Report No. 1339

New York State Bar Association

Tax Section

Report on Draft New York State

Business Apportionment Factor Regulations

March 8, 2016

Contents

I. Introduction 1

II. Background 1

III. Executive Summary 2

IV. Discussion 4

- A. Due Diligence and Document Retention 4
- B. Application of Hierarchies Where There is a Presumption 10
- C. Commingled Receipts 12
- D. Reasonable Approximation 15
- E. Individual versus Business Customers 16
- F. Apportionment Fraction for Preceding Taxable Year 18
- G. Intermediary Transactions 19
- H. Definition of Digital Product 23
- I. Primary Use Location & Where the Digital Product is Received 24

Report on Draft New York State

Business Apportionment Factor Regulations

I. INTRODUCTION

This report[1] comments on draft regulations (the "**Draft Regulations**") under Tax Law Article 9-A prepared by the New York State Department of Taxation and Finance (the "**Department**"), dated October 15, 2015, that principally relate to the apportionment of receipts from (i) "other" services and "other" business activities, and (ii) sales of digital products. The Draft Regulations are intended to provide guidance in interpreting certain provisions in the 2014 and 2015 New York State budget legislation (together, the "**Budget Bill**") that, among other things, implemented a market-sourcing apportionment regime for all receipts that are included in the computation of a taxpayer's business allocation percentage. The Department has requested that comments on the Draft Regulations be submitted by January 16, 2016.

As with other recently issued draft regulations, the Tax Section appreciates the Department's openness in making the Draft Regulations widely available on its website for comment before they are formally proposed pursuant to Article 2 of the State Administrative Procedure Act. We again commend the Department for having prepared generally clear and comprehensive guidance for businesses and practitioners in this entirely new aspect of the Tax Law. This report offers the Tax Section's comments and recommendations on certain of the draft amendments.

II. BACKGROUND

The Budget Bill made significant changes to the rules governing the apportionment of business income and capital under Article 9-A. The Budget Bill retained the receipts-only apportionment scheme under prior law but eliminated the disparate apportionment rules that previously applied to general business corporations and banking corporations. Under the new law, both categories of corporations are subject to the same apportionment rules.

[1] The principal drafters of this report were Jack Trachtenberg, Christopher L. Doyle, Maria Eberle, Lindsay M. LaCava, Alysse McLoughlin, Elizabeth Pascal, Leah Robinson, Irwin M. Slomka, and Jennifer S. White. Helpful comments were received from Peter L. Faber, Maria T. Jones, Stephen B. Land, Arthur R. Rosen, and Michael L. Schler. This report reflects solely the views of the Tax Section and not those of the NYSBA Executive Committee or House of Delegates.

The Budget Bill imposed specific market-based sourcing rules for receipts from sales of tangible personal property and electricity, rentals and royalties, sales and licenses of digital products, various financial transactions, railroad and trucking services, aviation services, advertising, and gas transmission and transportation services. For receipts not specifically addressed, the Budget Bill created a category for receipts from "other services" and "other business receipts."

The Budget Bill established the following hierarchy of methodologies for sourcing receipts from digital products to New York based on customer location: (i) the customer's primary use location; (ii) the location where received by the customer; (iii) the apportionment fraction for that type of receipt from the preceding taxable year; and (iv) the apportionment fraction for the current taxable year for all receipts from digital products that can be sourced using the first two methods in the hierarchy. Similarly, "other services" and "other business receipts" are sourced to New York based on customer location, which is determined using the following hierarchy of methods: (i) where the benefit is received; (ii) the delivery destination; (iii) the apportionment fraction for that type of receipt from the preceding taxable year; and (iv) the apportionment fraction for the current taxable year for all receipts that can be sourced using the first two methods in the hierarchy. In identifying the location of its customers, a taxpayer must exercise due diligence to obtain the customer information under each method in the hierarchy before rejecting it.

The shift to a market-based receipts factor sourcing regime is significant. For roughly 70 years, Article 9-A of the Tax Law primarily sourced receipts based on information in the possession of the *taxpayer*—e.g., where the taxpayer performed the services that generated the receipts to be sourced. Under the new regime, the focus for sourcing such receipts is generally based on where the taxpayer's *customer* uses the service or derives the benefit from the service, which the taxpayer may not know. Accordingly, maintaining a workable corporate income tax will require clear rules, presumptions and safe harbors that taxpayers can rely on in completing their returns.

III. EXECUTIVE SUMMARY

The Tax Section's comments address the following areas of the Draft Regulations: the due diligence and document retention requirements; application of the sourcing hierarchies where there is a presumption; commingled receipts; the rules for using reasonable approximations to determine where a customer receives the benefit of a service; individual versus business customers; the rules for using the apportionment fraction from a preceding taxable year; intermediary transactions; the definition of digital products; and the rules for primary use location and where digital products are received. The Tax Section's comments regarding each of these areas are summarized as follows:

Due Diligence and Document Retention. The Tax Section has concerns regarding the burdens taxpayers will face in complying with the due diligence and document retention requirements. We recommend the Department consider a safe harbor for certain taxpayers and transactions to alleviate these burdens. We further recommend that certain aspects of the requirements be clarified and that taxpayers be protected from penalties when their attempts to meet the requirements are undertaken in good faith.

Application of Hierarchies Where There is a Presumption. The Tax Section agrees that the presumptions in the sourcing hierarchies should be rebuttable, but recommends that the standards for overcoming the presumptions be clarified and made uniform for the Department and taxpayers. We also question whether there is a need for separate standards to overcome the presumptions since the Tax Law already permits discretionary adjustments to a taxpayer's apportionment fraction if it does not result in a proper reflection of the taxpayer's business income or capital within the state.

Commingled Receipts. The Tax Section generally agrees with the Department's interpretations of law as contained in the Draft Regulations, but believes certain clarifications are needed.

Reasonable Approximations. The Tax Section recommends that the reasonable approximation rules to clarified to make it clear that taxpayers do not need the Department's permission to use a reasonable approximation and that the use of any such reasonable approximation is not required before moving to the next step in the sourcing hierarchy. We also question why the Department needs a new grant of authority to substitute a method of approximation if it determines that the taxpayer's chosen method is not reasonable. Since the Department already has discretionary authority under the Tax Law to adjust the apportionment fraction if it does not result in a proper reflection of the taxpayer's business income or capital within the state, we recommend that the substitution authority in the Draft Regulations be removed or at least made consistent with the Commissioner's existing statutory authority.

Individual versus Business Customers. The Tax Section questions whether the Department has the statutory authority to distinguish between individual and business customers in the context of other business receipts. We also note that the requirement to treat a customer as a business customer when the taxpayer cannot reasonably determine whether the customer is an individual may present practical difficulties.

Apportionment Fraction for Preceding Taxable Year. The Tax Section questions the statutory basis for the requirement that, in determining whether the apportionment fraction from the preceding taxable year may be used, the factors that produced the preceding year's fraction must remain substantially similar in the current year. We also believe additional clarity is needed regarding what the term "factors" means in this context.

Intermediary Transactions. The Tax Section questions whether the Department has the statutory authority to source receipts based on the location of the end user in an intermediary transaction where the intermediary is properly considered to be the customer, except in limited circumstances. We also question whether it is proper to treat, in all cases, the end user as the party receiving the benefit of a service in an intermediary transaction. We recommend that a deviation from this rule be permitted in appropriate circumstances or that the rule be abandoned in favor of determining where the benefit of a service is received in an intermediary transaction by using the statutorily established sourcing hierarchies. Other clarifications and corrections are also recommended.

Definition of Digital Product. The Tax Section notes our concern that some transactions or sales will involve aspects of both excluded professional services and digital products, the treatment of which is not clear under the definition contained in the Draft Regulations.

Primary Use Location and Where the Digital Product is Received. The Tax Section is concerned that using the customer's billing address, or address in the customer contract, may not accurately represent where a digital product is used. We suggest that IP addresses or similar information may be more accurate and should be included in the first tier of the sourcing hierarchy. At the same time, we believe the Department should acknowledge that not all taxpayers will have access to this information.

IV. DISCUSSION

A. Due Diligence and Document Retention

1. Draft Regulations

The new market-sourcing regime imposed by the Budget Bill provides that, in certain circumstances, a taxpayer is to apply a hierarchy of sourcing methods to determine whether certain receipts should be sourced to New York. Furthermore, the statute provides that a taxpayer in applying the hierarchy of sourcing methods "must exercise due diligence under each method … before rejecting it and proceeding to the next method in the hierarchy, and must base its determination on information known to the taxpayer or information that would be known to the taxpayer upon reasonable inquiry." This due diligence requirement applies with respect to the rules for sourcing receipts from the provision of digital products, for the sourcing of receipts from other services and other business receipts, and for the sourcing of receipts from financial transactions when such receipts are sourced to the location of the commercial domicile of a business entity.[2]

[2] N.Y. TAX LAW §§ 210-A(4), (5), (10).

2. Comments

(a) Potential safe harbor or relaxed due diligence standard with respect to certain receipts

The Draft Regulations focus on the due diligence requirement related to sourcing of both (a) receipts from the provision of digital products and (b) receipts from other services and other business receipts.[3] The Draft Regulations are virtually identical with respect to sourcing of both types of receipts and, in each case, the Tax Section is concerned that they impose too heavy a burden on certain taxpayers. As an illustration of the magnitude of the work involved, consider the following example:

> A taxpayer has 100,000 customers. Assuming (a) the time involved in performing the necessary due diligence takes only 10 minutes per customer, (b) that one employee is assigned the responsibility of performing the necessary due diligence, and (c) that such employee works nine productive hours a day (allowing for a one hour lunch break), five days a week and has three weeks of vacation in each year, the total due diligence effort would take approximately seven-and-a-half years to complete. Assuming the same facts, but with 10 employees assigned to the task, the due diligence effort would take approximately nine months to complete.

This is an extraordinary amount of time for a taxpayer to spend in determining a sourcing method for only one category of receipts. If the taxpayer has receipts from the provision of more than one digital product or receipts from different types of services or other business receipts, the taxpayer may have to spend even more time on due diligence. The Tax Section believes that the Department should consider a safe harbor whereby, if a taxpayer has over a certain number of customers, then for all customers whose receipts fall below a certain threshold, the taxpayer would be allowed to use the information contained in the customer contract and in the taxpayer's own books and records to determine the proper location to which the receipts should be sourced. The amount of effort to be expended by a taxpayer in conducting due diligence should depend upon both the amount of work that would be involved in performing the due diligence and the potential materiality of the data that might be acquired from those due diligence efforts.

Massachusetts has adopted a safe harbor that allows certain taxpayers to rely on the customer's billing address as reflected in the taxpayer's books and records, as a way of balancing the amount of taxpayer effort with the goal of obtaining reasonably accurate information regarding the location of the taxpayer's customers. Massachusetts amended its Corporation Excise Tax

[3] Presumably the Department will impose similar standards with respect to the hierarchy used to determine the commercial domicile of a business entity for the purpose of sourcing receipts from financial transactions. However, the Department has not yet issued regulations concerning the sourcing of such receipts.

sourcing regulations on January 2, 2015, effective as of January 1, 2014. In its new regulations, Massachusetts essentially divided taxpayers and their customers into three categories, with each different category determining how much work a taxpayer needs to perform in deriving the proper sourcing information with respect to any customer**.** For example, the Massachusetts regulations specify that if a taxpayer receives receipts from the performance of professional services, it is required to identify the state in which the contract of sale is principally managed by the customer for *those customers from which the taxpayer derives more than 5% of its sales of services*.[4] Thus, Massachusetts has determined that for those customers from which a taxpayer derives more than 5% of its sales, it is necessary for the taxpayer to determine definitively where the contract of sale is principally managed by the customer. The rationale seems to be that the level of effort expended in determining this location will not be excessive since the number of such customers will be limited and the sourcing of such receipts could have a material impact on the receipts factor.

Following this relative materiality approach, Massachusetts imposes a lesser burden with respect to those taxpayers that do not derive more than 5% of their receipts from sales of services from any one business customer (or with respect to customers that fall below the 5% level). In those situations, although the taxpayer needs to examine where the contract of sale is principally managed by the customer, if it does not have that information, it moves to the next determinative factor in the hierarchy, which is the location of the customer's place of order and, if that cannot be determined, to the location of the billing address.[5] Furthermore, in those situations where the taxpayer engages in similar service transactions with more than 250 business or individual customers, the taxpayer can elect not to use the sourcing hierarchy at all and just use the billing address for those customers from which it does not derive more than 5% of its receipts from sales of services.[6] In such situations, there seems to be an acknowledgement that if a taxpayer has more than 250 customers, the billing address can be used as a proxy for customer location since the sourcing with respect to any one customer will likely not substantially impact the apportionment. Thus, the Massachusetts regulations essentially recognize that the performance of certain activities in determining definitive sourcing information will in some circumstances be an excessive burden in comparison to the benefit to be derived from any improvement in methodology that would accrue from the performance of those activities.[7]

[4] 830 MASS. CODE REGS. § 63.38.1(9)(d)(4)(d)(iii)(A)(2).

[5] *Id.*

[6] 830 MASS. CODE REGS. § 63.38.1(9)(d)(4)(d)(iii)(A)(3).

[7] The MTC is considering incorporating the same type of language in the latest version of its market sourcing regulations, although in the MTC version, the word "all" would be added to the 5% requirement so that such requirement would apply to situations where the taxpayer "does not derive more than 5% of its receipts from sales of *all* services to the customer." MTC Prop. Reg. § IV.17.(d)(3)(B)(2)b.iv (emphasis added).

Similarly, Washington State's Department of Revenue, in the administration of its Business and Occupation Tax, seems to acknowledge that only in certain circumstances is it necessary to expend substantial effort in determining the sourcing information for any one customer. As in the Massachusetts regulations, the Washington regulations set out a hierarchy of steps whereby the taxpayer starts with the first sourcing method and continues down the list until the sourcing location is properly determined. The first step in the hierarchy imposes a significant burden by requiring the taxpayer to determine where the benefit was received.[8] However, the regulation significantly softens this requirement by providing that it applies only if that location can "reasonably" be found.[9]

The Washington regulation does not explicitly provide a bright-line safe harbor, as found in the Massachusetts regulation. However, in two examples the Washington regulation implies that a *de minimis* safe harbor does exist and demonstrates how the reasonableness limit mentioned above should apply.

The taxpayer in both examples is a law firm that "has thousands of charges to clients."[10] Due to this large volume of transactions, "[i]t is not commercially reasonable for [the taxpayer] to track each charge to each client to determine where the benefit related to each service is received."[11] Instead, the regulation states that "it is reasonable to assume that the benefits of [the taxpayer's] services are received at the location of the customer as reflected by the customer's billing address."[12] Thus, the regulation concludes that the taxpayer in this circumstance "can use the billing addresses of each client as a reasonable method of proportionally attributing the benefit of its services."[13]

In the second example, the regulation provides that the use of billing address does not apply to a customer "that represents a *statistically significant portion* of [the taxpayer's] revenue and whose billing address is unrelated to any of the services provided."[14] For that particular client, the taxpayer "would need to evaluate the specific services provided to that client to

[8] The steps in the hierarchy are the location (1) from where the benefit was received; (2) from where the customer placed its order; (3) to which the taxpayer sends the customer's invoices; (4) from the where the customer sends its payments; (5) for the customer per the taxpayer's business records; and (6) where the taxpayer is domiciled. WASH. ADMIN. CODE § 458-20-19402(301).

[9] WASH. ADMIN. CODE § 458-20-19402(301)(a)(i) (The first step applies only "[i]f a taxpayer can reasonably determine the amount of a specific apportionable receipt that relates to a specific benefit of the services received in a state.").

[10] WASH. ADMIN. CODE § 458-20-19402(301), Example 4.

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id*. Example 5 (emphasis added).

determine where the benefits of those services are received."[15] For the other clients, however, the use of billing address would still be sufficient.[16]

We recommend that the Department consider adopting these or similar regimes to reduce the burden on taxpayer compliance, while maintaining a system that allows the sourcing reasonably to reflect the location of the taxpayer's market and therefore an appropriate apportionment of the taxpayer's receipts to New York State.

(b) Further Clarity is Necessary in Defining What Constitutes Due Diligence

The Draft Regulations provide that the taxpayer's exercise of due diligence must be based on objective criteria and "should consider all sources of information reasonably available to the taxpayer at the time of filing its original tax return including, without limitation, the taxpayer's books and records kept in the normal course of business."[17] This standard seems appropriate; a taxpayer should be able to use and rely on the information that it acquires in the ordinary conduct of its business activities.

While the Draft Regulations provide some necessary overarching guidance, the Tax Section believes that further clarification is needed. In defining the proper due diligence standard, the Draft Regulations use the terms "reasonably" and "good faith"[18] but there is no clear defini-

[15] *Id.*

[16] *Id.*

[17] Draft Regulations §§ 4-4.6(a)(2); 4-4.9(a)(2).

[18] As specifically set forth in the Draft Regulations:

> (2) In exercising due diligence, all of the following standards apply:
>
> (i) A taxpayer's application of the regulatory standards set forth in this section must be based on objective criteria and should consider all sources of information *reasonably* available to the taxpayer at the time of filing its original tax return including, without limitation, the taxpayer's books and records kept in the normal course of business.
>
> (ii) A taxpayer's method of sourcing its receipts must be determined in *good faith*, applied in *good faith*, and applied consistently with respect to similar transactions.
>
> (iii) A taxpayer must retain contemporaneous records that explain the determination and application of its method of sourcing its receipts, including its underlying assumptions, and must provide such records to the Commissioner upon request.
>
> (iv) If applying a level of the hierarchy other than subdivision (c), records must also document the steps taken before abandoning each level of the hierarchy. When abandoning a level of the hierarchy, the standard of due diligence is not satisfied if a taxpayer merely relies on the fact that its existing systems of

tion of these concepts. It would be helpful if the regulations clarified what types of actions will qualify as meeting the due diligence standards. We note that the terms "reasonably" and "good faith" have developed meanings in the context of penalty abatement and sales tax (regarding exemption certificates) that may prove useful in developing such guidance.

(c) The Good Faith Standard Should Trigger a Presumption of Correctness

In determining application of the due diligence standards, the Draft Regulations specify that "[a] taxpayer's method of sourcing its receipts must be determined in *good faith*, applied in *good faith*, and applied consistently with respect to similar transactions."[19] Under this provision, if the method used by the taxpayer is determined to be in "good faith" under the regulations, the Tax Section believes there should be a limited presumption of correctness that flows to the taxpayer. Such a presumption would apply to indicate that the taxpayer properly performed its due diligence obligations before abandoning one or more methods in the apportionment hierarchy in favor of a method at a lower level in the hierarchy. While there will be no presumption of correctness that attaches to the actual apportionment percentage calculated by the taxpayer, the taxpayer would be protected from the imposition of penalties if the Department were to audit the taxpayer and ultimately determine that a different sourcing methodology should have been used.

(d) The Contemporaneous Records Requirement Needs Clarification

The Draft Regulations specify that a taxpayer must "retain contemporaneous records that explain the determination and application of its method of sourcing its receipts, including its underlying assumptions, and must provide such records to the Commissioner upon request."[20] We are uncertain what the phrase "contemporaneous records" means. Must the documentation be prepared at the time of the transaction that generates the receipt? At the time that the tax return is prepared? Or at some other time? The Tax Section recommends that the regulations define the event to which the word "contemporaneous" pertains.

(e) Unaddressed Issues

In addition to the concerns described above, the Tax Section believes that some additional questions should be addressed in the regulations. For example, if a taxpayer is required to

recording transactions or the current format of its books and records do not capture the information required by these rules. (emphasis added)

Draft Regulations §§ 4-4.6(a)(2), 4-4.9(a)(2) (emphasis added).

[19] Draft Regulations §§ 4-4.6(a)(2)(ii); 4-4.9(a)(2)(ii) (emphasis added).

[20] Draft Regulations §§ 4-4.6(a)(2)(iii); 4-4.9(a)(2)(iii).

contact its customers to request information regarding the customers' primary use location and/or location of the receipt, how many times must the information be requested if a customer does not respond and in what form must the request for information be made? The Tax Section recommends that the level of due diligence required in such circumstances (and the reasonableness with which the taxpayer's efforts will be viewed) should depend on a spectrum that accounts for the amount of effort the taxpayer would need to expend relative to the potential materiality of the information to be obtained from the customer (in absolute and relative terms) and its impact on the receipts factor.

An additional unanswered question is whether a taxpayer can rely on representations from its customer. Whatever test is used, we believe that a taxpayer should be allowed to rely on representations by a customer without further inquiry, so long as the reliance is reasonable and made in good faith.

B. Application of Hierarchies Where There is a Presumption

1. Draft Regulations

Sections 4-4.6(a)(3) and 4-4.9(a)(3) in the Draft Regulations state that "at any point in the hierarchy where there is a presumption," that presumption can be overcome by either the taxpayer or the Department. A taxpayer can overcome the presumption by demonstrating, by a preponderance of the evidence, that its proposed alternative sourcing method "more accurately sources the receipts" under the applicable rules of the hierarchy. The Department can overcome the presumption if it can prove by a preponderance of the evidence that the presumption does not "adequately source" the receipts under the applicable rules of the hierarchy *and* that the taxpayer had access to or could have obtained information to more accurately source the receipts.

2. Comments

The Draft Regulations do not specify whether this threshold applies only to explicit presumptions in the law or regulations, or also to implied presumptions. For example, we assume that this provision applies to Section 4-4.6(c)(1)(i), which explicitly presumes that the benefit of a service provided to an individual customer is received at the billing address of the customer in the taxpayer's records. If the language of a particular regulation does not explicitly provide a presumption, does that mean that the regulation's approach will be applied in all situations with no exceptions? That seems inappropriate. Some clarification as to when a presumption applies would be helpful to both taxpayers and auditors attempting to apply the regulations.

We agree that both taxpayers and the Department should have an opportunity to challenge the presumed applicable methodology, but the current draft of the regulations does not define the phrase "adequately source," creating a potential for significant disputes between tax-

payers and the Department as to whether a presumption can be overcome. Moreover, we question whether the standard of proof to overcome a presumption should be different for the Department and the taxpayer (*i.e.*, proving the presumption does not "accurately" source the receipts versus not "adequately" sourcing the receipts). The standard and burden of proof for overcoming the presumption should be uniform for both parties and consistent with the statute. In this regard we believe that the standard requiring the receipts to be "accurately sourced" is the better option.

It is also not clear how the Draft Regulations jibe with the discretionary authority under Tax Law § 210-A(11). Under § 210-A(11), the Commissioner is authorized in his or her discretion to adjust the apportionment fraction if it does "not result in a proper reflection of the taxpayer's business income or capital within the state" and the taxpayer may request that the Commissioner adjust the apportionment fraction. The burden of proof under this provision is placed on the party seeking the adjustment, and that party must demonstrate by clear and convincing evidence that the apportionment fraction does not properly reflect the taxpayer's business income or capital in the state and that the proposed adjustment is appropriate.[21] If overcoming the presumptions in the regulations is simply a different way of adjusting the apportionment fraction, the regulation should recognize that and the standard and burden of proof should not be altered or reduced. One of the reasons the statute is so specific on how receipts are to be sourced is to add clarity and avoid disputes. Taxpayers and the Department should not be allowed to circumvent the certainty provided by the new statute with ease.

If the additional language in the Draft Regulations permitting either party to challenge the presumption is deemed necessary, it should be consistent with the discretionary authority language in § 210-A(11). That is, the threshold to successfully challenge the presumed methodology should be that it does not properly reflect the taxpayer's business income within the State, rather than the overly broad and elusive standard of "adequately source" the receipts. And the standard of proof required to allow presumptions to be overcome should be "clear and convincing evidence" (and should be on the party asserting the alternative sourcing methodology).

[21] N.Y. TAX LAW § 210-A(11).

C. Commingled Receipts

1. Draft Regulations

Digital Products. With respect to digital products, the Tax Law addresses commingled receipts and provides that:

> "[i]f the receipt for a digital product is comprised of a combination of property and services, it cannot be divided into separate components and is considered to be one receipt regardless of whether it is separately stated for billing purposes. The entire receipt must be allocated by [the hierarchy provided in Tax Law § 210-A(4)]."[22]

The Draft Regulations for digital products reiterates this statutory requirement and provides that "[w]hen a digital product is comprised of both digital property and a digital service, the receipt cannot be divided into separate components . . . and is considered to be one receipt regardless of whether the components are separately stated for billing purposes."[23]

The Draft Regulations further provide that (1) "[w]hen a sale includes both tangible personal property and a digital product commingled into one receipt, the entire receipt will be sourced as tangible personal property" under Tax Law § 210-A(2)(a) unless "the tangible personal property is incidental to the digital product," and (2) "[w]hen a sale includes both a digital product and a service or other business activity … commingled into one receipt, the entire receipt will be sourced as a digital product" unless "the digital product is incidental to the service or other business activity."[24]

Services and Other Business Activities. The Tax Law does not address commingled receipts in the context of services and other business activities. However, the Draft Regulations provide that (1) "[w]hen a sale includes both a service or other business activity . . . and tangible personal property commingled into one receipt, the entire receipt will be sourced as tangible personal property" under Tax Law § 210-A(2)(a) unless "the tangible personal property is incidental to the service or other business activity," and (2) "[w]hen a sale includes both a digital product and a service or other business activity . . . commingled into one receipt, the entire receipt will be sourced as a digital product" under Tax Law § 210-A(4) unless "the digital product is incidental to the service or other business receipt."[25]

[22] N.Y. TAX LAW § 210-A.4.

[23] Draft Regulations § 4-4.9(a)(4)(i).

[24] Draft Regulations § 4-4.9(a)(4)(ii) and (iii).

[25] Draft Regulations § 4-4.6(a)(4)(i) and (ii). We note that the use of "business receipt" instead of "business activity" in the second sentence of Draft Regulations § 4-4.6(a)(4)(ii) appears to be a typographical error that should

2. Comments

Draft Regulations § 4-4.9(a)(4)(i), which addresses commingled receipts for digital products consisting of digital property and digital services, appears to mirror the Tax Law provision addressing commingled digital products. However, we note that the Tax Law refers to a "receipt for a digital product comprised of a combination of *property* and *services*" while the Draft Regulations appear to narrow this provision to a digital product comprised of "both *digital* property and *digital* services." The Draft Regulations then go on to provide separate sourcing rules for commingled receipts consisting of digital products and tangible personal property and of digital products and other services or other business receipts. We believe there is room for interpretation regarding whether the statutory language should apply to all three categories of commingled receipts (*i.e.*, (1) digital products consisting of digital property and digital services, (2) digital products and tangible personal property, and (3) digital products and other services and other business receipts) or just the first category (*i.e.*, digital products consisting of digital goods and digital services), but we think the Department's interpretation is the better interpretation.

Therefore, the following comments pertain only to the remaining commingled receipts rules contained in Draft Regulations §§ 4-4.6(a)(4)(i) and (ii) and 4-4.9(a)(4)(ii) and (iii) (the "**Commingled Receipts Provisions**"), unless otherwise stated.

As a preliminary matter, because the Tax Law is silent with respect to commingled receipts consisting of tangible personal property, digital products, and/or other services and other business receipts (as contrasted with commingled receipts consisting of digital products and digital services, as discussed above), the Commingled Receipts Provisions may be inconsistent with the Tax Law. However, because the sourcing rules for receipts from other services and other business activities are clearly intended to operate as a catchall provision for receipts that are not specifically sourced under another rule, it does not seem unreasonable to provide that the specific sourcing rule should apply when these "catchall" receipts are commingled with other types of receipts that are subject to a specific sourcing rule (*e.g.*, receipts from tangible personal property or digital products). Thus, we believe that the hierarchy established by the Commingled Receipts Provisions is a reasonable interpretation of the Tax Law.

There are, however, a few aspects of the Commingled Receipts Provisions that need clarification. First, the Commingled Receipts Provisions refer to a "sale" that includes multiple products or services (tangible personal property, digital products, and services or other business receipts) "commingled into one receipt." However, the Draft Regulations do not define the term

be corrected so the second sentence reads: "This rule does not apply to sales of a service or other business activity when the digital product is incidental to the service or other business activity; such sales must be sourced under these rules instead of Tax Law § 210-A(4)."

"sale" or "one receipt" for this purpose. We believe that the Commingled Receipts Provisions should be applied on a transaction-by-transaction basis as opposed to on some other basis (*e.g.*, an invoice-by-invoice basis or contract-by-contract basis) and recommend that the term "sale" be clarified to refer to a "sale transaction."

In addition, the Commingled Receipts Provisions do not address whether the commingled receipts rules apply to a single sale transaction if the receipts for each component of the transaction are separately stated. (As noted above, the Tax Law addresses this in the context of digital products, providing that the receipt cannot be divided into separate components regardless of whether the components are separately stated, and the Draft Regulations reasonably interpret this provision as applying only to digital products consisting of digital property and digital services).[26] Consistent with other areas of the Tax Law, we recommend that the Commingled Receipts Provisions not apply to transactions where the receipts for each component are separately stated and the sales price is reasonably allocated between the component parts. For example, in the sales and use tax context, where taxable and nontaxable items are sold together as one package a vendor may collect sales tax on only the taxable portion of the bill (*i.e.*, not collect tax on the nontaxable items) if, among other requirements, the charges are separately stated.[27]

Lastly, we note that the exception for incidental components is consistent with well-established case law, primarily in the sales and use tax context.[28] However, such a test heavily depends on facts and circumstances and the Draft Regulations are void of any examples that would show either quantitatively or qualitatively a scenario wherein something would be deemed "incidental." We recommend that examples be added to the regulation to provide guidance with respect to this issue. We also recommend that a quantitative guideline for "incidental" be estab-

[26] N.Y. TAX LAW § 210-A.4(b).

[27] For sales and use tax purposes, a vendor may collect sales or use tax on only the taxable portion of the bill (*i.e.*, not collect tax on the nontaxable items) if (1) the taxable and nontaxable items may be purchased separately, (2) the charges are separately stated on the bill and (3) the charges are reasonable in relation to the total charges. *See* TB-ST-860 (June 16, 2011). We do not believe that the other requirement (*i.e.*, that the taxable and nontaxable items may be purchased separately) is applicable in the context of receipts classification and sourcing because sales tax is concerned with taxability and this requirement is designed to address that concern. In the apportionment context, the entire receipt would be subject to apportionment, but to the extent dividing the transaction into separate items may yield a more favorable apportionment for one component of the transaction versus the other, the receipts for each component should be separately stated and the sales price reasonably allocated.

[28] The New York courts have also consistently applied a "primary purpose" or "primary function" test when determining the taxability of an integrated service offering that has both taxable and nontaxable characteristics. *See, e.g.,* New York Cable Television Association v. State Tax Commission, 388 N.Y.S.2d 560 (N.Y. Sp. Term. 1976), *aff'd*, 397 N.Y.S.2d 205 (N.Y. App. Div. 1977); *see also* Matter of SSOV '81 Ltd. d/b/a/ People Resources, DTA No. 810966, 810967 (N.Y. Tax App. Trib. 1995).

lished by the regulations, since this ambiguous concept has been a source of much sales tax controversy for many years. For example, there could be a rebuttable presumption that if an item's fair market value is 15% or less of the entire bundle's fair market value, that item would be considered incidental and the tax treatment would be determined by the other item or items in the bundle. The percentage set by the regulations could be more or less than the 15% suggested here, but in any case would provide an important guideline by which taxpayers could determine what is considered "incidental."

D. Reasonable Approximation

1. Draft Regulations

Section 4-4.6(c)(1)(iv) and Section 4-4.9(c)(1)(iv) permit taxpayers to use a reasonable approximation to determine where a customer actually receives the benefit and/or the percentage of the total value received at each location, but only if a taxpayer cannot adequately determine this information from its books and records kept in the ordinary course of business or from reasonable inquiries to customers. The Draft Regulations raise a number of questions about when a reasonable approximation is available to the taxpayer and when the Department may substitute another method for the taxpayer's reasonable approximation.

2. Comments

First, the rules for reasonable approximation state that where a taxpayer is *permitted* to reasonably approximate the taxpayer must use a method meant to approximate the results under the rules for determining where the benefit is received. The use of the word "permitted" suggests that the taxpayer must obtain the Department's permission to use reasonable approximation. The Draft Regulations should clarify this by replacing the word with the phrase, "permitted under this section."

Second, the Draft Regulations do not make clear whether taxpayers have the choice to use reasonable approximation *or* move to the next step in the hierarchy in situations where the taxpayer cannot adequately determine where the benefit is received. The Tax Section recommends that taxpayers be permitted to elect either to reasonably approximate where the benefit is received or to move to the next step in the hierarchy. If the regulations intend to make reasonable approximation part of the taxpayer's due diligence before moving on to the next step in the hierarchy, they should expressly require the taxpayer to engage in that exercise.

Third, the Draft Regulations allow the Commissioner to substitute a method of approximation that "the Commissioner determines is appropriate" if the Commissioner determines that

the method of approximation employed by the taxpayer "is not reasonable."[29] The Draft Regulations do not define what constitutes "reasonable" or "not reasonable." They also give the Commissioner broad discretionary authority to substitute any "appropriate" alternative method without establishing any criteria or standard for what would be "appropriate" or imposing a similar "reasonableness" requirement on the Commissioner's choice of alternative methods. Given that the Commissioner already has discretionary authority under Tax Law § 210-A(11) to adjust the apportionment fraction if it does "not result in a proper reflection of the taxpayer's business income or capital within the state," it is not clear that the Commissioner needs additional discretionary authority to substitute for the taxpayer's method of reasonable approximation. If the Department believes that the authority to substitute a method of approximation is separately required, the Tax Section recommends the provision clarify that the Commissioner may substitute a method of approximation that "the Commissioner reasonably determines is appropriate to properly reflect where the benefit of the service is received." This would prevent the Commissioner's discretion from being inappropriately unfettered and help ensure that the exercise of such discretion is consistent with the intent of the statute. The Tax Section also recommends that this paragraph make explicit that the Commissioner bears the burden of demonstrating the reasonableness of any approximation method the Commissioner intends to compel a taxpayer to use through clear and convincing evidence.

E. Individual versus Business Customers

1. Draft Regulations

Draft Regulations section 4-4.6(c)(1) indicates that, except where a different treatment is required under subsections 4-4.6(2) and (3), the determination of where a benefit is received starts with identification of the customer as either an "individual" or a "business," both of which are defined in section 4-4.6(b). When the taxpayer "cannot reasonably determine whether the customer is an individual customer," the customer must be treated as a business customer.

If the customer is an individual, the benefit is presumed to be received at the billing address of the customer in the taxpayer's records. If the customer is a business, the benefit is presumed to be received in New York State to the extent the contract between the taxpayer and customer, or the taxpayer's books and records kept in the normal course of business, without regard to the billing address of the customer, indicate the benefit of the service is in New York State.

If the taxpayer does not have an individual customer's billing address, the Draft Regulations would not require the taxpayer to make an inquiry to the customer. If the taxpayer's

[29] Draft Regulations §§ 4-4.6(c)(1)(iv)(B)(III) & 4-4.9(c)(1)(iv)(B)(III).

contracts with a business customer or its records kept in the normal course of business do not indicate where the benefit of the business customer's service is received, the Draft Regulations would require the taxpayer to make "reasonably inquiries" to the customer as to where the benefit is received.

While subsection (c)(1) does not explicitly state that the individual and business presumptions are rebuttable, the examples clarify that they are. For instance, Example #1 involves a travel agency providing services to individuals. Fifteen percent of the customers have billing addresses in New York State, but the taxpayer's records reflect that only seven percent of the calls originated from within New York State. The Example indicates that the taxpayer may overcome the billing address presumption to assign receipts by using the call origination detail (which would result in a lower apportionment). Example #2 has similar facts but involves a monthly charge unrelated to actual usage. In that case, the call origination detail would not overcome the billing address presumption because the charges are unrelated to the origin of the calls.

If a taxpayer cannot determine where the customer received the benefit under the steps discussed above, it must look to the delivery destination as described in section 4-4.6(d). For customers that are individuals, the taxpayer should determine delivery destination based on records available to it. For business customers, the delivery destination is presumed to be the location where the contract is managed by the customer. If that cannot be determined, the delivery address would be presumed to be the billing address.

2. Comments

(a) The Authority for a Distinction Between Individual and Business Customers

While the Tax Law provides for different treatment between individual and business customers for some purposes, such as for assigning receipts from qualified financial instruments in Tax Law § 210-A.5(a)(2), the Tax Law section that would be interpreted by section 4-4.6 does not include any distinction between individual and business customers. An argument could be made that the Legislature's inclusion of a distinction in other sections, such as Tax Law § 210-A.5(a)(2) *Qualified Financial Instruments*, and its failure to include a distinction in Tax Law § 210-A.5(a)(10) *Other Business Receipts*, reflects an affirmative decision not to distinguish between them in the context of Other Business Receipts.

(b) Other Considerations

The requirement to treat a customer as a business customer when the taxpayer cannot reasonably determine whether the customer is an individual may present practical difficulties. If the customer simply gives the taxpayer his or her individual name, the taxpayer may have no way of

knowing whether it is reasonable to rely on that information to treat the customer as an individual, rather than presuming that it is a business customer. We recommend that the regulations provide that a taxpayer can assume, without further inquiry, that a customer is an individual customer if the customer's name appears to be that of an individual and the taxpayer has no reason to suspect otherwise.

Section 4.4-6(c)(1) would provide presumptions, as described above. The examples make clear that the presumption is rebuttable and may be overcome by the taxpayer. We recommend that the rebuttable nature of the presumption be stated explicitly in the text, and not merely implied by the example.

F. Apportionment Fraction for Preceding Taxable Year

1. Draft Regulations

Under the Tax Law, the third tier of the sourcing hierarchies applicable to digital products and other services and other business receipts provide that these receipts are to be sourced using the apportionment fraction for the receipts "determined pursuant to this subdivision [*i.e.*, Tax Law §§ 210-A.4 or 210-A.9, as the case may be] for the preceding taxable year."

The Draft Regulations reiterate that if a taxpayer cannot apply the first two levels of the hierarchy applicable to receipts from digital products or from other services or other business activities after exercising the requisite due diligence, that taxpayer may use the apportionment fraction determined for those receipts for the preceding taxable year but only "to the extent the factors that produced the preceding year's fraction remain substantially similar in the current year."[30]

2. Comments

The requirement that the "factors that produced the preceding year's fraction remain substantially similar in the current year" is not found in the Tax Law, so we question whether the imposition of this additional requirement is inconsistent with the Tax Law and thereby exceeds the Department's authority.[31]

[30] Draft Regulations §§ 4-4.6(e)(1), 4-4.9(e)(1).

[31] *See, e.g.,* Dreyfus Special Income Fund, Inc. v. State Tax Commission, 72 N.Y.2d 874 (1988) (striking down as invalid an Article 9-A regulation that conflicted with the plain meaning of the statutory definition of "entire net income"); Servomation Corp. v. State Tax Commission, 51 N.Y.2d 608 (1980) (striking down a sales tax regulation that attempted to limit an exemption provided by statute and stating that "[a]n administrative agency cannot by regulatory fiat directly or indirectly countermand a statute enacted by the Legislature").

Additionally, there is no guidance on what the term "factors" means in this context. This is a term of art in the state tax context that typically refers to the components of a taxpayer's apportionment fraction (*e.g.*, property, payroll and sales), so its meaning in this context is unclear. An example in each of the Draft Regulations suggests that the relevant inquiry is whether the taxpayer's "customers" are substantially similar in the preceding year and the current year for purposes of sourcing receipts from a particular type of service or digital product.[32] However, it is unclear if this would always be the relevant inquiry. For example, what if the taxpayer is trying to source receipts from a service or digital product provided to one particular customer? Would the fact that the customer was the same in both the preceding and current year be sufficient to satisfy the "substantially similar" factors standard? What if that customer moved its physical location so it was located in one state in the preceding year and in a different state in the current year? Whatever manner the Department chooses to clarify the term "factors," we note that taxpayers must be able to ascertain those factors in light of the fact that the first two tiers of the sourcing hierarchy will have been abandoned.

The Draft Regulations also clarify that this level of the hierarchy cannot be used in the taxpayer's first taxable year beginning on or after January 1, 2015 and before January 1, 2016 and cannot be used in a new taxpayer's first taxable year. Taxpayers in those situations are directed to move to the fourth level of the hierarchy.[33] An example in each of the Draft Regulations also suggests that this level of the hierarchy cannot be used in the first year in which a taxpayer offers a particular service or digital product.[34] We note that these requirements seem consistent with the Tax Law, which requires that taxpayers source receipts using the apportionment fraction for the preceding taxable year that was determined "pursuant to this subdivision [*i.e.*, Tax Law §§ 210-A.4 or 210-A.9, as the case may be]." In the case of a taxpayer's first taxable year beginning on or after January 1, 2015 and before January 1, 2016, a new New York taxpayer's first taxable year, and a taxpayer's first taxable year offering a new service, business activity, or digital product, the taxpayer would not have an apportionment fraction "pursuant to this subdivision" for the receipts at issue for the preceding taxable year.

G. Intermediary Transactions

1. Draft Regulations

Sections 4-4.6(g) and 4-4.9(g) of the Draft Regulations contain rules for sourcing receipts from "intermediary transactions." The Draft Regulations enumerate two types of intermediary

[32] Draft Regulations §§ 4-4.6(e)(2) (Example 14), 4-4.9(e)(2) (Example 11).

[33] Draft Regulations §§ 4-4.6(e)(1), 4-4.9(e)(1).

[34] Draft Regulations §§ 4-4.6(f)(2) (Example 15), 4-4.9(f)(2) (Example 12).

transactions: (1) products and services provided "on behalf of" an intermediary to a consumer, and (2) products and services provided "through" an intermediary to a consumer.

Receipts derived from all intermediary transactions are sourced using the hierarchy rules described in subsections (c) and (d) with reference to determining the location of the *consumers*. If after exercising due diligence there is inadequate information to apply the hierarchy rules with reference to consumers, the taxpayer is to apply the hierarchy rules described in subsections (c) and (d) for determining the location of the *intermediaries*. If after exercising due diligence adequate information is still not available, the taxpayer must apply the hierarchy rules described in subsections (e) and (f). When applying all hierarchy rules, the taxpayer must make reasonable inquiries to the *intermediary*, and not the *consumer.*

2. Comments

(a) Lack of Statutory Authority to Source Receipts Based on Consumer

The relevant statutes provide that sourcing of digital products and other business receipts is generally determined by reference to the taxpayer's *customer*. N.Y. Tax Law § 210-A(4)(b) states that the hierarchy of sourcing methods, as applied to digital products, is based on the customer's location. For receipts from digital products, sourcing is also permitted based on the location of the person "designated for receipt [of the digital product] by the customer." N.Y. Tax Law § 210-A(10)(a), as applied to receipts from other services and other business receipts, states that the sourcing methodology must be based on the "location of the *customer* … within the state." (emphasis added).

For receipts from services, the statute's sourcing provisions are void of any reference to a party other than the customer, and we question whether the regulations may permissibly provide for a sourcing scheme by which receipts are sourced based on the location of a consumer (*i.e.*, the end user in an intermediary transaction), as opposed to the location of the taxpayer's customer (which in many cases may properly viewed as the intermediary). The language of the statute does not appear to contemplate this rule. Arguably, the statute does contemplate that sourcing for receipts from digital products may be based on the location of the consumer in situations where the digital product is sold in an "on behalf of" intermediary transaction. The same does not, however, appear to be true for receipts from digital products sold in a "through" intermediary transaction.

(b) Distinction Between Transactions "On Behalf Of" and "Through" an Intermediary

Subsections (1) and (2) of Draft Regulations 4-4.6(g) and 4-4.9(g) address the sourcing methodologies to be used for products and services provided "on behalf of" an intermediary to a

consumer, and products and services provided "through" an intermediary to a consumer. A product or service provided "on behalf of" an intermediary "is a [product or] service that is provided by the taxpayer directly to a consumer of the service at the direction of the intermediary pursuant to the terms of a contract or other agreement."[35] A product or service provided "through" an intermediary to a consumer "is a [product or] service that is sold by the taxpayer to an intermediary, who then passes on the [product or] service to the consumer."[36]

With respect to receipts from services, the Draft Regulations state that, although the intermediary is the taxpayer's customer in a "through" intermediary transaction, "the service is sold pursuant to a contract or other agreement stipulating that the service will be passed onto the consumer and the service is in fact not performed until after the consumer receives it from the intermediary."[37] Similarly, for digital products, the Draft Regulations provide that although the intermediary is the taxpayer's customer in a "through" intermediary transaction, "the digital product is sold pursuant to a contract or other agreement stipulating that the digital product will be passed on to the consumer [and] if the digital product is a service, the service is in fact not performed until after the consumer receives it from the intermediary."[38]

While the Draft Regulations define intermediaries differently based on whether a product or service is provided "on behalf of" or "through" an intermediary, the same sourcing rules apply to both types of transactions. If the Department intends to treat the transactions the same, we suggest that, instead of providing different subsections for each type of intermediary (containing the same language regarding sourcing), the regulations include only one subsection pertaining to the sourcing rules for both types of transactions. If the separate subsections are intended to imply that different sourcing rules may apply to different types of intermediaries, the Draft Regulations should clarify the differences. In that event, there may be a basis for limiting the intermediary rules to "through" transactions, since only in an "on behalf of" transaction would the taxpayer typically be dealing directly with the consumer.

(c) Presumption of Party Receiving the Benefit

Assuming that the Tax Law permits the sourcing of receipts based on the location of a party other than the customer, we question whether the Draft Regulations capture the realities of "intermediary transactions." As currently drafted, the intermediary transaction rules assume that in all intermediary transactions the consumer is the party receiving the benefit of the product or service. While there may be situations where a benefit is received by the consumer, this is not

[35] Draft Regulations §§ 4-4.6(g)(1), 4-4.9(g)(1).

[36] Draft Regulations §§ 4-4.6(g)(2), 4-4.9(g)(2).

[37] Draft Regulations § 4-4.6(g)(2).

[38] Draft Regulations § 4-4.9(g)(2).

always the case. Conversely, there are many fact patterns under which the benefit is arguably received by the intermediary, the consumer, or both. Determining the party receiving the benefit requires a fact-intensive analysis.[39]

Since the crux of the Draft Regulations is to source receipts based on where the benefit of a service is received whenever possible, we recommend that the Department revise sections 4-4.6(g) and 4-4.9(g) to include a provision to allow for a discretionary deviation from the rules as ultimately promulgated. In other words, where it is determined that the benefit is received or primarily received by the intermediary, rather than the consumer, the Commissioner would have the discretion to source the receipts based on the location of the intermediary.[40] In the alternative, the Department could instead eliminate sections 4-4.6(g) and 4-4.9(g) and all relevant definitions in their entirety. In the absence of these sections, intermediary transactions would be addressed through the already established hierarchies for determining customer location.

Where the benefit of the product or service is received by the intermediary or both the intermediary and the consumer, the "look through" sourcing rules contemplated by the Draft Regulations may be conceptually appropriate. The Tax Section is concerned, however, that there may be circumstances where the look through approach would not be appropriate because the taxpayer does not have ready access to the consumer's location and, therefore, compliance would be overly burdensome and difficult.

Example 18 of the Draft Regulations illustrates where such difficulties may arise in service transactions. The example provides that an automobile warranty company should source its receipts from providing warranty services based on the location of the consumer or based on the ratio of covered cars sold from the car dealer's New York locations to the number of all covered cars sold from all of the dealer's locations within and without New York State. While it may be true that the consumer derives the benefit from the warranty service, the approach suggested by the example seems unworkable and we would favor a rule that permits sourcing, in this example, based on the dealer location.

The Tax Section has similar concerns with example 17 of the Draft Regulations, which illustrates the difficulties that may arise in requiring a look through sourcing rule for transactions

[39] We note that in sourcing receipts from sales of tangible personal property, sales by taxpayers to distributors are usually sourced to where the distributor takes delivery of the property, not to the location of its customers. In contrast, "dock sales" receipts—where the property is delivered to the purchaser's designee—are typically sourced based on the ultimate destination of the property. 20 NYCRR § 4-4.2(b). Nonetheless, in neither case is the end user of the tangible personal property considered to be the customer.

[40] We note that the "look through" sourcing rule in the Draft Regulations will not necessarily result in intermediary transaction receipts being sourced to New York. Thus, looking to the location of the intermediary for sourcing purposes could turn what would otherwise have been a non-New York receipt into a New York receipt and vice versa.

involving digital products. Example 17 provides that a software repair company providing software warranty support to a retail corporation that sells laptops to consumers should source its receipts based on the consumer's billing address. This seemingly places the obligation on the software company to obtain billing addresses from the retailer. We question whether that is workable and would favor a rule that permits sourcing, in this example, based on the location of the retail corporation. Similar concerns arise with examples 14 and 15 of the Draft Regulations.

(d) Inquiries Made to Intermediaries, and Not Consumers

Under the Draft Regulations, the taxpayer is required to make inquiries to intermediaries in order to obtain information about consumers. The Tax Section commends the Department for adopting this rule, as obtaining information from consumers directly would create significant administrative burdens. However, we think it is appropriate to allow taxpayers to rely on information obtained from an intermediary without undertaking any further inquiries as to whether the information is correct where the taxpayer reasonably and in good faith relies on the information from the intermediary.

(e) Technical Correction

Draft section 4-4.6(g)(2) contains a typographical error. Line 487 contains the phase "will be passed onto the consumer" twice.

H. Definition of Digital Product

1. Draft Regulations

The Draft Regulations define a "digital product" as:

> Any property or service, or combination thereof, of whatever nature delivered to the customer, or the consumer on behalf of or through an intermediary, through the use of wire, cable, fiber-optic, laser, microwave, radio wave, satellite or similar successor media, or any combination thereof. Digital product also includes, but is not limited to, an audio work, audiovisual work, visual work, book or literary work, graphic work, electronic database, game, information or entertainment service, storage of digital products and computer software by whatever means delivered. The term "delivered to" includes furnished or provided to or accessed by. A digital product does not include legal, medical, accounting,

architectural, research, analytical, engineering or consulting services provided by the taxpayer.[41]

2. Comment

The Draft Regulations define a digital product as including various services provided electronically but would exclude "legal, medical, accounting, architectural, research, analytical, engineering or consulting services." We anticipate that some transactions or sales will involve aspects of both excluded professional services and digital products. In such cases, the transaction would presumably be governed, depending on the circumstances, by either the "commingled receipts" provisions in the Draft Regulations or a test similar to the true object test applicable in sales tax. We anticipate future controversies based on the classification of such transactions as either a service or a digital product unless guidance is provided.

I. Primary Use Location & Where the Digital Product is Received

1. Draft Regulations

The Draft Regulations enumerate specific rules for how to determine the primary use location of digital products under the first tier of the hierarchy and where the products are deemed to be received under the second tier of the hierarchy. In the case of individual customers, the primary use location is presumed to be the customer's billing address, and the place received is determined based on evidence of where it is used, such as IP address information. Conversely, in the case of business customers, the primary use location is presumed to be in New York if the contract or books and records indicate use in New York (without regard to billing address), and the place received is presumed to be the location at which the contract of sale is managed by the customer.

2. Comments

We question whether the Draft Regulations capture the realities of the digital product industry. Digital products, whether sold to an individual or business, can be accessed remotely from nearly any location around the world. As such, the billing address, or address otherwise used in the contract, is often not an accurate representation of where the product is primarily used. The Department has seemingly contemplated this reality by referencing a customer's IP address information as a reflection of where the product is *received*. We suggest that IP address information, or other similar information, may be a more accurate reflection of the primary use of a digital product, and thus should be included in the first tier of the hierarchy.

[41] Draft Regulations § 4-4.9(b)(8).

Nonetheless, while IP address information may be a useful and accurate sourcing methodology, we recommend that the Department affirmatively recognize that not all companies have access to this information. Affirmative recognition would help eliminate the need for taxpayers to prove a negative (*i.e.*, prove that they are unable to obtain this information) under the Department's due diligence standards.

For larger taxpayers, it may also be advisable to adopt an approach that is similar to the Multiple Points of Use ("**MPU**") rules that exist in some states in the sales tax context. Ohio, for example, allows purchasers of services or computer software that are delivered electronically to provide the vendor with a MPU Exemption Certificate when the services or computer software will be concurrently available for use in more than one taxing jurisdiction. A similar certificate could be used with respect to sourcing receipts from digital products for income tax purposes. In other words, certain customers could be required to provide the vendor with information as to where the digital product will be used and the vendor would be permitted to reasonably rely on the information provided in the certificate.