**New York State Bar Association**
**Tax Section**

# Report on Proposed Amendments to Article 9-A Regulations Relating to the Taxation of Corporate Partners

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# New York State Bar Association
# Tax Section

## Report on Proposed Amendments to Article 9-A Regulations Relating to the Taxation of Corporate Partners[1]

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The Tax Section of the New York State Bar Association has been asked by the New York State Department of Taxation and Finance ("Department") to prepare a report commenting on draft amendments to regulations under Tax Law Article 9-A relating to the taxation of corporate partners, dated January 10, 2006 ("draft amendments").

The draft amendments are the culmination of a nearly three-year long project conducted by a working group assembled by the Department, including New York City Department of Finance officials, tax practitioners and representatives of trade and professional organizations. Several members of the Tax Section participated in the working group.[2] The impetus for the amendments is the pressing need for guidance for determining how a corporation that is a partner in a partnership conducting business in New York State ("corporate partner") should file its Article 9-A returns and compute its tax.[3] The absence of meaningful guidance has resulted in considerable confusion and inconsistent filing methods by many corporate partners, and unsettled administration by the Department.

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[1] The principal drafter of this Report was Irwin M. Slomka. Helpful comments were received from Andrew N. Berg, Kimberly S. Blanchard, Peter C. Canellos, Patrick C. Gallagher, Maria T. Jones, Carolyn Joy Lee, Robert J. Levinsohn, Andrew L. Oringer, Arthur R. Rosen, Michael L. Schler and David R. Sicular.

[2] Andrew Berg, Paul R. Comeau, Peter L. Faber, Carolyn Joy Lee, Arthur R. Rosen and Irwin M. Slomka participated in the working group.

[3] Although the draft amendments relate only to Tax Law Article 9-A, many of the issues addressed by the draft amendments should also apply to the New York City general corporation tax, which is substantially similar to Article 9-A. The New York City Department of Finance has indicated in its regulatory agenda for the current fiscal year ended June 30, 2006 that it will implement amendments to its general corporation tax rules after these regulations are promulgated.

The Tax Section commends the Department for having undertaken this project as a collaborative rule-making effort, and for proposing a comprehensive and reasonable set of rules that will aid corporate partners in properly computing their Article 9-A tax liabilities. The draft amendments provide welcome and long-overdue guidance to the business community and tax practitioners, easing compliance uncertainty and, it is anticipated, lessening the likelihood of audit adjustments of Article 9-A returns filed by corporate partners. The Tax Section supports the approach taken by the Department in these draft amendments in prescribing the aggregate method as the preferred method, and in retaining the entity method in limited circumstances, and recommends that they be promulgated in a timely manner. As noted below, however, we do have several comments and recommendations.

## I. BACKGROUND

By way of background, a corporation that is doing business in New York State is required to file returns under Article 9-A and to pay a tax on its entire net income apportioned to the State, or on one of three alternative bases if greater.[4] As a general rule, the Department takes the position that a corporation that is a partner in a partnership that is doing business in New York State is itself doing business in the State and is subject to Article 9-A.[5] Article 9-A prescribes separate methods for apportioning business income and investment income.

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[4] The corporate franchise tax is the largest of a tax on allocated entire net income, allocated business and investment capital, minimum taxable income or a fixed-dollar minimum tax.

[5] For purposes of this report, it is assumed that a corporate partner in a partnership that conducts business in New York State is subject to Article 9-A. This report does not express any opinion on whether or the extent to which a foreign (*i.e.*, non-New York) corporation's partnership interest confers nexus for Article 9-A purposes. The draft amendments do not change the existing nexus rules for corporate partners.

Under Article 9-A, business income is apportioned within and outside New York State by a business allocation percentage. Currently, the business allocation percentage is measured by the ratio of a corporation's in-state property, receipts (double-weighted), and payroll to its property, receipts and payroll everywhere.[6] Investment income is apportioned by an investment allocation percentage, generally based on the degree of New York capital of the corporations in which the taxpayer owns investments in stocks, bonds and other securities. Interest, dividends and capital gains from subsidiary capital are excluded in computing a corporation's entire net income under Article 9-A. Subsidiary capital is defined as an investment in the stock of a corporation in which the corporate taxpayer owns more than 50% of the voting stock.

Many issues arise in the taxation of corporate partners under Article 9-A. They principally relate to the apportionment of the partner's distributive share of partnership income. A partnership is not a taxable entity for New York State tax purposes, although items of partnership income, gain, loss and deduction flow through to its corporate partners, which are entities that may be taxable under Article 9-A. Despite the increasingly widespread use of partnerships (and entities electing partnership treatment for tax purposes), the impact of these partnership flow-through items (and the "flow-through" of partnership assets and liabilities) on the computation of a corporate partner's Article 9-A tax liability has never been definitively and fully addressed by the Department.

[6] For most corporations, the property and payroll factors of the business allocation percentage are being phased out over a 3-year period. For tax years beginning after 2007, most Article 9-A filers will use a single factor business allocation percentage based on the receipts factor.

Currently, the Article 9-A regulations provide only limited guidance in this area. They principally address (i) when a foreign (*i.e.*, non-New York) corporate partner will be subject to Article 9-A,[7] (ii) the manner in which a corporate partner includes its proportionate part of the partnership's property, receipts and payroll in its own business allocation percentage factors,[8] and (iii) the manner in which a corporate partner computes its investment allocation percentage by including its proportionate part of the partnership's items of investment capital. Under the existing regulations, a corporate partner is always required to include its proportionate share of the partnership's factors in computing its own business allocation percentage. However, it has been unclear how a corporate partner is to determine what items of the partnership constitute items of business, investment or subsidiary capital income, especially where the partner has no access to that information from the partnership. It has also been unclear how a partner is to determine its proportionate share of partnership items. Certain issues regarding the effect of partnership flow-through items have been addressed only through litigation.[9]

The Department, business community and tax practitioners agree that additional guidance is needed so that corporate partners are able to meet their Article 9-A compliance responsibilities. In May 2003, the Department convened a working group to collaborate in developing that guidance. The working group met regularly to deliberate on the issues, with the goal of preparing draft regulations that reflected the group's recommendations. On January 10, 2006, the Department sent to the Tax Section for

[7] *See* 20 NYCRR § 1-3.2(6).
[8] *See* 20 NYCRR §§ 3-13.2, 3-13.3 and 4-6.5(a).
[9] *See, e.g., Arcade Broadway Plaza Rentals, Inc.*, DTA No. 816027 (N.Y.S. Div. of Tax Appeals Dec. 31, 1998) (a non-precedential administrative law judge determination holding that in computing a corporate partner's alternative tax on capital, it was appropriate to value the corporation's partnership interest as personal property, valued under generally accepted accounting principles, rather than based on the fair market value of the partnership's assets).

comment draft amendments to the existing Article 9-A regulations. We understand that the Department intends to promulgate these draft amendments shortly.

The draft amendments provide guidance in several important respects. First and foremost, they focus on the concepts of the "aggregate method" and the "entity method" of taxing corporate partners, and address the effects of applying each method on the source and character of partnership items of income, gain, loss and deduction, and on partnership assets and liabilities. The applicability of these two alternative methods will have important consequences in computing a corporate partner's Article 9-A liability, such as whether it must include the partnership's property, receipts, and payroll in its own business allocation percentage factors, the effect on the computation of its investment capital and investment income, and the impact in computing the alternative tax on capital.

The draft amendments adopt the aggregate method as the required method for computing the corporate partner's Article 9-A tax liability unless the taxpayer is unable to obtain the partnership information necessary for reporting under that method. Use of the aggregate method is generally consistent with the manner in which corporate partners are taxed under the Internal Revenue Code ("IRC").[10] The aggregate method is also consistent with the Division's existing regulations regarding the flow-through of partnership factors and items of investment capital, and the retention of the source and character of partnership items of income, capital, gain, loss or deduction reported for federal income tax purposes by the corporate partners. Further, it is generally consistent

[10] Under IRC § 702(b), a partner's distributive share of income, gain, loss, deduction or credit is determined for federal income tax purposes as if realized directly from the source from which it was realized by the partnership, or incurred in the same manner as incurred by the partnership.

with the treatment of partnership flow-through items in many states.[11] Finally, the aggregate method generally insures that partnership income earned in New York is subject to tax in a corporate partner's hands.

The draft amendments would be effective for a corporate partner's taxable years beginning after 2006.

## II. SUMMARY OF THE DRAFT AMENDMENTS

The draft amendments propose the following rules for the taxation of corporate partners:

### A. Defining the Aggregate and Entity Methods of Taxation

A corporate partner in a partnership that conducts business in New York State would compute its Article 9-A tax with respect to its interest in that partnership under either the aggregate method or the entity method, as required by rules described below. Under the aggregate method, a corporate partner is considered to have an undivided interest in each of the partnership's assets, liabilities and items of income, gain, loss and deduction, and as participating in the partnership's transactions and activities. The corporate partner is treated as directly deriving the income, incurring the expenses and owning the assets of the partnership.

[11] We do not mean to suggest that the draft amendments present the only viable method for addressing this issue. For example, California has developed comprehensive and sensible rules that take a somewhat different approach. If a partnership and its corporate partner are engaged in a unitary business, then the corporate partner includes its distributive share of partnership income with its own, and includes its proportionate part of the partnership's apportionment factors with its own apportionment factors. If they are *not* engaged in a unitary business, and if the distributive share of partnership income constitutes business income to the corporate partner, then the corporate partner does not include the partnership income and factors with its own, but instead apportions its distributive share of partnership income separately based only on the partnership's apportionment factors, and without regard to its own apportionment factors. Cal. Code Regs. Title 18, 25137-1.

In contrast, under the entity method, the partnership is treated as a separate entity, with the corporate partner being considered as owning only an intangible interest in that partnership. The draft amendments provide that the partner's partnership interest is treated as business capital, regardless of the character of the partnership's underlying assets.

### B. The Aggregate Method Is the Preferred Method

The draft amendments require that a corporate partner use the aggregate method if it has access to the partnership information necessary to compute its Article 9-A tax using that method. Reg. Amend. § 3-13.2.[12] The draft amendments set forth situations in which it will be presumed, subject to rebuttal, that a corporate partner has access to information necessary to use the aggregate method, such as where the corporate partner is a general partner of the partnership, where it is conducting a unitary business with the partnership or where it has at least a one percent interest in the partnership. Only if none of the presumptions applies or the corporate partner "establishes to the satisfaction of the Commissioner" that neither it nor any member of its affiliated group has access to the information, is the entity method used.[13] In such cases the corporate partner would be required to certify to the Department that neither it nor any affiliate will have timely access to the partnership information necessary to use the aggregate method.

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[12] References to "Reg. Amend. § ___" are to sections of the draft amendments to Subchapter A of Chapter I of Title 20 of the Official Compilation of Codes, Rules and Regulations of the State of New York, dated January 10, 2006.

[13] As currently drafted, the amendments require rebuttal whether none of the presumptions is met, or one or more of them is met. As noted in the discussion below, this is illogical, and we understand that the draft amendments will be changed so that rebuttal is unnecessary where none of the presumptions is met.

C. Computation of Tax Under the Aggregate Method

The draft amendments prescribe the manner in which the aggregate method would be implemented for Article 9-A purposes:

1. Source and Character of Partnership Items. A corporate partner's distributive share of each item of partnership receipts, income, gain, loss and deduction, as well as its proportionate part of partnership assets and liabilities, are taken into account by the corporate partner and will have the same source and character in the hands of the corporate partner as they have for federal income tax purposes. Reg. Amend. § 3-13.3(a). Where a partnership item is not characterized or required to be taken into account for federal income tax purposes (e.g. as to its classification as an item of business income or investment income), the source and character of that item is determined as if realized or incurred directly by the partner. A corporate partner's proportionate part of partnership assets and liabilities would generally be determined based on the partner's "capital interest in the partnership" during the taxable year, unless it did not properly reflect the partner's share of partnership items constituting business and investment income. A corporate partner's alternative tax on capital base would include its proportionate part of the assets and liabilities of the partnership, but to avoid double counting, the partner would not also include the basis of its interest in the partnership. Reg. Amend. § 3-13.3(c)(i).

In the case of a tiered partnership structure, the same rules would apply. Thus, in a two-tiered partnership structure -- where a corporate partner is a partner in an upper tier

partnership, which is itself a partner in a lower tier partnership -- the source and character of the corporate partner's distributive share or proportionate part of the lower tier partnership items which flow to it through the upper tier partnership would also retain the source and character they had in the lower tier partnership. Reg. Amend. § 3-13.6.

2. Certain Partnership Allocations Disregarded. Where the allocation of partnership receipts, income, gain, loss or deduction among the partners has as its principal purpose the avoidance or evasion of New York State or New York City tax on the corporate partner, the allocation will not be recognized. In that event, the corporate partner's distributive share would be determined in accordance with the partner's interest in the partnership, based on all facts and circumstances. Reg. Amend. § 3-13.3(a)(3). The draft amendments contain a list of circumstances relevant in determining whether tax avoidance or evasion is the principal purpose of a partnership allocation, such as whether the allocation affects the dollar amount of the partner's share of partnership income or loss independent of the tax consequences of such allocation.

3. No Subsidiary Capital Treatment. A corporate partner's proportionate part of corporate voting stock owned by a partnership in which it is a partner would not be considered subsidiary capital for Article 9-A purposes. Reg. Amend. § 3-13.3(e). The Department believes this treatment is in conformity with the existing regulations, which provide that in order to be considered subsidiary capital, the stock must be directly owned by the corporate partner.[14] The corporate partner would treat its proportionate part of the stock held by the partnership as either investment or

[14] See existing regulation 20 NYCRR §3-6.2(b).

business capital, based generally on its classification in the hands of the partnership (as though the partnership were a corporation).

4. Inclusion of Partnership Apportionment Factors. In computing its own business allocation percentage, a corporate partner would include its distributive share or proportionate part of the partnership's receipts, payroll and property in its own receipts, payroll and property factors. Reg. Amend. § 4-6.5(a). In computing its own investment allocation percentage, a corporate partner would include its proportionate part of the partnership's items of investment capital.

5. Transactions Between a Corporate Partner and Partnership Disregarded. The draft amendments would generally disregard transactions between a corporate partner and a partnership in order to prevent the transaction from being reflected in the partner's Article 9-A calculations more than once. For example, where a corporate partner has receipts from sales to a partnership in which it is a partner, it must reduce its gross receipts by its distributive share of the partnership's purchases. Reg. Amend. § 4-6.5(a)(2).

6. Investment Capital Issues. In making the election under Tax Law §208.7(a) to treat "cash on hand and on deposit" ("cash") as either investment capital or business capital, a corporate partner would be required to make the election with respect to both its own cash and its proportionate part of the partnership's cash. Reg. Amend. §§ 3-3.2(a)(1) and 3-3.3(d). In determining whether a corporate debt instrument was acquired by a taxpayer "principally engaged in the business of lending funds," which precludes such instruments from qualifying as investment capital, the corporate partner

would be required to include both its own gross receipts, interest from loans and net gains, together with its distributive share of partnership gross receipts, interest from loans and net gains, in determining whether more than 50 percent of its gross receipts consist of those items. Reg. Amend. § 3-3.2(d)(2)(ii). The determination of whether a stock, bond or other security owned by the partnership is held for sale to customers in the regular course of business, which precludes such instrument from qualifying as investment capital, would be made at the partnership level.

D. Computation of Tax Under the Entity Method

The draft amendments prescribe the manner in which the entity method would be implemented by the corporate partner for Article 9-A purposes:

1. Partnership Interest as Business Capital. Under the entity method, a corporate partner is treated as owning an interest in the partnership entity itself, rather than as having an interest in each of the partnership's assets, liabilities and items of income, gain, loss and deduction. A corporate partner's interest in a partnership would be considered an intangible asset which would always be classified as business capital for Article 9-A purposes, even if all of the partnership's assets consisted of investment assets. Reg. Amend. § 3-13.4(a). To the extent a corporate partner's entire net income includes its distributive share of partnership items of income, gain, loss or deduction, those items would be treated as business income, even if they would otherwise be treated as investment income (or, if our recommendation is adopted, as income from subsidiary capital). Reg. Amend. § 3-13.4(b)(i). This result would apply whether or not the corporate partner has some of the information necessary to make one or more of the

modifications to federal taxable income, such as the deduction for state bond interest, in computing entire net income. Reg. Amend. § 3-13.4(b)(i).

2. No Flow-Through of Apportionment Factors. Under the entity method, the corporate partner would apportion its income from the partnership only by applying its own business allocation percentage, and would not take the partnership's factors into account in such apportionment. There is an exception to this rule where the resulting business allocation percentage does not properly reflect the corporation's activity, business income or business capital in the State. Reg. Amend. § 4-6.5(b)(1)(i).

3. Alternative Tax on Capital. For purposes of measuring the tax on capital, the basis of the corporate partner's interest in the partnership would be its basis under IRC § 705 on the last day of the partnership's taxable year ending within the corporation's taxable year. Reg. Amend. § 3-13.4(c)(i).

4. No Subsidiary Capital Treatment. As under the aggregate method, stock owned by the partnership would not be considered subsidiary capital of the corporate partner. Reg. Amend. § 3-13.4(e).

E. Development of Tax Form for Reporting Information to Corporate Partners

Although not mentioned in either the draft amendments or the draft summary of amendments, we understand that the Department intends to develop a tax form by which partnerships would be required to furnish to their corporate partners information necessary for the partner to compute its Article 9-A liability using the aggregate method.

## III. COMMENTS AND RECOMMENDATIONS

We offer the following comments and recommendations:

### A. Access to Partnership Information

The draft amendments require the use of the aggregate method when a corporate partner "has access to the [partnership] information necessary to compute its tax using such method." Reg. Amend. § 3-13.2(a). We endorse the Department's plan (not reflected in the draft amendments) to require partnerships that file New York State Partnership Returns to furnish the necessary partnership information to corporate partners through a prescribed tax form. [15] This would significantly assist corporate partners in using the aggregate method, rather than the entity method. In addition, the requirement would significantly reduce the possibility that corporate partners who otherwise have minimal or no New York State business allocation apportionment factors of their own might attempt to avoid tax on New York income by operating a New York business in partnership form and claiming that the partnership refuses to make information available to the partners.

Notwithstanding the Department's plan administratively to require certain partnerships to provide the necessary information using a prescribed tax form, there undoubtedly will be situations where a corporate partner is unable to obtain access to

[15] We have not examined the scope of the Department's authority under Tax Law § 658(c) to require partnerships that file New York State Partnership Returns to provide other information to their corporate partners. We note, however, that not all partnerships in New York are required to file New York State Partnership Returns. For example, because Tax Law § 658 requires the filing of a Partnership Return only if the partnership generates New York source income or has a New York resident partner, it may not apply to an investment partnership that trades in stocks or securities for its own account, all of the partners of which are nonresidents of New York.

partnership information necessary to use the aggregate method. The standard for whether a corporate partner has access to information should be based on whether the partner is able to obtain the information in a timely fashion using reasonable efforts.

1. Presumption Based on One Percent Partnership Interest.

The draft amendments prescribe six instances where a corporate partner is presumed to have access to partnership information and is therefore required to use the aggregate method, absent an effective rebuttal. We believe the creation of presumptions of access provides important guidance to corporate partners, and is consistent with the designation of the aggregate method as the preferred method.

However, we believe that the presumption of access to information where a corporate partner has as little as a one percent interest in a partnership may be overly harsh. Reg. Amend. § 3-13.2(a)(3). The one percent threshold appears to have been borrowed from the existing partner nexus regulations, but the nexus regulations raise no issue concerning the inability of a partner to obtain the requisite information from the partnership. Given the relatively de minimis threshold of one percent, we are concerned that the presumption of access to partnership information will apply to corporate partners that simply do not have access to the partnership information necessary to use the aggregate method.

While a corporate *general* partner having a least a one percent interest in a partnership should normally be able to obtain the necessary partnership information, we doubt that a similarly-situated corporate *limited* partner would always be able to do so. The creation of a presumption under those circumstances could impose a substantial

burden on limited partners to rebut the presumption by having to prove that they are unable to obtain access to that information. As discussed below, the lower the threshold for the presumption is set, the lower the standard of rebuttal should be, and we question whether the Department should place meaningful, substantial burdens of proof of corporate partners who own no more than a one percent limited partnership interest, without other factors indicating that they have access to the required information.

Moreover, as a practical matter, corporate limited partners will often have an incentive diligently to seek partnership information in order to report under the aggregate method. This is because only the aggregate method will allow a corporate partner to treat items of partnership income as investment income, and partnership assets as investment capital, which usually benefits from a more favorable apportionment formula than business income and capital. However, given the potential difficulties of a limited partner in compelling a partnership to furnish detailed financial and tax information beyond that contained in Federal Schedule K-1, we believe that setting the threshold at one percent for the presumption of access in the case of a limited partner may impose too high a burden on the partner to disprove.

We therefore recommend that the Department consider revising the draft amendments so that the presumption of access to partnership information for a corporate limited partner arises where it owns at least a 10 percent partnership interest, rather than a one percent interest. The federal Internal Revenue Code, in similar situations involving

access to information and presumptions of shareholder control, has often used a 10 percent threshold.[16]

Based on the assumption that the greater the corporate partner's monetary investment in a partnership the more likely the partner will be able to obtain the necessary partnership information, the Department should consider adding another presumption of access to information where the corporate partner's basis in the partnership, determined pursuant to IRC § 705, is more than $10 million.

2. Presumption Under a Tiered Partnership Structure.

In the case of a tiered partnership structure, we recommend that it be made clear that the presumption of access for a partner based on a minimum percentage interest (whether a one percent or 10 percent threshold is adopted) should be determined based on the partner's *beneficial* ownership percentage. For example, if a corporate partner owns a one percent interest in an upper tier partnership that in turn owns a one percent interest in a lower tier partnership, the presumption should not apply because the partner owns only a 0.01 percent *beneficial* interest in the lower tier partnership.

3. Effect Where None of the Presumptions Applies.

As discussed above, the draft amendments provide that if any one of the presumptions of access is met, the corporate partner can use the entity method only if it "establishes to the satisfaction of the Commissioner that neither it nor any of its affiliated group has access to the [necessary] information." Draft Amend. § 3-13.2(b). They also

[16] See, e.g., IRC § 902 (indirect foreign tax credits limited to 10% corporate shareholders); IRC § 951(b) (test for controlled foreign corporation status is ownership of at least 10% of voting stock); IRC § 871(h) (interest paid to a 10% or greater foreign shareholder presumed paid to a related party).

provide that if *none* of the presumptions is triggered, the corporate partner can use the entity method only if it similarly establishes to the Commissioner's satisfaction that it is unable to obtain access. This presents an illogical rule in which the same standard of proof applies whether or not the presumptions are triggered, and calls into question the usefulness for such presumptions in the first place.

We now understand that the Department intends to modify draft amendment § 3-13.2(b) to provide that if none of the presumptions is met, the corporate partner may use the entity method unless it has actual access to the necessary information. It would not be necessary for the corporate partner to "establish to the satisfaction of the Commissioner that neither it nor any member of its affiliated group has access to the [necessary] information." We assume that the partner will still be required to certify that it does not have access to the requisite partnership information. We support this modification of the draft amendments since it would lead to greater certainty regarding a corporate partner's ability to use the entity method where none of the presumptions is met.

The draft amendments would continue to provide that if any one of the presumptions is triggered, the corporate partner must establish lack of access to the satisfaction of the Commissioner in order to use the entity method. Because we believe that the aggregate method is preferable to the entity method, we considered but ultimately rejected the suggestion of creating a small class of irrebuttable presumptions, satisfaction of which would always require the aggregate method to be used. On balance, we felt that in order for an irrebuttable presumption to be fair, the threshold would have to be set so high as to be meaningless, and that a lower threshold would unfairly penalize those

corporate partners that simply cannot obtain access to the information needed to apply the aggregate method correctly.

Short of creating irrebuttable presumptions, we think it might be worth considering whether the burden of proof to establish lack of information should be higher in some cases and lower in others. As noted previously, we generally believe a one percent limited partner interest should give rise to no presumption; but if it does, the presumption should be able to be overcome more easily that would a presumption based on the ownership of, say, a 50 percent partnership interest, in which case the presumption might be overcome only by compelling proof.

4. Distinction Between Certification and Establishing Lack of Access to Information.

The draft amendments provide that in order to use the entity method, a corporate partner must "establish[] to the satisfaction of the Commissioner that neither it nor any member of its affiliated group has access to the [necessary information]." The draft amendments also provide that a corporate partner "shall certify" that neither it nor any member of its affiliated group has access to the necessary information. This certification appears to be separate from the requirement that the partner "establish to the satisfaction of the Commissioner" that it does not have access to the information; further clarification of that intention would be helpful.

As noted above, we understand that the Department will amend the regulations such that, if none of the presumptions is met, a partner will not be required to establish to the satisfaction of the Commissioner that it lacks access to the necessary information. However, we assume that certification would still be required, and that such a partner

would certify that none of the presumptions is met. In other cases, where at least one of the presumptions is met, we recommend that the regulations specifically require that the corporate partner state in its certification that it meets one or more of the presumptions, and assume that such partner would remain subject to the rule requiring it to rebut the presumptions if it wishes to use the entity method.

B. Subsidiary Capital Treatment.

Overall, the draft amendments apply the aggregate method in a consistent manner, with the corporate partner required to treat partnership items as if earned or incurred directly by the partner. One exception is that a corporate partner cannot treat its proportionate part of the partnership's ownership of a corporate subsidiary as an item of subsidiary capital, even if the corporate partner beneficially owns 50% or more of the voting stock of that subsidiary through the partnership. We understand that this is based on the Department's belief that in order to qualify as subsidiary capital, the subsidiary's voting stock must be directly owned by the corporate partner.

We recognize that the statutory definitions of the terms "subsidiary" and "subsidiary capital" are based on the taxpayer's ownership of more than 50% of the voting stock of a corporation, and that the existing regulations do require a *direct* stock ownership.[17] We believe, however, that the aggregate method requires looking through the partnership to treat the partner as owning its proportionate part of what the

[17] Tax Law § 208.3 and .4; 20 NYCRR § 3-6.2(b).

partnership owns.[18] (We agree that a corporate partner would never be treated as owning stock of a partnership subsidiary under the entity method.)

Although the New York State Tax Appeals Tribunal has held that a corporation's indirect ownership interest in a second-tier subsidiary qualified as subsidiary capital, *Racal Corp.*, DTA No. 807361 (N.Y.S. Tax App. Trib. May 13, 1993), the Tribunal's decision was based on the Department's then-existing regulation that defined "subsidiary capital" in terms of beneficial ownership, rather than direct legal ownership of corporate stock. The Department later amended 20 NYCRR § 3-6.2(b) to require that a corporate taxpayer have a direct stock ownership in a corporation in order for that stock to be considered subsidiary capital, thereby limiting the applicability of the *Racal* decision.

Despite this limitation on *Racal*, we believe that the case is helpful in approaching the issue of application of the aggregate method to stock held through partnerships. The Tax Appeals Tribunal in *Racal* held that the Tax Law definition of subsidiary capital is broad enough to permit an indirect ownership interest in stock to qualify as subsidiary capital. Therefore, the Tax Law itself is not an impediment to amending 20 NYCRR § 3-6.2(b) to apply the aggregate method to a corporate partner's proportionate part of a partnership's ownership of corporate stock that would otherwise qualify as subsidiary capital. Moreover, whereas in *Racal* the Tribunal was attempting to "look through" a nontransparent corporate entity, in the context of these draft amendments it is only looking through a partnership that is required, and this is precisely what the draft

[18] A closely analogous issue arose under IRC § 902, which generally requires a corporation to own 10% or more of a foreign corporation's stock directly before indirect foreign tax credits will be allowable to be claimed. The Internal Revenue Service had ruled, and Congress eventually made clear, that the direct 10% ownership rule was satisfied where a corporation owned it interest through a partnership.

amendments require in every other respect. Just as no one would think to look through a corporate entity as a general rule, we believe no one would fail to look through a partnership as a general rule.

We wish to point out that our understanding of the aggregate method would not treat as subsidiary capital any income or asset of a corporate subsidiary of a partnership, simply by reason of *the partnership* owning a 50 percent interest in the subsidiary. Rather, it is the corporate *partner* who must own the requisite 50 percent interest. For example, a 70 percent corporate partner of a partnership that owned 80 percent of a subsidiary corporation would qualify, whereas a 60 percent partner would not.

Permitting a flow-through of subsidiary capital treatment would eliminate a significant inconsistency in the application of the aggregate method. Moreover, it would also be consistent with the tax policy considerations for the long-standing beneficial tax treatment of income from subsidiary capital to encourage holding companies to locate in New York State. We are aware of no compelling policy reason to deny this beneficial tax treatment merely because a holding company owns subsidiary capital through a partnership.

### C. Disregard of Partnership Allocation for Tax Avoidance or Evasion

In Section 3-13.3(a)(3) of the draft amendments, the Department first provides that it will not recognize a partnership allocation of partnership items where tax avoidance or evasion of taxes is "*a* principal purpose" (emphasis added). Later in that section, the reference is to tax avoidance or evasion as "*the* principal purpose" (emphasis

added). These references appear to be inconsistent, and we recommend that the Department conform one to the other.

D. Partner's Capital Interest in a Partnership

The draft amendments provide that under the aggregate method a corporate partner's proportionate part of partnership assets and liabilities generally is based on the partner's "capital interest in the partnership." We agree with this approach, but note that ascertaining a partner's overall "capital interest in a partnership" is not always a clear-cut exercise, as a partner's capital interest percentage may change during the course of the taxable year for any number of reasons. This is an area that will likely require further study. We recommend that the Department reconvene the working group at a later time to address this issue.

E. Disregard of Partnership Factors Under the Entity Method

A corporate partner using the entity method does not include any portion of the partnership's receipts, payroll and property in calculating its own business allocation percentage. Although draft amendment § 4-6.5(b)(i) provides that that corporate partner using the entity method computes its business allocation percentage "without regard to its distributive share of any partnership items of income, gain, loss or deduction," we recommend that it also be made clear that the computation is also made "without regard to its proportionate part of partnership assets and liabilities."

F. Treatment of Gain or Loss on Sale of Partnership Interest

The draft amendments do not address how a corporate partner should report the gain or loss on the sale or exchange of its partnership interest under either the aggregate or entity method. We believe guidance in this area would be helpful.

There are two possibilities for reporting gain or sale on the loss of a partnership interest under the aggregate method. One possibility is to treat the gain or loss as the sale of the partner's proportionate interest in the partnership assets and liabilities themselves. Alternatively, the rule could provide that since a partnership interest does not qualify as either subsidiary capital or investment capital, it necessarily constitutes business capital. In that event, the gain or loss would be apportioned based on the corporate partner's own business allocation percentage, unless that does not properly reflect the partner's activity, business, income or capital in New York. Although not truly consistent with the aggregate method, we believe the latter approach is preferable because it would make compliance and administration easier.

G. Effective Date

We have been advised by the Department that it plans to have the draft amendments apply to tax years beginning after 2006. This leaves unresolved how the Department will handle Article 9-A returns filed by corporate partners for tax years beginning before 2007, and how those partners should file their returns for 2006.

To the extent the draft amendments prescribe the aggregate method, they merely reflect a continuation and clarification of the Department's existing policy. That being so, we see no reason to limit the regulations to prospective-only application for those corporate partners that had access to the necessary partnership information to file under

the aggregate method. Moreover, we recommend that the Department not preclude application of the regulations to situations where a corporate partner can now obtain the necessary information and amends its Article 9-A returns consistent with that method, provided the corporate partner consistently applies the aggregate method in all respects.