel. See examples below. Deductions listed in subparagraph (i)(A) of this paragraph are irrebuttably presumed to benefit business capital and, therefore, are directly attributed entirely to business capital.

(v) Operating Divisions. (A) If taxpayer can substantiate that at least 95 percent of the noninterest expenses of an operating division are directly attributable to a particular class of capital or income, 100 percent of the noninterest expenses of that operating division may be directly attributed to that class of capital or income. Noninterest expenses subject to this rule include expenses listed in subparagraph (i)(A) of this paragraph and all other noninterest expenses of that operating division.

(B) For purposes of this subparagraph, the term "operating division" shall mean a subunit of a corporation that meets the following criteria:

(a) the activities of the subunit constitute a trade or business; and

(b) a separate set of books and records is maintained with respect to the subunit.

(C) Trade or Business. The determination as to whether activities constitute a trade or business is dependent on all of the facts and circumstances. Generally a trade or business is a specific set of activities that constitutes or would constitute an economic enterprise carried on for profit if carried on by a separate entity. To constitute a trade or business, a group of activities must ordinarily include every operation that forms a part of, or a step in, an income producing or profit making process including the collection of income and the payment of expenses. It is not necessary that the activities carried out by an operating division constitute a different trade or business from those carried out by other divisions of the taxpayer. A vertical, functional or geographic division of the same trade or business may be a trade or business for this purpose provided that the activities otherwise qualify as a trade or business under this paragraph (C). However, activities that are merely ancillary to a trade or business do not constitute a trade or business. For example, financing activities or legal, accounting or

other administrative activities will generally be considered ancillary and will not constitute a trade or business for this purpose.

(D) Separate Books and Records. To have a separate set of books and records a subunit must maintain at a minimum, a separate set of ledger accounts (i.e. cash receipts, cash disbursements, accounts receivable, and accounts payable) and a general journal or similar book of original entry.

(c) Indirect attribution of residual noninterest deductions.

(i) Noninterest deductions that cannot be directly attributed as provided in section IV.A(3)(b) above ("residual noninterest deductions") must be attributed to subsidiary and investment capital using either the combined asset and income method set out in subparagraph (ii) below, or if an election is made as provided for therein, the alternative asset method set out in (iii) below. The amount of residual noninterest deductions is determined by subtracting the amount of noninterest deductions attributed directly under section IV.A(3)(b) above from the total amount of attributable noninterest deductions.

(ii) Combined asset and income method.

(A) An amount of residual noninterest deductions determined by multiplying residual noninterest deductions by the subsidiary capital combined percentage (defined in (v) below), must be indirectly attributed to subsidiary capital, and the income, gains or losses therefrom.

(B) An amount of residual noninterest deductions determined by multiplying residual noninterest deductions by the investment capital combined percentage (defined in (v) below), must be indirectly attributed to investment capital and income.

(C) The excess of the amount of residual noninterest deductions over the amount of residual noninterest deductions indirectly attributed pursuant to (A) and (B) above must be indirectly attributed to business capital and income.

(iii) Alternative Asset Method.

(A) Method of Attribution

(a) The taxpayer must indirectly attribute to subsidiary capital and income an amount of residual noninterest deductions determined by multiplying residual noninterest deductions by the asset factor (defined in (iv) below) for subsidiary capital.

(b) The taxpayer must indirectly attribute to investment capital and income an amount of residual noninterest deductions determined by multiplying residual noninterest deductions by the asset factor (defined in (iv) below) for investment capital.

(c) The taxpayer must indirectly attribute to business capital and income the excess of the amount of residual noninterest deductions over the amount of residual noninterest deductions indirectly attributed pursuant to (a) and (b) above.

(B) Election. In order to use the alternative asset method to allocate its residual noninterest deductions, the taxpayer must elect to do so on a timely return, including extensions, for its first taxable year beginning on or after January 1, 1995 on which the taxpayer reports subsidiary or investment capital. This election is irrevocable; if the taxpayer elects the alternative asset method, the taxpayer must use that method to allocate its residual deductions in all subsequent taxable years. The taxpayer may not elect the alternative asset method on a late or amended return. In the absence of a timely election the taxpayer must use the combined asset and income method specified in (ii) above.

(iv) Computation of Asset and Income Factors.

(A) Asset Factor. The asset factor with respect to subsidiary capital is determined by dividing the average value of the taxpayer's subsidiary capital, without reduction for liabilities attributable to subsidiary capital, by the total average value of all the taxpayer's assets without reduction for liabilities. The asset factor with respect to investment capital is determined by dividing the average value of the taxpayer's assets constituting investment capital, without reduction for liabilities attributable to investment capital, by the total average value of all the taxpayer's assets without reduction for liabilities. For these purposes, real property and marketable securities must be valued at fair market value and the value of personal property other than marketable securities must be the value thereof shown on the books and records of the taxpayer in accordance with generally accepted accounting principles.

(B) Income factor. The income factor for subsidiary capital is determined by dividing the taxpayer's gross income from subsidiary capital by its total gross income. The income factor for investment capital is determined by dividing the taxpayer's gross income from investment capital by its total gross income.

(a) For these purposes total gross income is the amount determined under Internal Revenue Code section 61, adjusted as provided in Code section 11-602.8(c).

(b) Gross income from subsidiary capital is that portion of total gross income consisting of dividends, interest, and gains from subsidiary capital; and

(c) Gross income from investment capital is that portion of total gross income consisting of dividends, interest, and gains from investment capital.

(v) Computation of subsidiary and investment capital combined percentages.

(A) The subsidiary capital combined percentage is computed by adding together two times the taxpayer's income factor for subsidiary capital and the taxpayer's asset factor for subsidiary capital and dividing the total by three. (The income and asset factors are defined in (iv) above.)

(B) The investment capital combined percentage is computed by adding together two times the taxpayer's income factor for investment capital and the taxpayer's asset factor for investment capital and dividing the total by three.

(C) In determining the subsidiary capital and investment capital combined percentages, if total gross income is zero, the subsidiary and investment capital percentages are equal to their respective asset factors. If total assets are zero, the subsidiary and investment capital percentages are equal to their respective income factors.

B. Examples

The following examples illustrate the direct and indirect attribution of noninterest deductions to subsidiary, investment and business capital.

Example 1: Each member of a taxpayer's accounting staff spends 40% of his or her time analyzing whether the taxpayer should restructure its subsidiaries. Each member of the accounting staff spends 20% of his or her time analyzing the taxpayer's investment portfolio. The accounting staff does not spend any other time on issues relating to subsidiary or investment capital or income. The taxpayer attributes 40% of the accounting staff's salaries and related expenses to subsidiary capital and 20% to investment capital. This method is acceptable.

Example 2: The facts are the same as in example 1. In addition, the accounting staff occupies 10% of a building rented by the taxpayer. The other 90% is used for the taxpayer's service business. All rental expense should be directly attributed to business capital pursuant to subparagraph (i)(A)(d). None of the rental expense should be attributed to subsidiary or investment capital or income.

Example 3: The facts are the same as in example 1. The taxpayer has a total of 100 employees. Ten employees are in the accounting department. Ten employees are in the personnel department. They are responsible for managing the hiring, salaries, pension and medical benefits of all employees. Of the remaining 80 employees, five spend 20% of their time on activities related to investment capital and 40% of their time on activities related to subsidiary capital. The 15 employees engaged in activities relating to investment and subsidiary capital represent 25% of the total payroll of the taxpayer.

The taxpayer attributes 5% ($25\% \times 20\%$) of the salaries and related expenses of the personnel department employees to investment capital and 10% ($25\% \times 40\%$) to subsidiary capital. This method, based on time and payroll, is reasonable under the circumstances and is acceptable.

Example 4: The CEO of a corporation does not maintain detailed time records. However, she does maintain a diary that shows that she spends approximately 20% of her time in planning the corporation's strategy for investment in subsidiaries and 80% of her time in planning the corporation's strategy for developing, manufacturing and marketing its products. The taxpayer should attribute the CEO's salary to business capital pursuant to subparagraph (i)(A)(m) of this paragraph. None of the CEO's salary should be attributed to subsidiary (or investment) capital.

Example 5: Income and Assets. Corp. X has \$10,000 of business income, \$4,000 of business assets, \$300 of income from subsidiary capital, \$1,000 of subsidiary assets, \$500 of investment income and \$2000 of investment assets. (Assets here are calculated without reduction for liabilities.)

Expenses. Corp. X has \$6,000 in noninterest expenses, of which \$3,500 is directly attributable to business capital and properly substantiated, including items on the list of expenses presumed attributable to business

capital under paragraph (b)(i)(A) above.

Separate Operating Division. Corp. X has a manufacturing plant that has its own human resources department and keeps separate books and records of expenses. \$1,000 of the \$6,000 of noninterest expenses are attributable to that plant and are not included in the \$3,500. Of that \$1,000, \$400 is wages and salaries, \$100 is for equipment rental and depreciation, and \$500 consists of items on the list in section IV.A.(3)(b)(1)(A) above. Corp. X can substantiate that at least \$950 of the \$1,000 is directly attributable to business capital. Therefore, all \$1,000 of the expenses of that plant are considered directly attributable to business capital.

The total of directly attributable expenses is \$4,500. (\$1,000 from the division and \$3,500 from the corporation as a whole.)

Subsidiary and Investment Capital Combined Percentages

Subsidiary: [$\$300/\$10,800$ (income) + $\$300/\$10,800$ (income) + $\$1,000/\$7,000$ (assets)]/3 = 6.61%

Investment: [$\$500/\$10,800$ (income) + $\$500/\$10,800$ (income) + $\$2,000/\$7,000$ (assets)]/3 = 12.61%

Indirect residual noninterest deductions of \$1,500 (\$6,000 less the \$4,500 directly attributed to business) are attributed, 6.61% (\$99.15) to subsidiary capital and 12.61% (\$189.15) to investment capital. The remainder, \$1211.70 ($\$1500 - [\$99.15 + \$189.15]$) is attributed to business capital.

The total direct and indirect noninterest expense attribution is \$5711.70 to business, \$99.15 to subsidiary and \$189.15 to investment capital.

Example 6: Income and Assets. Corp. X has \$10,000 of business income, \$4,000 of business assets, \$300 of income from subsidiary capital, \$1,000 of subsidiary assets, \$500 of investment income and \$2000 of investment assets. (Assets here are calculated without reduction for liabilities.)

Expenses. Corp. Y, a broker dealer, has \$5,000 in noninterest expenses, of which \$2,000 is substantiated as compensation of account representatives, \$1,000 is

substantiated as for computer equipment and software and wire services used exclusively to manage customer accounts and execute customer transactions, \$1,000 consists of items on the list in section IV.A(3)(b)(1)(A) above and \$500 is substantiated as directly attributable to investment capital.

The total of directly attributable expenses is \$4,500. (\$4,000 to business capital and \$500 to investment capital)

Subsidiary and Investment Capital Combined Percentages.

Subsidiary: [$\frac{\$300}{\$10,800} + \frac{\$300}{\$10,800} + \frac{\$1,000}{\$7,000}$]/3 = 6.61%

Investment: [$\frac{\$500}{\$10,800} + \frac{\$500}{\$10,800} + \frac{\$2,000}{\$7,000}$]/3 = 12.61%

Indirect residual noninterest expenses of \$500 are attributed 6.61% (\$33.05) to subsidiary capital and 12.61% (\$63.05) to investment capital. The remainder, \$403.90, ($\$500 - [\$33.05 + \$63.05]$) is attributed to business capital.

The total direct and indirect noninterest expense attribution is \$4403.90 to business, \$33.05 to subsidiary and \$563.05 to investment capital.