NEW YORK STATE BAR ASSOCIATION
One Elk Street, Albany, New York 12207 • 518.463.3200 • www.nysba.org

TAX SECTION

2008-2009 Executive Committee

DAVID S. MILLER
Chair
Cadwalader Wickersham & Taft LLP
One World Financial Center
23rd Floor
New York, NY 10281
212/504-6318
CHARLES MORGAN
First Vice-Chair
212/735-2470
ERIKA W. NIJENHUIS
Second Vice-Chair
212/225-2980
PETER H. BLESSING
Secretary
212/848-4106
COMMITTEE CHAIRS:
Bankruptcy and Operating Losses
Stuart J. Goldring
Russell J. Kestenbaum
Compliance, Practice & Procedure
Elliot Pisem
Bryan C. Skarlatos
Consolidated Returns
Lawrence M. Garrett
David H. Schnabel
Corporations
Deborah L. Paul
David R. Sicular
Employee Benefits
Andrew L. Gaines
Andrew L. Oringer
Estates and Trusts
Carlyn S. McCaffrey
Jeffrey N. Schwartz
Financial Instruments
Michael S. Farber
Stephen B. Land
"Inbound" U.S. Activities of Foreign Taxpayers
Peter J. Connors
David R. Hardy
Individuals
Elizabeth T. Kessenides
Sherry S. Kraus
Multistate Tax Issues
Robert E. Brown
Paul R. Comeau
New York City Taxes
Robert J. Levinsohn
Irwin M. Slomka
New York State Franchise and Income Taxes
Maria T. Jones
Arthur R. Rosen
"Outbound" Foreign Activities of U.S. Taxpayers
Andrew H. Braiterman
Douglas R. McFadyen
Partnerships
Andrew W. Needham
Joel Scharfstein
Pass-Through Entities
James R. Brown
Marc L. Silberberg
Real Property
Robert Cassanos
Jeffrey Hochberg
Reorganizations
Jodi J. Schwartz
Linda Z. Swartz
Securitizations and Structured Finance
Jiyeon Lee-Lim
W. Kirk Wallace
Tax Accounting
Edward E. Gonzalez
Yaron Z. Reich
Tax Exempt Bonds
Bruce M. Serchuk
Patti T. Wu
Tax Exempt Entities
Michelle P. Scott
Richard R. Upton
Tax Policy
David W. Mayo
Diana L. Wollman

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE
S. Douglas Borisky
Kathleen L. Ferrell
Lisa A. Levy
John T. Lutz
Charles I. Kingson
Gary B. Mandel
William L. McRae
David M. Schizer
Peter F. G. Schuur
Andrew P. Solomon
Andrew Walker
Gordon Warnke
Victor Zonana

January 28, 2009

The Honorable Robert L. Megna
Commissioner of Taxation and Finance
New York State Department of Taxation and Finance
Building 9, State Campus
Albany, NY 12227

The Honorable William Ryan
Director, Taxpayer Guidance Division
New York State Department of Taxation and Finance
Building 9, State Campus
Albany, NY 12227

Re: Draft Amendments to Regulations With Regard to Combined Returns

Dear Commissioner Megna and Director Ryan:

This letter comments on draft amendments to regulations under Tax Law Articles 9-A and 32 relating to combined returns, dated October 10, 2008 (the "draft amendments"). [1]

The principal purpose for the draft amendments is to provide guidance with respect to amendments to Tax Law Section 211.4, made by Chapter 60 (S.B. 2110), Laws of 2007 ("2007 Legislation"), which

[1] The principal drafters of this letter are Irwin M. Slomka and Aaron Russell. Helpful comments were received from Peter L. Faber, Maria T. Jones, Carolyn Joy Lee, Robert J. Levinsohn, David S. Miller, Arthur R. Rosen and Michael L. Schler.

FORMER CHAIRS OF SECTION:
Edwin M. Jones
John E. Morrissey, Jr.
Martin D. Ginsburg
Peter L. Faber
Hon. Renato Beghe
Alfred D. Youngwood
Gordon D. Henderson
David Sachs
J. Roger Mentz
Willard B. Taylor
Richard J. Hiegel
Dale S. Collinson
Richard G. Cohen
Donald Schapiro
Herbert L. Camp
William L. Burke
Arthur A. Feder
James M. Peaslee
John A. Corry
Peter C. Canellos
Michael L. Schler
Carolyn Joy Lee
Richard L. Reinhold
Richard O. Loengard
Steven C. Todrys
Harold R. Handler
Robert H. Scarborough
Robert A. Jacobs
Samuel J. Dimon
Andrew N. Berg
Lewis R. Steinberg
David P. Hariton
Kimberly S. Blanchard
Patrick C. Gallagher

significantly changed the circumstances under which the filing of combined returns with related entities under Article 9-A will be

required.[2] The thrust of the 2007 Legislation was to mandate combined reporting under Article 9-A for any taxable year where there are substantial intercorporate transactions between related corporations, regardless of the transfer price of those transactions. The New York State Department of Taxation and Finance (the "Department") has previously issued guidance regarding the legislation in a Taxpayer Guidance Division Memorandum, *Combined Reporting for General Business Corporations (including Real Estate Investment Trusts and Regulated Investment Companies) and Insurance Corporations*.[3] Many of the interpretations reflected in the draft amendments are substantially identical to those in that memorandum.

I. BACKGROUND

1. Prior Law

Under Article 9-A, a corporation that is either incorporated under New York State law or does business, employs capital or owns or leases property in the State is required to file a return and pay tax computed either on its entire net income apportioned to the State, or under one of three alternative bases. For tax years beginning prior to 2007, a corporation could be required or permitted to file a combined return with one or more affiliated corporations if: (i) there was substantial common ownership or control, set by regulation as 80% or more ownership or control; (ii) the corporations were engaged in a unitary business; and (iii) filing on a separate company basis resulted in a distortion of the taxpayer's income or activities in the State.[4] The presence of "substantial intercorporate transactions," a term previously contained only in the Article 9-A regulations, created a presumption that distortion would result from filing on a separate company basis. This presumption could be rebutted by showing that the intercompany transactions were at arm's-length, such as by proof that they satisfied the standards of Internal Revenue Code ("IRC") § 482.[5]

2. 2007 Legislation

As a result of the 2007 Legislation, for tax years beginning on or after January 1, 2007, the Tax Law now provides for mandatory combined reporting between "related corporations" with "substantial intercorporate transactions" during the taxable year.

A "related corporation" is defined under the new law as any corporation that meets any of three capital stock requirements: (i) its stock is substantially owned or

---

[2] Although Chapter 60, Laws of 2007, also amended sections Tax Law Articles 32 and 33, most of the draft amendments relate to Article 9-A. This report offers comments on the draft amendments that pertain to Article 9-A only; it also does not address the special rules under the 2007 Legislation (and under 2008 amendments to the legislation) applicable to REITs and RICs.

[3] TSB-M-08(2)C (Mar. 3, 2008), which superseded an earlier memorandum, TSB-M-07(6)C (June 25, 2007).

[4] Former Tax Law § 211.4(a); existing 20 N.Y.C.R.R. §§ 6-2.1, 6-2.2 and 6-2.3.

[5] *See, e.g., Hallmark Mktg. Corp.*, DTA No. 819956 (N.Y.S. Tax App. Trib. July 19, 2007).

controlled, directly or indirectly, by the taxpayer; (ii) it substantially owns or controls, directly or indirectly, the capital stock of the taxpayer; or (iii) the taxpayer and the corporation are substantially owned or controlled, directly or indirectly, by the same interests.[6] The term "related corporation" appears intended to reflect the same capital stock ownership requirements as under the prior law.

The Tax Law now contains the term "substantial intercorporate transactions," defined by reference to the activities and transactions of the taxpayer corporation and its related corporations, specifically including, the following: (i) manufacturing, acquiring goods or property, or performing services for related corporations; (ii) selling goods acquired from related corporations; (iii) financing sales of related corporations; (iv) performing related customer services using common facilities and employees for related corporations; (v) incurring expenses that benefit, directly or indirectly, one or more related corporations; and (vi) transferring assets, including such assets as accounts receivable, patents or trademarks, from one or more related corporations.[7] Activities (i) through (iv) above are virtually identical to the types of substantial intercorporate transactions under the existing regulations applicable under the prior law.[8] However, activities (v) and (vi) above are new.

The 2007 Legislation does not define the word of "substantial" as it pertains to the term "substantial intercorporate transactions," leaving it to interpretation such as by regulation.

The 2007 Legislation also amended Tax Law § 211.4(a)(4) to make clear that, in addition to mandatory combination, combined returns may, as under prior law, be permitted or required where, because of some agreement, understanding, arrangement or transaction, combination is necessary in order properly to reflect a taxpayer's Article 9-A liability.[9]

II. SUMMARY OF THE DRAFT AMENDMENTS

The draft amendments help clarify the two most important terms in the new law, "related corporations" and "substantial intercorporate transactions."[10] Under the draft amendments, the substantial ownership requirement for related corporations is 80% or more direct or indirect ownership or control.[11] This 80% threshold is the same as the substantial ownership requirement under the existing regulations, although the amendments would further define substantial ownership as at least 80% of the "voting power of the issued and outstanding stock," instead of simply 80% of the "voting stock"

---

[6] Tax Law § 211.4(a).
[7] Tax Law § 211.4(a).
[8] Existing 20 N.Y.C.R.R. § 6-2.3(c)(1)–(4).
[9] On May 31, 2007, the Tax Section issued Report No. 1128 which, among other things, commented on the 2007 Legislation and recommended that certain provisions in the 2007 Legislation be clarified by regulation.
[10] For ease of reference, a copy of the draft amendments is attached to this report.
[11] Draft § 6-2.2(3) (references to "Draft § __" are to sections of the draft amendments to the Article 9-A regulations).

as under the existing regulations, clarifying what had been a longstanding, albeit academic, concern of some practitioners.

The principal focus of the draft amendments is interpreting the term "substantial intercorporate transactions." The draft provides two alternative tests for determining whether substantial intercorporate transactions exist in the taxable year. First, substantial intercorporate transactions will be found to exist when 50% or more of a corporation's receipts or expenditures in the taxable year are from a related corporation or from a group of related corporations ("receipts or expenditures test").[12] If the percentage of a corporation's intercorporate receipts or expenditures is between 45% and 55% during the taxable year, then a multi-year test must be performed. Under this multi-year test, the substantial intercorporate transactions requirement will be met where 50% or more of a corporation's total receipts or expenditures during the taxable year and prior two taxable years in the aggregate is from one or more related corporations.[13]

In addition to the receipts or expenditures test, the draft amendments provide an alternative "asset transfer test" for substantial intercorporate transactions. Under this test, a transfer of assets to a related corporation engaged in a unitary business with the taxpayer will satisfy the substantial intercorporate transactions requirement if in the taxable year 20% or more of the transferee corporation's gross income, as defined in IRC § 61(a), is derived directly from the transferred assets.[14] The test would apply only to assets transferred in exchange for stock or as paid-in capital, and would not apply to transfer of cash.

III. COMMENTS AND RECOMMENDATIONS

We welcome the draft regulations for providing much-needed clarity. Among the helpful additions to the regulations is the "10-step analysis" for determining which related corporations must be included in the combined return under the mandatory combination provision. In light of the fact that the 2007 Legislation is still relatively new, we anticipate additional issues will arise, and we are hopeful that the Department will continue to provide guidance with additional regulation amendments in this area.

While we support the issuance of the draft amendments, we have the following comments and recommendations:

1. Removal of the unitary business requirement for combination.

The draft amendments would eliminate from the regulations the long-standing unitary business requirement for combination, retaining it only for the limited purpose of the asset transfer test for substantial intercorporate transactions.[15]

---

[12] Draft § 6-2.3(b)(3)(i)(a)(1)-(3).
[13] Draft § 6-2.3(b)(3)(i)(b).
[14] Draft § 6-2.3(b)(3)(ii).
[15] Draft § 6-2.3(b)(3)(ii).

Nothing in the 2007 Legislation suggests that the Legislature intended to change the unitary business requirement for combination. Indeed, the Governor's Memorandum in Support of the Governor's Budget Bill (which bill, with certain changes, became the 2007 Legislation) acknowledged that the unitary business requirement would continue to exist under the new law, and we understand from conversations with Department officials that the removal of the unitary business requirement is not intended to be a substantive change.

We strongly recommend that the unitary business requirement be restated expressly in the regulations.[16] Since we understand that the deletion was not a substantive change, we believe that it will eliminate possible confusion for taxpayers and the Department's auditors to have all of the requirements for combination set out in the regulations. The amendments should retain the unitary business requirement as an express prerequisite for combination, whether that combination is elected by the taxpayer or mandated by the Department.

2. Effect of incurring expenses that benefit related corporations.

The 2007 Legislation contains a non-exclusive list of categories of intercorporate transactions that will be considered by the Department in determining whether substantial intercorporate transactions exist. Among the types of activities and transactions listed is where a corporation "incur[s] expenses that benefit, directly or indirectly, one or more related corporations."[17] This vague provision does not appear in the existing regulations, and there is no available precedent on how it should be interpreted. The draft amendments do not address how a corporation should determine whether expenses paid to third parties "directly or indirectly benefit" a related corporation.

We note that the draft amendments provide that a corporation's expenditures directly or indirectly benefiting a related corporation or group of related corporations will result in substantial intercorporate transactions where those expenditures constitute 50% or more of the sum of (i) those expenditures that "benefit" related corporations and (ii) the expenditures of the beneficiary corporation.[18] This is helpful in determining how those expenditures affect the 50% receipts or expenditures calculation. However, the amendments do not address the threshold question of when a corporation's expenses will be considered to "directly or indirectly benefit" a related corporation.

Because a principal purpose for the 2007 Legislation was to provide clarity and minimize litigation over combination, it is particularly important that the regulations provide clear guidance for determining when an expense will be considered to directly or indirectly benefit a related corporation. Perhaps the approach taken in the Department's Technical Services Bureau Memorandum, *Attribution of Noninterest Deductions*[19] (which

---

[16] Retention of the unitary business requirement would also be consistent with the treatment of a single corporation operating two separate non-unitary businesses. In that case, the corporation should separately reflect the income and apportionment factors of each business on one tax return, rather than combine them.
[17] Tax Law § 211.4(a).
[18] Draft § 6-2.3(b)(3)(i)(a)(3).
[19] TSB-M-95(2)C (Jan. 8, 1996).

contains rules on the direct and indirect attribution of noninterest expenses to subsidiary capital under Article 9-A) can serve as a model. The Memorandum identified categories of a corporation's noninterest expenses that are considered to be directly attributable to its subsidiary, business and investment capital, with the remaining noninterest expenses being indirectly attributable to subsidiary capital by formula.

In addition, we assume that a corporation's expenditures for administrative service functions provided to related corporations that are incidental to the corporation's business will not be considered for purposes of the direct or indirect benefit provision, but the regulations should clarify this point. This clarification would be consistent with the existing regulations (unchanged by the draft amendments), which provide that incidental service functions are not considered in determining whether substantial intercorporate transactions exist.[20]

3. **Multi-year test for substantial intercorporate transactions**.

The draft amendments provide that in any taxable year where intercorporate receipts or expenditures are between 45% and 55%, the substantial intercorporate transactions test "will be satisfied" if, during the taxable year and prior two years, the intercorporate transactions are, in the aggregate, 50% or more of total receipts or expenditures for that period.[21]

We recommend that the regulations make explicit that this three-year test should be used not only to "satisfy" the test, but to prove that the test is not "satisfied" -- that is, to show that the 50% receipts or expenditures threshold was not met in the aggregate over the three-year period. For example, if a corporation has intercorporate transactions between 50% and 55% for the taxable year, but over the three-year period those transactions in the aggregate are less than 50%, the taxpayer should not be subject to mandatory combined reporting under the receipts or expenditures test. The regulations should make this clear by stating that the multi-year test is to be used to determine when mandatory combination is not required, as well as to determine when it is.

4. **Asset transfer test for substantial intercorporate transactions**.

The draft amendments contain an alternative asset transfer test for determining whether there are substantial intercorporate transactions. Under this test, the requirement is satisfied if at least 20% of the transferee's gross income in any year is derived directly from the transferred assets. The amendments would limit the number of years the test must be performed based on the depreciation or amortization period of those assets under the IRC. For assets that are not amortized or depreciated, such as accounts receivable, the test would need to be performed for each year the asset is reflected on the transferee's books and records under generally accepted accounting principles.[22]

[20] Draft § 6-2.3(b)(2); (existing 20 N.Y.C.R.R. § 6-2.3(c)(4)).
[21] Draft § 6-2.3(b)(3)(i)(b).
[22] Draft § 6-2.3(b)(3)(ii).

The possibility that the asset transfer test must be performed indefinitely for certain assets could impose a considerable burden on taxpayers. The regulations should limit the number of years the asset transfer test must be performed in the case of assets that are not depreciated or amortized, such as accounts receivable or stock, to the maximum 15 year amortization period for intangible assets under the IRC §197.

The draft amendments also state that where the asset transferred is an interest in another entity, income "distributed or deemed distributed" is considered income directly derived from that asset.[23] If the Department intends for this reference to mean dividends from that entity, as we believe it does, then it should make that explicit.

For purposes of the asset transfer test, the draft amendments also provide that where more than one asset is transferred, gross income from all "qualifying assets" will be considered.[24] Although the term "qualifying assets" is undefined, we assume that the reference is to the transferred assets. We suggest substituting the word "transferred" for "qualifying" to avoid any ambiguity.

Finally, the regulations should make clear whether the asset transfer test applies only to assets transferred on or after January 1, 2007 -- the effective date of the 2007 Legislation -- or whether taxpayers will be required to perform the test for assets transferred prior to 2007. For ease of taxpayer compliance, we suggest that the test apply only to assets transferred on or after January 1, 2007.

5. Relevance of a taxpayer's motivation for an intercorporate transactions.

Under the draft amendments, in determining whether the substantial intercorporate transactions requirement is met, the Department will consider, among other things, "the extent to which the motivation of the taxpayer in undertaking the transactions was to affect the membership of the combined group."[25] The reference to taxpayer "motivation" creates potential uncertainty and should be explained in the regulations. If "motivation" is relevant, the regulations should provide guidance regarding how it can be established, both by the taxpayer and by the Department.

Draft amendment § 6-2.7(b), Examples 5 and 6, involve the creation of intermediate corporate entities solely to meet the 50% substantial intercorporate transactions test to effect the Article 9-A combined group. These two examples conclude that in those instances the Department will disregard the intercorporate transactions in the calculation of substantial intercorporate transactions. However, there may be instances where bona fide intercorporate transactions are carried out a particular way in order to make sure that a related corporation falls within -- or avoids falling within -- the mandatory combination provisions. For example, a corporation may have the ability to sell goods or services to either of two related corporations. Its decision regarding which related corporation to sell to could be motivated by how it would affect the combined

[23] Draft § 6-2.3(b)(3)(ii)(g).
[24] Draft § 6-2.3(b)(3)(ii)(h).
[25] Draft § 6-2.3(b)(3)(iii).

group. In such a case, the taxpayer's motivation should not cause the transactions with the related corporation to be disregarded.

A taxpayer should be permitted to change the composition of its combined return through legitimate transactions with related corporations, even if the intent is to affect the membership of the Article 9-A combined group. This is distinguishable from situations where legal entities are formed solely to engage in transactions to manipulate the 50% substantial intercorporate transactions test. The Department should be permitted to disregard artificial intercorporate transactions for purposes of the substantial intercorporate transactions requirement regardless of whether the transactions are with an existing corporation or a newly-formed corporation.

It would be helpful to include in the regulations an additional example where a tax motivation was among the considerations for engaging in a transaction that has economic substance, but which does not involve the creation of an intermediate corporation formed solely for the purpose of bringing a corporation into the Article 9-A combined group.

6. Combination in the absence of substantial intercorporate transactions.

The 2007 Legislation amended Tax Law § 211(4)(a)(4) to make clear that, in addition to mandatory combination, combined returns may also be required or permitted where, because of some agreement, arrangement or understanding, combination is necessary to properly reflect the taxpayer's Article 9-A tax liability. Consistent with this provision, the draft amendments state that combination may be required or permitted where the capital stock requirement is met, but where the substantial intercorporate transactions requirement is not met.[26]

It would be helpful for the regulations to provide some guidance for when this alternative combination provision will apply. For example, while the new law provides that the test for substantial intercorporate transactions is computed "regardless of the transfer price," we believe the existing case law involving "distortion" -- such as whether the intercorporate transfer pricing is consistent with IRC § 482 -- remains relevant under this alternative combination provision. The regulations should also make clear that taxpayers will be given the same opportunity as the Department to prove that their Article 9-A liability is not properly reflected, and if they meet that burden, then to file on a combined basis, even in the absence of substantial intercorporate transactions. Such an approach seems correct under the Tax Law, and would be consistent with the still relevant decisions of the New York State Tax Appeals Tribunal and the New York courts, in which transfer pricing was considered in determining whether combined returns were appropriate in the absence of substantial intercorporate transactions.[27]

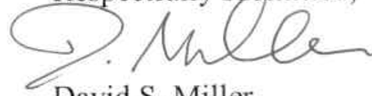
We appreciate your consideration of our comments. We would be pleased to discuss these matters with you further or to provide any other assistance that you would find helpful.

---

[26] Draft §§ 6-2.1(b) and 6-2.3(d).

[27] *See, e.g., Mohasco Corp.*, DTA No. 808901 (N.Y.S. Tax App. Trib. Nov. 10, 1994).

Respectfully submitted,



David S. Miller
Chair

cc:

The Honorable Daniel Smirlock
Deputy Commissioner and Counsel of the Department of Taxation and Finance
New York State Department of Taxation and Finance
Building #9
W.A. Harriman Campus
Albany, NY 12227

The Honorable William Comiskey
Deputy Commissioner of Enforcement and Operations
New York State Department of Taxation and Finance
Building #9
W.A. Harriman Campus
Albany, NY 12227

The Honorable Jamie Woodward
Executive Deputy Commissioner
New York State Department of Taxation and Finance
Building #9
W.A. Harriman Campus
Albany, NY 12227

STATE OF NEW YORK

DEPARTMENT OF TAXATION AND FINANCE

COMMISSIONER OF TAXATION AND FINANCE

ALBANY, NEW YORK

Pursuant to the authority contained in subdivision First of section 171 and subdivision (a) of section 1096 of the Tax Law, the Commissioner of Taxation and Finance hereby proposes to make and adopt the following amendments to the Business Corporation Franchise Tax Regulations, as published in Subchapter A of Chapter I of Title 20 of the Official Compilation of Codes, Rules and Regulations of the State of New York and the Franchise Tax on Banking Corporations Regulations, as published in Subchapter B of Chapter I of such Title, such amendments to read as follows:

Section 1. Subdivision (d) of section 3-2.2 of such regulations is amended to read as follows:

(d) The amount of any specific exemption or credit allowed in any law of the United States imposing any tax on or measured by the income of corporations is not allowed in computing entire net income. [The exempt foreign trade income of a FSC, which is excluded from gross income for Federal income tax purposes pursuant to section 921 of the Internal Revenue Code, is not a specific exemption or credit for purposes of this subdivision. A "FSC" is a corporation which meets the definition of the term "FSC" contained in section 922 of the Internal Revenue Code and which has made an election to be treated as a FSC under section 922(a)(2) of the Internal Revenue Code or an election to be treated as a FSC under section 922(a)(2) of the Internal Revenue Code or an election to be treated as a small FSC under section 922(b)(1) of the Internal Revenue Code. For the rule regarding inclusion of a FSC in a combined report, see section 6-2.5(b) of this Title.]

DRAFT

Section 2. Subdivisions (c), (d), and (e) of section 3-11.1 of such regulation are relettered to (d), (e), and (f), respectively, and a new subdivision (c) is added to read as follows:

(c) For information relating to the inclusion of a REIT in a combined report, see section 211.4 of the Tax Law.

Section 3. Subdivisions (c), (d), and (e) of section 3-12.1 of such regulations are relettered to (d), (e), and (f), respectively and a new subdivision (c) is added to read as follows:

(c) For information relating to the inclusion of a regulated investment company in a combined report, see section 211.4 of the Tax Law.

Section 4. The index of Subpart 6-2 of such regulations is amended to read as follows:

SUBPART 6-2

COMBINED REPORTS

Sec.

6-2.1 General

6-2.2 Capital stock [and unitary business requirements] requirement

6-2.3 [Other requirement] Substantial intercorporate transactions requirement and other considerations

6-2.4 [Permission for filing] Filing combined reports

6-2.5 Corporations not required or permitted to file a combined report

6-2.6 Combined reports: [election] other entities

6-2.7 Examples

[6-2.7] 6-2.8 Combined reports cross - references

Section 5. Subdivision (a) of section 6-2.1 of such regulations is amended to read as follows:

DRAFT

(a) Every corporation is a separate taxable entity and shall file its own report. However, [the Tax Commission, in its discretion, may require a group of corporations to file a combined report or may grant permission to a group of corporations to file] a combined report covering any taxpayer and another corporation or corporations is required where:

(1) the [requirement of stock ownership or control] capital stock requirement (as described in section [6-2.2(a)] 6-2.2 of this [Part] Subpart) is met; and

(2) [the group of corporations is engaged in a unitary business (as described in section 6-2.2(b) of this Part); and

(3)] the [other requirement] substantial intercorporate transactions requirement set forth in section 6-2.3 [or section 6-2.5(a)] of this [Part, as the case may be,] Subpart has been met.

Section 6. Subdivision (c) of section 6-2.1 of such regulations is repealed, subdivision (b) is relettered to be subdivision (c) and a new subdivision (b) is added to read as follows:

(b) Where the capital stock requirement is met and substantial intercorporate transactions are absent, a combined report may be required or permitted if the Commissioner deems such a report necessary, because of intercompany transactions or some agreement, understanding, arrangement, or transaction, in order to properly reflect the tax liability under article 9-A of the Tax Law.

Section 7. Section 6-2.2 of such regulations is amended to read as follows:

§ 6-2.2 Capital stock [and unitary business requirements] requirement. (Tax Law, § 211(4))

(a) [*Capital stock requirement.*] (1) [In deciding whether to permit or require a group of corporations to file a combined report, the Tax Commission will first determine whether] A taxpayer and another corporation meet the capital stock requirement if :

(i) the taxpayer owns or controls, either directly or indirectly, substantially all of the capital stock of [all the other corporations which are to be included in the combined report] another corporation; or

(ii) substantially all of the capital stock of the taxpayer is owned or controlled, either directly or indirectly, by [other corporations which are to be included in the combined report] another corporation; or

(iii) substantially all of the capital stock of the taxpayer and substantially all of the capital stock of [the] one or more other corporations [which are to be included in the combined report] are owned or controlled, either directly or indirectly, by the same interests.

(2) Corporations that meet the capital stock requirement are "related corporations."

(3) The term *substantially all* means ownership or control of 80 percent or more of the voting power of the issued and outstanding stock. Ownership includes actual or beneficial ownership. To be considered the owner, the stockholder must have the right to vote and the right to receive dividends. The term *control* refers to all cases where the taxpayer controls the stock of [all the other corporations] another corporation or the stock of the taxpayer is controlled by [other corporations] another corporation or the taxpayer and [the] one or more other corporations are controlled by the same interests. The [decision] determination as to whether or not a corporation is controlled by or controls another corporation or is controlled by the same interests will be determined by the facts in each case.

DRAFT

Example 1: The taxpayer, X Corporation, owns 70 percent of the voting stock of Y Corporation. The remaining voting stock is owned by three employees of X Corporation. These employees have agreed in writing to sell their stock to X Corporation when they leave the corporation. As part of the agreement, the employees have given X Corporation their voting proxy. Thus, X Corporation owns or controls 80 percent or more of the voting stock of Y Corporation.

[(b) *Unitary business requirement.* (1) In deciding whether a corporation is part of a unitary business, the Tax Commission will consider whether the activities in which the corporation engages are related to the activities of the other corporations in the group, such as:

(i) manufacturing or acquiring goods or property or performing services for other corporations in the group; or

(ii) selling goods acquired from other corporations in the group; or

(iii) financing sales of other corporations in the group.

(2) The Tax Commission, in deciding whether a corporation is part of a unitary business, will also consider whether the corporation is engaged in the same or related lines of business as the other corporations in the group, such as:

(i) manufacturing or selling similar products; or

(ii) performing similar services; or

(iii) performing services for the same customers.

(3) *Examples:*

Example 2: A manufacturing corporation organizes an 80 percent or more owned subsidiary and transfers all of its selling activities to the subsidiary. The subsidiary sells

only the parent's products for which it receives a commission. The subsidiary has a place of business of its own and its own employees. The corporations are conducting a unitary business.

Example 3: The taxpayer, a manufacturing corporation, forms a holding company which is also subject to tax. The holding company owns all of the manufacturing company's stock. The only activity of the parent-holding company is to receive dividends from the manufacturing corporation. The corporations are not conducting a unitary business.]

Section 8. Subdivision (a) of section 6-2.3 of such regulations is amended to read, subdivision (b) is repealed, subdivision (c) is relettered to (b) and amended to read as follows:

§ 6-2.3 [Other Requirement] Substantial intercorporate transactions requirement and other considerations. (Tax Law, Sec. 211(4) and (5)).

(a) [If the capital stock and unitary business requirements described in section 6-2.2 of this Part have been met, the Tax Commission may permit or require a group of taxpayers to file a combined report if reporting on a separate basis distorts the activities, business, income or capital in New York State of the taxpayers. The activities, business, income or capital of a taxpayer will be presumed to be distorted when the taxpayer reports on a separate basis if there are] In determining whether substantial intercorporate transactions among the related corporations exist, the facts and circumstances of all activities and transactions will be considered regardless of the transfer price for such intercorporate transactions. It is not necessary that there be substantial intercorporate transactions between any one corporation and every other related corporation. However, it is necessary that there be substantial intercorporate transactions between the taxpayer and a related corporation or collectively a group of such related corporations.

[(c)] (b)(1) In determining whether there are substantial intercorporate transactions, the [Tax Commission] Commissioner will consider and evaluate all activities and transactions [directly connected with the business conducted by] of the taxpayer and its related corporations, [such as] including but not limited to:

[(1)] (i) manufacturing or acquiring goods or property or performing services for [other corporations in the group] related corporations;

[(2)] (ii) selling goods acquired from [other corporations in the group] related corporations;

[(3)] (iii) financing sales of [other corporations in the group; or] related corporations;

[(4)] (iv) performing related customer services using common facilities and employees for related corporations;

(v) incurring expenses that benefit, directly or indirectly, one or more related corporations; and

(vi) transferring assets, including assets such as accounts receivable, patents, or trademarks from one or more related corporations.

(2) For purposes of determining whether substantial intercorporate transactions exist, dividends are not considered in the measure of intercorporate receipts, total receipts, intercorporate expenditures, or total expenditures described in subparagraph (i) of paragraph (3) of this subdivision. However, in determining whether the substantial intercorporate transactions requirement has been met based on asset transfers, dividends are considered in the measure of gross income for purposes of the test described in subparagraph (ii) of paragraph (3) of this subdivision. Loans and interest on loans between related corporations are considered in determining if there are substantial intercorporate transactions. However, if a loan constitutes subsidiary capital pursuant to section 3-6.3 of this Title and section 208.4 of the Tax Law, the interest paid and received on the

DRAFT

loan is treated as a dividend. Similar transactions must be treated in a consistent manner from taxable year to taxable year. Service functions will not be considered when they are incidental to the business of the corporation providing such service. Service functions include, but are not limited to, accounting, legal and personnel services.

(3) [The] (i)(*a*) Subject to clause (*b*) of this subparagraph, the substantial intercorporate [transaction] transactions requirement [may be met] based on a corporation's receipts or expenditures is met where: [as little as 50 percent of a corporation's receipts or expenses are from one or more qualified activities described in this subdivision. It is not necessary that there be substantial intercorporate transactions between any one member with every other member of the group. It is, however, essential that each corporation have substantial intercorporate transactions with one other corporation or with a combined or combinable group of corporations. For example, Corporation Z sells 30 percent of its product to Corporation X and 40 percent of its product to Corporation Y. If Corporations X and Y constitute a combined or combinable group, there are substantial intercorporate transactions between Corporation Z and such a combined group because 70 percent of Corporation Z's sales are to such combined group. If Corporations X and Y do not constitute a combined or combinable group, there are not substantial intercorporate transactions between Corporation Z and Corporations X and Y.]

(*1*) during the taxable year, 50 percent or more of a corporation's receipts includable in the computation of entire net income (excluding nonrecurring receipts) are from a related corporation or a group of related corporations;

(*2*) during the taxable year, 50 percent or more of a corporation's expenditures includable in the computation of entire net income, including expenditures for inventory but excluding nonrecurring expenditures, are to a related corporation or a group of related corporations or directly or indirectly benefit a related corporation or a group of related corporations; or

DRAFT

(*3*) during the taxable year, a corporation's expenditures (excluding nonrecurring expenditures) directly or indirectly benefiting a related corporation or a group of related corporations are equal to 50 percent or more of the sum of such expenditures and the expenditures (excluding nonrecurring expenditures) of the beneficiary corporation or corporations.

(*b*) If, in a particular taxable year, a corporation's intercorporate receipts or expenditures described in subclauses (*1*), (*2*), or (*3*) of clause (*a*) of this subparagraph, are between 45 percent and 55 percent of the total of the corporation's receipts or expenditures, as the case may be, then the test will be satisfied if the corporation's receipts or expenditures, as the case may be, from one or more related corporations during the taxable year and the prior two taxable years in aggregate equals or exceeds 50 percent of its total receipts or expenditures, as the case may be, during the taxable year and the prior two taxable years in aggregate. If the corporation or one or more of the related corporations involved in the intercorporate transactions did not exist for all of the two prior taxable years, then the 50 percent measure for each corporation will be computed using the number of months that it existed.

(ii) The substantial intercorporate transactions requirement based on a corporation's asset transfers is met where a corporation transfers assets (including through incorporation) to a related corporation engaged in a unitary business (as described in subdivision (e) of this section) with the transferor and 20 percent or more of the transferee's gross income, including any dividends received, in the taxable year of the transfer or in taxable years subsequent to the year the asset or assets were transferred, is derived directly from the transferred assets. For purposes of this test:

(*a*) only assets that are transferred in exchange for stock or paid in capital are considered;

(*b*) transfers of cash to a related corporation in exchange for stock or paid in capital are not considered;

(*c*) the term "gross income" means gross income as defined in section 61(a) of the Internal

Revenue Code;

(*d*) gross income is derived directly from an asset if the asset or the use of the asset by the transferee produces gross income. Assets that directly produce gross income include, but are not limited to, real property, accounts receivable, and intangibles such as patents, copyrights, and trademarks;

(*e*) gross income received by the transferee as a result of the reinvestment of income attributable to the transferred asset is not derived directly from the transferred asset;

(*f*) the test must be applied for each year of an asset's normal depreciation recovery period under sections 167 or 168(c) of the Internal Revenue Code or amortization period under section 197(a) of the Internal Revenue Code, without regard to any reduction or disallowance of the depreciation or amortization period contained in the Internal Revenue Code. In the case of an asset that is not required to be depreciated or amortized for Federal income tax purposes, such as accounts receivable, the test must be applied for each year the asset is reflected on the books and records of the transferee under generally accepted accounting principles;

(*g*) if the asset transferred is an interest in another entity, the income distributed or deemed distributed to the transferee by such entity is income derived directly from the transferred asset;

(*h*) where more than one asset is transferred, the gross income from all qualifying assets is used in determining whether the test is met; and

(*i*) the determination of whether a transaction or series of transactions constitutes an asset transfer in exchange for stock or paid-in-capital is based on the facts and circumstances of the transaction. The form of the transactions will not be respected if they lack economic substance or if the taxpayer intended a series of actions to be part of a single integrated transaction.

(iii) In determining whether the substantial intercorporate transactions requirement has been met, the Department will consider the materiality of the transactions and whether the transactions have economic

DRAFT

substance, including the extent to which the motivation of the taxpayer in undertaking the transactions was to affect the membership of the combined group.

Section 9. A new subdivision (c) is added to section 6-2.3 of the regulations to read as follows:

(c) The following steps should be used to determine whether a combined report is required and, if so, which corporations are included in that combined report:

(1) Every taxpayer must identify all of the corporations to which it is related. Where one or more of the related corporations are taxpayers, identify all of the corporations related to these taxpayers. Do this until all related corporations have been identified. If a taxpayer has no related corporations, it must file on a separate basis. This constitutes the Step 1 group of related corporations.

(2) Identify all of the related corporations that have substantial intercorporate transactions with any taxpayer identified in Step 1. These related corporations and the taxpayers constitute the Step 2 tentative combined group.

(3) Add to the Step 2 tentative combined group every related corporation that has substantial intercorporate transactions with any corporation identified in Step 2. This constitutes the Step 3 tentative combined group.

(4) Add to the Step 3 tentative combined group every related corporation that has substantial intercorporate transactions with any corporation identified in Step 3. Repeat this process until it adds no more corporations to the group. This constitutes the Step 4 tentative combined group.

(5) Identify each related corporation not in the Step 4 tentative combined group that has substantial intercorporate transactions with another related corporation not in the Step 4 tentative combined group. Compare all such groups and combine into one group those with common members ("unattached related group"). There may be more than one unattached related group.

(6) If there are substantial intercorporate transactions between any one corporation in an

DRAFT

unattached related group and the Step 4 tentative combined group, then all corporations in that unattached related group are included in the combined group. Do this for each unattached related group. As unattached related groups are included in the combined group, do this analysis between the expanded group and each unattached related group. The resulting group is the Step 6 tentative combined group.

(7) If there are substantial intercorporate transactions between any one corporation in the Step 6 tentative combined group and an unattached related group, then all corporations in the unattached related group are included in the combined group. Do this for each unattached related group. As unattached related groups are included in the combined group, do this analysis between the expanded group and each unattached related group. The resulting group is the Step 7 tentative combined group.

(8) Add to the Step 7 tentative combined group each related corporation that has substantial intercorporate transactions with the Step 7 tentative combined group.

(9) Repeat the processes set forth in Steps 4, 6, 7, and 8 until no more corporations can be added to the tentative combined group.

(10) Eliminate from the tentative combined group those corporations that are formed under the laws of another country (alien corporations), that are taxable under another franchise tax imposed by the Tax Law (or would be taxable under another franchise tax if subject to tax), and corporations that compute their business allocation percentage using a statutory method that is different from the taxpayer's (e.g., aviation corporations and trucking corporations compute their business allocation percentage using a different business allocation percentage than manufacturing corporations), New York S corporations defined in section 208(1-A) of the Tax Law, and foreign corporations not subject to tax that have an election in effect under subchapter S of chapter one of the Internal Revenue Code. Also eliminate any captive REIT or captive RIC as defined in subdivisions 9 and 10 of section 2 of the Tax Law, respectively, that is required to be included in a combined return under section 1462(f) or 1515(f)

DRAFT

of the Tax Law. If two or more corporations are eliminated, it is possible that they will constitute a combined group if they have substantial intercorporate transactions. For example, one group could consist of trucking corporations and another group could consist of manufacturing corporations. However, section 211.4(a)(5) of the Tax Law provides that alien corporations are not to be included in a combined group (also see section 6-2.5 of this Subpart – Corporations not required or permitted to file a combined report).

Section 10. Subdivisions (d), (e) and (f) of section 6-2.3 of the regulations are repealed and new subdivisions (d) and (e) are added to read as follows:

(d) If the capital stock requirement described in section 6-2.2 of this Subpart has been met, but substantial intercorporate transactions are absent, a combined report may be required or permitted if the Commissioner deems such a report necessary because of inter-company transactions or some agreement, understanding, arrangement, or transaction in order to properly reflect the tax liability under article 9-A.

(e)(1) For purposes of this section, in determining whether a corporation is part of a unitary business, the Commissioner will consider whether the activities in which the corporation engages are related to the activities of the other corporations in the group, such as:

(i) manufacturing or acquiring goods or property or performing services for other corporations in the group; or

(ii) selling goods acquired from other corporations in the group; or

(iii) financing sales of other corporations in the group.

DRAFT

(2) In determining whether a corporation is part of a unitary business, the Commissioner will also consider whether the corporation is engaged in the same or related lines of business as the other corporations in the group, such as:

(i) manufacturing or selling similar products; or

(ii) performing similar services; or

(iii) performing services for the same customers.

(3) Examples:

Example 1: A manufacturing corporation organizes an 80 percent or more owned subsidiary and transfers all of its selling activities to the subsidiary. The subsidiary sells only the parent's products for which it receives a commission. The subsidiary has a place of business of its own and its own employees. The corporations are conducting a unitary business.

Example 2: The taxpayer, a manufacturing corporation, forms a holding company. The holding company owns all of the manufacturing company's stock. The only activity of the parent-holding company is to receive dividends from the manufacturing corporation. The corporations are not conducting a unitary business.

Section 11. The title and subdivision (a) of section 6-2.4, of such regulations are amended to read as follows:

§ 6-2.4 [Permission for filing] Filing combined reports. (Tax Law, Sec. 211(4)).

(a)(1) [A] As provided in this Subpart a group of related corporations [meeting the requirements set forth in section 6-2.2 and 6-2.3 of this Subpart does not need to request prior permission] may be required

or permitted to file on a combined basis. To file on a combined basis the group must file a completed combined report. The first year the group files on a combined basis, and each year thereafter in which the composition of the group changes, the group must include the following information[, either on] with the report [or attached thereto]:

(i) the exact name, address, employer identification number and the state of incorporation of each corporation included in the combined report;

(ii) information showing that each of the corporations meets the capital stock requirement of section [6-2.2(a)] 6-2.2 of this Subpart for the taxable year; and

(iii) the exact name, address, employer identification number and the state of incorporation of all corporations (except alien corporations) [which] that meet the capital stock requirement of section [6-2.2(a)] 6-2.2 of this Subpart for the taxable year, [which] but are not included in the combined report.

(2) In addition, the following information may be required to be submitted for the taxable year at another time, such as in conjunction with an audit:

(i) a statement providing details as to why a combined report which includes only the corporations listed in subparagraph (1)(i) of this subdivision [equitably reflects the New York State activities of the corporations which] that meet the capital stock requirement of section [6-2.2(a)] 6-2.2 of this Subpart and the details as to why the corporations listed pursuant to subparagraph (1)(iii) of this subdivision [should be] are excluded; and

(ii) information establishing that[, for the taxable year,] each corporation included [on] in the report meets the [unitary business requirement of section 6-2.2(b) of this Subpart, as well as the] requirements of section 6-2.3 of this Subpart.

Section 12. Section 6-2.5 of such regulations is amended to read as follows:

§ 6-2.5 Corporations not required or permitted to file a combined report. (Tax Law, Sec. 211(4)).

(a) [A foreign corporation not subject to tax will not be required to be included in a combined report unless the requirements described in section 6-2.2 of this Subpart have been met and the Tax Commission determines that inclusion is necessary to properly reflect the tax liability of one or more taxpayers included in the group because of:

(1) substantial intercorporate transactions (see section 6-2.3(c) of this Subpart); or

(2) some agreement, understanding, arrangement or transaction whereby the activity, business, income or capital of any taxpayer is improperly or inaccurately reflected.

Example 1: A parent corporation, a taxpayer, is the sole owner of a finance subsidiary which is a foreign corporation not subject to tax The parent manufactures furniture which it sells to independent retail dealers. The parent has an agreement with its finance subsidiary that the subsidiary will directly finance the purchase of the parent's furniture when it is purchased by customers of the independent retail dealers. The subsidiary's income is predominantly derived from financing retail sales of its parent's products. The independent retail dealer arranges the financing for the customer with the subsidiary. The parent and finance subsidiary will be required to file a combined report because of this agreement.

DRAFT

(b) An alien corporation (see section 3-8.3 of this Title --Alien corporations)] A corporation organized under the laws of a country other than the United States (see Tax Law section 211.4(a)(5)) may not be included in a combined report. [Provided, however, that all FSCs, including those that are alien corporations, may be included in a combined report. For a special rule regarding the computation of the entire net income of a FSC, see section 3-2.2(d) of this Title.]

> [*Example 2:* A taxpayer has several 80 percent or more owned alien subsidiaries, none of which is a FSC. It organizes an 80 percent or more owned domestic subsidiary to provide financing for the alien subsidiaries. Assume the parent, the domestic subsidiary and the alien subsidiaries are conducting a unitary business. The parent and the domestic subsidiary will be permitted or required to file a combined report if they meet the requirement set forth in section 6-2.3 of this Subpart. However, in no event will the alien subsidiaries be allowed in a combined report.
>
> *Example 3:* A taxpayer has an 80 percent or more owned alien subsidiary which is a FSC. The parent and such alien subsidiary are conducting a unitary business. The parent and such alien subsidiary will be permitted to file a combined report if they meet the requirement set forth in section 6-2.3 of this Subpart or will be required to file a combined report if the Commissioner of Taxation and Finance determines that inclusion of such alien subsidiary in a combined report is necessary pursuant to subdivision (a) of this section. (c)]

(b) A corporation which is taxable under [some other article of] another franchise tax imposed by the Tax Law [(except corporations which are taxable under article 9-A and article 13-A, section 182, 182-a, 182-b or 186-a of article 9)] (or would be taxable under another franchise tax if subject to tax) may not be included in a combined report.

[*Example 4:* A corporation engaged in the manufacture and sale of furniture organizes an 80 percent or more owned subsidiary to which it transfers its delivery department. The subsidiary's only activity is making deliveries of the taxpayer's goods. Even though the activities of the two corporations constitute a unitary business, a combined report will not be required or permitted since the subsidiary is properly taxable under section 183 and section 184 of article 9 of the Tax Law as a transportation corporation. (d)]

(c) A taxpayer that allocates in accordance with section 210.3(a)(7)(A) of the Tax law (relating to aviation corporations) may not be included in a combined report with any other corporation that does not allocate pursuant to such section 210.3(a)(7)(A), unless such taxpayer or other such corporation is a qualified air freight forwarder as described in section 211.4(a)(2)(ii) of the Tax Law, with respect to such other corporation or taxpayer, respectively, and all corporations included in the combined report elect to have such qualified air freight forwarded so included.

(d) A taxpayer that allocates in accordance with section 210.3(a)(8) of the Tax Law (relating to railroad and trucking corporations) may not be included in a combined report with any [other such] corporation that does not allocate pursuant to such section 210.3(a)(8).

(e) A New York S corporation, as defined in section 208(1-A) of the Tax Law, may not be included in a combined report except with:

(1) one or more New York S corporations (see section [6-2.3(a)] 6-2.3 of this Subpart); and/or

(2) one or more foreign corporations not subject to tax, which have made an election under subchapter S of chapter one of the Internal Revenue Code (see section [6-2.3(b)] 6-2.3(d) of this Subpart [or subdivision (a) of this section)].

DRAFT

Section 13. Section 6-2.6 of such regulations is amended to read as follows:

§6-2.6 Combined Reports: [election] Other entities. (Tax Law, Sec. 211(4)).

(a) Any corporation which owns or controls either directly or indirectly substantially all of the capital stock of a taxable DISC, as defined in section 3-9.2 of this Title, will be allowed, at its election, to file a combined report which includes such DISC. [If] However, if the corporation fails to make the election allowed by this section, the [Tax Commission] Commissioner [may, in its discretion, require] is not prohibited from requiring a combined report covering the corporation and such DISC.

(b) For information relating to the inclusion of a real estate investment trust (REIT) in a combined report, see section 211.4 of the Tax Law.

(c) For information relating to the inclusion of a regulated investment company (RIC) in a combined report, see section 211.4 of the Tax Law.

Section 14. Section 6-2.7 of such regulations is renumbered to be section 6-2.8 and a new section 6-2.7 is added to read as follows:

§6-2.7 Examples

Unless otherwise provided, assume the following facts for all examples:

Corporation A owns all of the stock of corporations B, C, D, E, F, G, H, L, M, N, O, P, Q, and R. All of the corporations are calendar year taxpayers for federal income tax purposes. Corporations B and C are taxable under article 9-A of the Tax law and the other corporations would be subject to tax under article 9-A if they had nexus with New York. All of the corporations use (or would use) the business allocation percentage computed pursuant to section 210.3(a)(10) of the Tax Law. None of the corporations is a corporation organized under the laws of a country other than the United States.

Example 1: 90 percent of B's receipts are from D. Therefore, there are substantial intercorporate transactions between B and D. B and D are a tentative combined group and must file a

DRAFT

combined report.

Example 2: B's receipts are: 22 percent from A, 20 percent from C, 30 percent from D, 10 percent from E and the rest are from unrelated entities. 40 percent of C's expenses are to B. No other substantial intercorporate transactions occur between the corporations. Since there is no tentative combined group among the related corporations, corporations B and C file on a separate basis.

Example 3: 90 percent of B's receipts are from D and 100 percent of D's receipts are from E. D is an alien corporation. There are substantial intercorporate transactions between B and D, and D and E. B, D and E are a tentative combined group. However, since D is a corporation organized under the Laws of a country other than the United States, it cannot be included in a combined report (see sections 6-2.3(c)(10) and 6-2.5(b) of this Subpart). Therefore, B and E file a combined report.

Example 4: A is the only taxpayer and 50 percent of A's receipts are from B, with another 4 percent from E. 30 percent of E's expenditures are to A and 20 percent to D. C has no transactions with anyone in the group. 50 percent of D's receipts are from A. 50 percent of F's receipts are from A. 100 percent of H's receipts are from F. 100 percent of R's receipts are from H. 20 percent of B's receipts are from L, 20 percent from M, and 20 percent from N. 100 percent of L's receipts are from M. 100 percent of M's receipts are from N. 40 percent of O's receipts are from R and 30 percent are from D. 60 percent of P's receipts are from O. 80 percent of L's expenditures are to Q. All of these corporations are in the Step 1 group of related corporations described in section 6-2.3(c)(1) of this Subpart because they meet the stock ownership test.

DRAFT

The Step 2 tentative combined group as described in section 6-2.3(c)(2) of this Subpart consists of A, B, D, and F. As a result of Step 3 (see section 6-2.3(c)(3) of this Subpart), H is added to the tentative combined group. As a result of Step 4 (see section 6-2.3(c)(4) of this Subpart), R is added to the tentative combined group.

As described in Step 5 (see section 6-2.3(c)(5) of this Subpart), L, M, N and Q is an unattached related group and O and P is an unattached related group.

Corporations O and P are added to the tentative group pursuant to Step 6 (see section 6-2.3(c)(6) of this Subpart) because 70 percent of O's receipts are from R and D. The Step 6 tentative combined group is A, B, D, F, H, R, O and P.

The corporations in the unattached unrelated group of L, M, N and Q are all added to the tentative combined group pursuant to Step 7 (see section 6-2.3(c)(7) of this Subpart) because B has substantial intercorporate transactions with the unattached related group of L, M, N and Q. The Step 7 tentative combined group is A, B, D, F, H, R, O, P, L, M, N and Q.

Pursuant to Step 8 (see section 6-2.3(c)(8) of this Subpart), E is added to the Step 7 tentative combined group because 30% of its expenditures are from A and 20% are from D. The Step 9 (see section 6-2.3(c)(9) of this Subpart) tentative combined group is the same as the Step 8 tentative combined group. Since no corporations will be excluded from the Step 9 tentative combined group pursuant to Step 10 (see sections 6-2.3(c)(10) and 6-2.5 of this Subpart), the group of corporations that must file a combined report are A, B, D, F, H, R, O, P, L, M, N, Q and E.

DRAFT

Example 5: Same facts as Example 4 except that A, B, D, and F have filed on a combined basis for several years. In the current year, A realizes that it would reduce its New York State tax liability if it included C in the combined report. A creates K by contributing $10,000 of cash to it in exchange for all of K's stock. (In the alternative, A lends $10,000 to K, an existing dormant corporation). K enters into a contract with C to provide it with all of its office supplies (pens, paper, paper clips, etc.). K buys all of its office supplies from A and then sells them at a slight mark-up to C. In addition, K has a very small amount of interest income from a bank account.

The creation of K (or, in the alternative, making K an active corporation) and the transactions of A with K and K with C are not substantial intercorporate transactions because they lack economic substance.

Example 6: A is a bakery in NY and E is a bakery in Florida. Each year, A sells E a few pieces of equipment but the transactions are not substantial from either A's or E's point of view. In a particular year, A realizes it would reduce its New York State tax liability if it included E in a combined report with it. A creates K by contributing $10,000 to it in exchange for all of K's stock. A sells the equipment to K and K sells the equipment to E.

The creation of K and the transactions of A with K and K with E are not substantial intercorporate transactions because they lack economic substance.

Example 7: A's only activity is to receive dividends from its wholly owned subsidiaries. B sells stocks, C sells municipal bonds and D sells corporate bonds. B, C and D each have their own employees. However, the employees of one corporation are authorized to and do sell extensively the securities sold by the other corporations. 80 percent of the receipts of B, 70 percent of the receipts of C and 60 percent

of the receipts of D are generated by sales made by the common pool of employees of B, C, and D. All three corporations carry on their activities at or using common facilities. Because there are substantial intercorporate transactions among B, C and D, they are a combined group and must file a combined report. A is not included in the combined group because it has no substantial intercorporate transactions with a related corporation.

Section 15. Section 6-2.8 as renumbered by section 13 of this proposal is amended to read as follows:

§6-2.8 Combined Reports: Cross-References.

The following is a list of cross-references to other sections of this Subchapter which pertain to combined reports:

(a) Combined corporations ceasing to exercise franchise or to be subject to tax under article 9-A, see section 2-3.1(d) of this Title.

(b) [Computing] Computation of tax on a combined [reports] report, see section 3-1.3 of this Title.

[(c) Definition of entire net income, see section 3-2.2 of this Title.]

[(d)] (c) Computing entire net income on a combined [reports] report, see section 3-2.10 of this Title.

[(e)] (d) Computing business capital and investment capital on a combined [reports] report, see section 3-3.8 of this Title.

[(f)] (e) Computing minimum taxable income on a combined [reports] report, see section 3-4.5 of this Title.

[(g)] (f) Fixed dollar minimum on a combined [reports] report, see section 3-5.3 of this Title (for New York S corporations, see section [3-1.3[d]] 3-1.3(d) of this Title).

[(h)] (g) Computing subsidiary capital on a combined [reports] report, see section 3-6.6 of this Title.

(h) Net operating loss deduction – combined reports, see section 3-8.7 of this Title.

(i) Combined reports (DISC), see section 3-9.6 of this Title.

(j) Combined reports (Real Estate Investment Trusts), see section 3-11.1(c) of this Title.

(k) Combined reports (Regulated Investment Companies), see section 3-12.1(c) of this Title.

DRAFT

[(i)] (l) Allocation on combined reports, see section 4-1.2 of this Title.

[(j)] (m) Rented real and tangible personal property, see section 4-3.2(c)(1) of this Title.

[(k)] (n) Receipts factor on combined reports, see section 4-4.8 of this Title.

[(l)] (o) Form of reports on combined basis, see section 6-3.2 of this Part.

[(m)] (p) A corporation reporting on a combined basis ceasing to be subject to tax, or ceasing to exercise its franchise but remaining subject to tax, see section 6-4.3(c) of this Part.

[(n) Payment of tax on combined reports, see Subpart 7-1 of this Title.

(o)] (q) Assessment of tax on combined reports, see section 8-1.3 of this Title.

Section 16. Subdivisions (a) and (b) of section 6-3.2 of such regulations are amended to read as follows:

(a) In all cases where a combined report is required or permitted (see Subpart 6-2 of this Part) a combined franchise tax report must be submitted by the [corporation] taxpayer designated as the parent responsible for paying the combined tax on form CT-3-A. In addition, each related corporation in the combined group must submit such other reports and other information which the Commissioner [of Taxation and Finance] may require.

(b) [All] It is not necessary that all corporations in the combined group [must use] have the same accounting period. (See Subpart 2-1 for information relating to accounting periods). Where a corporation's taxable year is different than that of the taxpayer parent, the applicable taxable year of such corporation to be included in the combined report is the taxable year that ends within the taxable year of the taxpayer parent.

Section 17. Subdivisions (b) and (d) section 21-2.1 of such regulations are to read as follows:

(b) [Each] Generally, each of the corporations to be included in the combined return must be a banking corporation or a bank holding company. (See section 1462(f)(2)(v)(b) of the Tax

DRAFT

Law for information relating to the inclusion of captive REIT and captive RIC in a combined return.)

(d) [Each] It is not necessary that all [corporation] corporations included in a combined return [must use] have the same accounting period. (See section 21-3.2 of this Part – Form of combined returns.).

Section 18. Section 21-3.2 of such regulations is amended to read as follows:

(a) In all cases where a combined return is permitted or required (see Subpart 21-2 of this Part Combined Returns), a combined franchise tax return must be submitted by the [corporation] taxpayer designated as the parent responsible for paying the combined tax on form CT-32-A. In addition, each corporation in the combined group must submit such other reports and other information which the Commissioner [of Taxation and Finance] may require.

(b) [All] It is not necessary that all corporations in the combined group [must use] have the same accounting period. (See Subpart 17-1 for information relating to accounting periods). Where a corporation's taxable year is different than that of the taxpayer parent, the applicable taxable year of such corporation to be included in the combined report is the taxable year that ends within the taxable year of the taxpayer parent.

Dated: Albany, New York
, 2008

Robert L. Megna

DRAFT

Commissioner of Taxation and Finance

DRAFT