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Report No. 1353
September 6, 2016

The Honorable Jerry Boone
Commissioner
New York State Department of Taxation and Finance
W.A. Harriman Campus, Building 9
Albany, NY 12227

Re: *Draft Amendments to Sections 4-6.1, 4-6.3 and 4-6.4 of Subpart 4-6 of the New York State Business Corporation Franchise Tax Regulations*

Dear Commissioner Boone:

The Tax Section of the New York State Bar Association (the "**Tax Section**") is pleased to submit the comments[1] set forth below regarding the draft amendments to Sections 4-6.1, 4-6.3 and 4-6.4 of Subpart 4-6 of the New York State Business Corporation Franchise Tax Regulations (the "**Draft Amendments**"). The Draft Amendments were issued by New York State Department of Taxation and Finance (the "**Department**") on March 4, 2016 and are intended to provide guidance regarding the Department's

[1] The principal drafters of this letter were Jack Trachtenberg and Jennifer S. White. Helpful comments were received from Kimberly S. Blanchard, Peter J. Connors, Christopher L. Doyle, Peter L. Faber, Maria T. Jones, Lindsay M. LaCava, Alysse McLoughlin, Leah Robinson, Arthur R. Rosen, Michael L. Schler, and Irwin M. Slomka. This letter reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

authority to adjust a taxpayer's apportionment fraction under Tax Law Section 210-A.11 of Article 9-A.

Once again, the Tax Section appreciates the Department's openness in making the Draft Amendments widely available on its website for comment before they are formally proposed pursuant to Article 2 of the State Administrative Procedures Act. We again commend the Department for having prepared generally clear and comprehensive guidance for businesses and practitioners.

Background

1. New York's Apportionment Regime

For Article 9-A taxpayers, New York historically employed a three-factor apportionment formula that looked at the extent to which a corporation's property, payroll, and receipts were attributable to the state. New York also adopted a special statutory provision that gave the Department the authority to depart from this general three-factor formula when that formula failed to reflect the corporation's in-state income because of unique circumstances peculiar to that corporation or its business. This "discretionary apportionment" language has been in the New York State Tax Law for decades.

In 2006, the New York State legislature decided, reportedly for economic development reasons, that apportionment should be based only on a corporation's receipts. With the 2014–2015 corporate tax reform legislation, it further decided that receipts should always be sourced to the location of the customer. By doing this, the Legislature effectively concluded that the contributions of labor and capital in generating income should not be taken into account, a decision reportedly driven by the desire to eliminate any disincentive to corporations to locate or expand operations in the state. In effect, the Legislature decided that apportionment should not be based on where income is "earned" in the traditional sense, but rather on where the customer receiving the goods or services is located.

2. The Draft Amendments

The Draft Amendments to Section 4-6.1(a) state that the application of the apportionment formula found in Tax Law § 210-A generally results in a fair apportionment of business income and capital. However, if the statutory apportionment fraction does "not reach a fair result" then the Department may, in its discretion or at the request of the taxpayer, adjust the apportionment

fraction to more accurately reflect the taxpayer's business activity within New York.[2] Such an adjustment may: (i) exclude one or more items of receipts, net income, net gain, or other items otherwise included in the determination of the apportionment faction; (ii) include additional items in the determination of the apportionment fraction; or (iii) use any other similar or different method calculated to effect a fair and proper apportionment of business income and capital.[3]

According to the regulation, a taxpayer may not vary the statutory apportionment fraction without the Department's consent.[4] Thus, if a taxpayer does not have consent prior to filing its report, it must file the report using the apportionment fraction determined under section 210-A of the Tax Law.[5] If consent is received after the filing of the report, the taxpayer may amend the report using the approved method to compute its tax due.[6]

A taxpayer's request to vary its apportionment fraction must be submitted in writing, separately from the report.[7] If the taxpayer has not requested the use of an alternative apportionment fraction before an audit of the report begins, the determination of whether or not the apportionment fraction results in a proper reflection of business income and capital will be made during the course of the audit.[8]

The Draft Amendments also reflect the statutory mandate that the party seeking to vary the apportionment formula bears the burden of proof to demonstrate that the statutory method does not result in a proper reflection of the taxpayer's business income and capital within New York, and that the proposed adjustment is appropriate.

Comments

1. The Legislature Has Adopted an Economic Development Policy Based on Market-Based Sourcing.

It is critical to recognize that the Legislature has unambiguously adopted an economic development policy that sources the business income and capital of a corporation based on the

2 Draft Regulation § 4-6.1(a).

3 *Id.* at § 4-6.1(b).

4 *Id.* at § 4-6.1(c)(1).

5 *Id*.

6 *Id*.

7 *Id*. at § 4-6.1(c)(2).

8 *Id*.

location of the corporation's market, and not based on the traditional criteria for determining where income is earned. The state's adoption of a single-sales-factor apportionment formula has made the Department's discretionary authority something of an anomaly, because that authority was conceived of as a mechanism for accurately reflecting in-state earning of income in those rare cases when the traditional apportionment formula did not do so. Now that the statutory apportionment formula has nothing to do with where a taxpayer engages in activities that generate its in-state income, we anticipate the Department's use of its discretionary authority will be even rarer than before the implementation of market-based sourcing.

The reason for this is that when the Department does use its discretionary authority to adjust the statutory apportionment formula, it would be inappropriate for the Department to do so in any manner that undermines the market-sourcing regime adopted by the Legislature. Thus, absent unique circumstances, the location of a corporation's property and employees should not be considered in apportioning income and capital.

We recommend that the regulations be amended to specifically state that any alternative apportionment method used, whether sought by the Department or by the taxpayer, must be consistent with the location of the taxpayer's market. This is necessary to ensure that, whatever factors are considered, they are only considered to the extent they reflect the taxpayer's market, as is required by the Tax Law.

2. "Fair," by Itself, is an Unworkable Standard.

The Draft Amendments do not modify the existing regulation's use of the term "fair" in reference to determining when an alternative apportionment formula should be used, even though the statute also requires a "proper" reflection of business income and capital. Specifically, the regulation continues to provide that if the use of the statutory apportionment fraction does not result in a "fair apportionment" of business income and capital, or does not otherwise "reach a fair result," an alternative method may be used.[9] The regulation offers no guidance or examples as to what it means to be "fair" in this context or how the requirements of fairness and properness can both be satisfied. This is not a concern that arises as a result of the Department's proposed Draft Amendments; rather, it is a concern that the Tax Section has with the existing regulatory language.

In particular, the Tax Section is concerned that "fairness" alone is an unworkable standard in determining whether the statutory apportionment fraction should be adjusted under the

[9] *Id.* at § 4-6.1(a).

new Tax Law. What is considered "fair" may look significantly different from the point of view of the taxpayer and the Department. For example, the Department may consider it "unfair" if the statutory apportionment fraction results in little or no business income being apportioned to New York, particularly for a corporation with a significant presence in the State. Yet, such a result may nonetheless be warranted based on the Legislature's clear decision to adopt a market-based apportionment regime.

In our view, the regulation should mirror the language of the statute, which authorizes alternative apportionment when the statutory method "does not result in a *proper* reflection of the taxapyer's business income or capital" and which permits in such cases the use of an alternative method that is calculated to reflect both a "fair *and proper*" apportionment.[10] In this regard, the Tax Section believes that, in order to be "fair and proper," any alternative apportionment method used should reflect the underlying conceptual legislative mandate that business income and capital be apportioned to the location of the taxpayer's market.

3. The Requirement to Request and Gain Consent for Use of a Discretionary Adjustment is Problematic.

The regulation continues to require taxpayers to request permission and gain consent to use an alternative apportionment methodology prior to filing a tax report.[11] As an initial matter, we note that the statute is devoid of any prior consent requirement, and we question whether such a requirement may be imposed through a regulation. The Tax Section also believes the prior consent rule is inconsistent with established case law, as the courts have routinely sided with taxpayers that filed a report using an alternative method, so long as the taxpayer could prove it had the right to use the alternative method. If the goal of the prior consent requirement is to put the Department on notice than an alternative apportionment method is being employed, notice could be achieved by other means, such as a check-box on the apportionment schedule. If the goal of the prior consent requirement is something other than notice, that goal should be explained.

On a related point, the Draft Amendments add the provision that if a request to use an alternative apportionment formula has not been made before an audit begins, a determination as to the proper apportionment fraction will be addressed on audit. We believe this is consistent with

[10] Tax Law § 210-A.11 (emphasis added).

[11] Effective April 13, 2011, amendments to Section 4-6.1 of the Business Corporation Franchise Tax regulations updated the administrative procedure for requesting a discretionary adjustment. Before the amendment, a request for alternative apportionment was to be made with the filing of the report.

the decision of the Tax Appeals Tribunal's decision in *Matter of Autotote Limited*.[12] Under the principles set forth in *Autotote*, we do not believe the Department can deny a taxpayer's request for alternative apportionment based solely on the taxpayer's failure to request permission to do so before filing the report, if the Department has had a full and fair opportunity to audit the taxpayer. Arguably, however, the taxpayer's failure to request advanced permission would be grounds to assert penalties should the Department determine on audit that the taxpayer's alternative apportionment method was not appropriate. Of course, this would imply that a taxpayer who had sought prior consent but then had that methodology disallowed on audit would be entitled to have penalties abated (or not imposed in the first place) due to the Department's prior grant of consent.

While the Draft Amendments address the *Autotote* scenario of an alternative apportionment request being raised on audit, it is unclear how the requirement to request and receive consent for a discretionary adjustment before the filing of a report will be interpreted and applied in other situations. For example:

- Assume the taxpayer files an original report using the statutory apportionment fraction and subsequently requests permission to file a refund claim using an alternative method. Assume further that the Department does not respond to the taxpayer's request within the statute of limitations period for assessment. May the taxpayer file the refund claim using the alternative method before the statute of limitations period expires without the Department's permission to avoid an expiration of the statute of limitations for filing a refund claim? Alternatively, would the prior consent request somehow toll the statute of limitations period for refund purposes?

- If the Department grants a taxpayer's request to use an alternative apportionment fraction, does the granting of the request mean that the Department is accepting the alternative method as "fair" and "proper" or may the Department challenge the alternative apportionment on audit (even if the facts are not materially different than as set forth in the taxpayer's request)?

- Assume the Department denies a taxpayer's request to use an alternative apportionment fraction and the taxpayer reasonably believes the Department's denial is erroneous. How would the taxpayer protest the Department's refusal to grant permission to use an alternative apportionment fraction? Will the Department issue some type of notice denying the request that may be protested?

[12] N.Y. Tax App. Trib. (Apr. 12, 1990).

- Same assumptions as the third example above. May the taxpayer nonetheless file its report using the alternative apportionment fraction to challenge the Department's failure to grant permission to do so? If the Department rejects the report, will it issue a Notice of Deficiency or Refund Denial that allows the taxpayer to file a protest on the merits of its alternative apportionment position?

The Tax Section believes it would be helpful to provide additional guidance on these points specifically, as well as more generally regarding the mechanics for requesting, and protesting a denial of a request for, alternative apportionment. To that end, we note that the Alabama Department of Revenue has issued a regulation on alternative apportionment that addresses some of our concerns. For example, the Alabama regulation provides that if a taxpayer's proposed alternative apportionment method is not approved by the Department within 90 days it is deemed denied (unless the taxpayer and the Department agree in writing to extend this period), and that a taxpayer petitioning to use an alternative method with fewer than 91 days remaining before the statute of limitations expires may file a refund claim before the Department acts on the taxpayer's request for alternative apportionment. The Alabama regulation also provides that a taxpayer may appeal the denial of a petition for alterantive apportionment by filing an amended return using the proposed alternative method.[13]

The Tax Section believes the Alabama regulation is worthy of consideration because it addresses the the concern that taxpayers seeking alternative apportionment require clear procedures to contest the denial of alternative apportionment or the Department's failure to act on the taxpayer's request in a timely manner. We also encourage the Department to consider some other type of notification mechanism as a less-burdensome alternative to the proposed pre-approval process and one that would avoid some of the uncertainties discussed above.

4. Examples of Alternative Apportionment Methodologies Would be Helfpul.

Consistent with the statute, the Draft Amendments provide that an adjustment to the apportionment fraction may include or exclude additional items of receipts, net income, net gain, or other items otherwise included in the determination of the apportionment faction, or can altogether deviate from the formula found in section 210-A of New York Tax Law. However, the regulation lacks any examples of what types of alternative apportionment methods would or would not be acceptable to the Department.

[13] Ala. Admin. Code § 810-27-1-.18(1).

Providing additional guidance or examples on this point would be particularly helpful now that the Legislature has made a policy judgment that income and capital must be allocated based on customer location rather than, in the case of income and capital related to the provision of services, where income producing activities occur. In particular, it would be helpful to know when (if ever) the Department would seek to deviate from the one-factor apportionment fraction and include a property or payroll factor in the apportionment formula since, in most scenarios, the addition of either of these factors would be completely incompatible with the customer location method chosen by the Legislature. While the statute contemplates including "additional items" when using an alterantive apportionment formula, the Tax Section believes that the inclusion of these factors would be improper absent unique circumstances.

Similarly, we cannot envision a scenario where it would be proper for the Department to require or permit the use of a cost-of-performance method for determining the sales factor as opposed to the market-based approach sanctioned by the Legislature. Although the authority in the regulation to use "any other similar or different method calculated to effect a fair and proper apportionment of business income and capital" is broad, a cost-of-performance method would be contrary to the legislative mandate that business income and capital be sourced to the location of the taxpayer's market and would not be a "proper" apportionment method.

5. The Burden of Proof and Level of Distortion Needed to Trigger Alternative Apportionment Should be Clarified.

The Draft Amendments provide that the party seeking to vary the apportionment formula bears the burden of proof to demonstrate that the statutory method does not result in a proper reflection of the taxpayer's business income and capital within New York. We commend the Department for adopting this approach, which is mandated by the statute. However, the Draft Amendments do not address whether the burden of proof is preponderance of the evidence, clear and convincing evidence, or some other standard. In this regard, the Tax Section believes the Department has the authority to determine the applicable evidentiary standard, but notes that a clear and convincing evidence standard may be most consistent with the standard articulated in *British Land (Maryland) v. Tax Appeals Tribunal* (referring to a "heavy burden of showing, by clear and cogent evidence, that application of the statutory formula attributes New York income to [the taxpayer] 'out of all appropriate proportion to the business transacted by [it] in that

State'"). The clear and convincing evidence standard is also the standard that is generally used in all other proceedings involving disputes under the Tax Law.[14]

The standard articulated in *British Land* raises another important point. Specifically, we believe the regulation should make it clear that the same level of income distortion is required before either the Department or a taxpayer may diverge from the statutory approach. Under *British Land*, we believe such distortion must rise to the level of attributing income or capital to New York in a manner that is "out of all appropriate proportion to the business transacted" by the taxpayer in the state. Put differently, neither the Department nor taxpayers should be permitted to deviate from the statutory apportionment formula simply because *some* amount of distortion is present.

As with other areas, examples of how the burden of proof and distortion standards can be met would be helpful.

Thank you for your consideration of our comments and recommendations. If you have any questions or if we can be of further assistance, please let us know.

Respectfully submitted,

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Chair

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[14] *See* Carpenter Technology Corp. v. Comm'r of Tax'n & Fin., 745 N.Y.S.2d 86 (3d. Dept. 2002) ("We begin by noting the presumption of correctness that attaches to a deficiency notice and the burden on a petitioner to prove by clear and convincing evidence that the deficiency was erroneous" (*citing* Matter of Suburban Carting Corp. v. Tax App. Trib. of St. of N.Y., 694 N.Y.S.2d 211)).