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Report No. 1466
September 2, 2022

Amanda Hiller
Acting Commissioner and General Counsel
New York State Department of Taxation and Finance
W.A. Harriman Campus
Albany, NY 12227

Re: Report No. 1466- Report on Draft Business Apportionment Factor Regulations

Dear Acting Commissioner Hiller:

I am pleased to submit Report No. 1466 of the Tax Section of the New York State Bar Association discussing the draft business apportionment factor regulations prepared by the New York State Department of Taxation and Finance dated July 1, 2022 that are intended to clarify and interpret the general rules contained in Section 210-A of the New York Tax Law.

We appreciate your consideration of our Report. If you have any questions, please feel free to contact us and we would be happy to assist.

Respectfully Submitted,

Robert Cassanos
Chair

Enclosure

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Report No. 1466

New York State Bar Association Tax Section

REPORT ON DRAFT BUSINESS APPORTIONMENT FACTOR REGULATIONS

September 2, 2022

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I. Introduction

This report[1] (the "Report") comments on draft regulations (the "Draft Regulations") prepared by the New York State Department of Taxation and Finance (the "Department"), dated July 1, 2022, that are intended to clarify and interpret the general rules contained in Section 210-A of the New York Tax Law (the "Tax Law") for determining a corporation's business apportionment factor (the "BAF").

The New York State Bar Association Tax Section (the "Tax Section") appreciates the Department's openness in making the Draft Regulations widely available on its website for comment before they are formally proposed pursuant to Article 2 of the State Administrative Procedures Act. We again commend the Department for having prepared generally clear and comprehensive guidance for businesses and practitioners in this entirely new aspect of the Tax Law. This Report offers the Tax Section's comments and recommendations on certain of the Draft Regulations, specifically the following draft rules:

1. Sourcing of net interest income from federal funds and other financial instruments.
2. Power of the Commissioner to adjust the BAF.
3. Sourcing gain from the sale of an intangible.
4. Sourcing for receipts from passive investment customers.
5. Sourcing for receipts from digital products.
6. Definitions of cryptocurrency.
7. Items included in the BAF.

II. Discussion

A. Sourcing Net Interest Income from Federal Funds and Interest from Other Financial Instruments

1. Statutory Language

The Tax Law states that eight percent of "net interest from federal funds" (i.e., determined after deducting interest expense from federal funds) is sourced to New York.[2] "Interest from other financial instruments," however, is sourced to New York if the payor is located in New York.[3] For this purpose, an individual is deemed to be located in New York if his or her billing address is in

[1] The principal drafters of this report were: Jack Trachtenberg, Mary Jo Brady, Michelle Chionchio, Maria Famiglietti, Doran Gittelman, J.D. Hogan, Gabrielle Kraushaar, Alysse McLoughlin, Marc Simonetti, Irwin Slomka, and Jenn White. Helpful comments were received from Kimberly Blanchard, Robert Cassanos, Peter Connors, Michael Schler, Stephen Shay, and Eric B. Sloan. This report reflects solely the views of the New York State Bar Association Tax Section and not those of the New York State Bar Association's Executive Committee, its individual members, or its House of Delegates.

[2] N.Y. Tax Law § 210-A(5)(a)(2)(F).

[3] *Id.* at § 210-A(5)(a)(2)(H).

the state. A business entity is deemed to be located in the state if its commercial domicile is located in New York.[4]

2. The Draft Regulations

Draft Regulation Section 4-2.9 is consistent with the Tax Law, stating that "[e]ight percent of net interest income (not less than zero) from federal funds is included in New York receipts. . . Net interest income from federal funds is determined after the deduction of interest expense from federal funds."[5]

Draft Regulation Section 4-2.9 defines "interest income from federal funds" to mean "interest income paid by another institution in the federal reserve system for borrowing the corporation's funds deposited at a federal reserve bank."[6] The Draft Regulations specifically exclude "[i]nterest paid to the corporation directly by the federal reserve for reserves maintained at a federal reserve bank."[7] Instead, this income is treated as "income from other financial instruments" and is sourced to New York "if the payor is located in New York State."[8] According to the Draft Regulations, an individual payor is located in New York if his or her billing address is in New York, and a business payor is located in New York if its commercial domicile is in New York.[9] The location for a government entity, as payor or purchaser, is dependent on the type of government entity.[10]

The Draft Regulations set forth the following example:

> Taxpayer C maintains reserves at its required Federal Reserve Bank. These funds generate $1,000 of interest income that is not considered interest income from federal funds. Only one of the twelve Federal Reserve Banks is located in New York. As a result, 1/12 of the interest income is included in New York receipts. All $1,000 of interest income is included in everywhere receipts.[11]

3. Comments

The Tax Law does not define "net income from federal funds" for apportionment purposes, other than to state that it "is determined after deduction of interest expense from federal funds."[12] The Draft Regulations, however, provide a definition and exclusion. Per Draft Regulation Section

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[4] *Id*. at § 210-A(5)(a)(2).

[5] Draft Regulations, Part 4 § 4-2.9(a)-(b) (N.Y.S. Department of Taxation & Finance July 1, 2022) (cited hereinafter as, "Draft Reg.").

[6] *Id*. at § 4-2.9(b).

[7] *Id*. at § 4-2.9(c).

[8] *Id*. at §§ 4-2.9(c), 4-2.12(b).

[9] *Id*. at § 4-2.12(c)(1).

[10] Draft Reg. § 4-2.12(c)(2).

[11] *Id*. at § 4-2.12(f) (Example 3).

[12] N.Y. Tax Law § 210-A(5)(a)(2)(F).

4-2.9, "[i]nterest income from federal funds means interest income paid by another institution in the federal reserve system for borrowing the corporation's funds deposited at a federal reserve bank."[13] "Interest paid to the corporation directly by the federal reserve for reserves maintained at a federal reserve bank" is not considered "interest income from federal funds," and is thus sourced as "interest from other financial instruments"—that is, according to the payor's location.[14]

Example 3 of Draft Regulation Section 4-2.12(f) is intended to illustrate the sourcing of "interest income from other financial instruments" when the payor of such interest is a Federal Reserve Bank. Although the Tax Law and Draft Regulations state that such income should be sourced to the payor's location, Example 3 indicates that this income should be sourced based on the number of Federal Reserve Banks located in New York (one out of twelve, or 8.3 percent).[15] Arguably, the analog to the commercial domicile of a business entity (which the Tax Law looks to when sourcing interest from other financial instruments received from a business entity) for a federal government entity payor is Washington, D.C., generally the headquarters of federal government agencies. We acknowledge, however, that the Department's approach to source this interest based on the number of Federal Reserve Banks located in New York as a percentage of the total number of Federal Reserve Banks is not unreasonable and appears consistent with the analogous Draft Regulation Section 4-2.12(c)(2), which states that the location for a government entity, as payor or purchaser, is dependent on the type of government entity. This approach also is illustrated in Example 4 of the Draft Regulations:

> As a member of the Federal Home Loan Bank (FHLBank), Taxpayer D is required to invest in the FHLBank. During the taxable year, Taxpayer D receives $10,000 of income from this investment. Only one of the eleven Federal Home Loan Banks is located in New York. As a result, while $10,000 is included in everywhere receipts, only 1/11 of that amount, or $909, is included in New York receipts.[16]

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[13] Draft Reg. § 4-2.9(b).

[14] *Id*. at § 4-2.12(b).

[15] *Id*. at § 4-2.12(f) (Example 3).

[16] *Id*. at § 4-2.12(f) (Example 4). In addition, Example 6 of Draft Regulation § 4-4.11 (under N.Y. Tax Law § 210-A(10), receipts from other services and other business receipts) takes a similar approach with respect to receipts from a government agency, although there are other rules involved in this example, including the inquiries safe harbor:

> Consulting Corp provides two main types of facility consulting services—licensing requirements and environmental compliance. Consulting Corp has 60 business customers who have hired them to obtain applicable permits and licenses and 200 business customers who have hired them to provide environmental compliance services. Despite the differing subject matter, the consulting services are substantially similar enough that Consulting Corp may use the inquiry safe harbor. Consulting Corp provides environmental compliance services to QRS, a federal government agency, which has one regional office located in New York and 11 regional offices located in other states. The contract, which is managed in State B, provides that Consulting Corp will provide consulting services to help QRS run its internal operations at all 12 office buildings in an environmentally compliant manner. However, Consulting Corp only knows the number of offices and does not have any information about the size of the regional offices.

Assuming the accuracy of the proposition that interest paid to a corporation directly by the Federal Reserve for reserves maintained at a Federal Reserve Bank is not considered "interest income from federal funds" and should not be sourced under Tax Law Section 210-A(5)(a)(2)(F), the Tax Section also agrees that it makes sense that taxpayers required to maintain reserves at the New York Federal Reserve Bank should not be required to source such interest 100 percent to New York, given that there are twelve federal reserve bank locations. However, it would be helpful to have additional guidance for the reasoning behind Example 3 of Draft Regulation Section 4-2.12(f), which might include clarification of Draft Regulation Section 4-2.12(c)(2) stating that "[t]he location for a government entity, as payor or purchaser, is dependent on the type of government entity."

We note that removing interest income paid to a corporation by the Federal Reserve Bank from "interest income from Federal funds" may cause taxpayers to have economic nexus with New York if they would otherwise lack nexus. Under the current Draft Regulations, if a foreign corporation's only receipts consist of interest income from federal funds, such foreign corporation would not be deemed to be deriving receipts from activities in New York.[17] However, if those receipts are classified as interest income from other financial instruments, the foreign corporation could have New York nexus for franchise tax purposes from deriving receipts from New York activities. For example, if a Boston-based bank, a separate company filer, earns $14 million of interest income paid directly by the Federal Reserve for reserves maintained at a Federal Reserve Bank in Boston and has no other New York receipts, the bank could have New York nexus as a result of deriving receipts of at least $1.138 million from activities in New York.[18]

B. Power of the Commissioner to Adjust the BAF

1. Statutory Language

The Tax Law provides authority for the Commissioner to deviate from the standard statutory BAF based on the appearance of an improper reflection of the taxpayer's business income or capital within the state ("Alternative Apportionment"). Specifically, the Tax Law provides:

> Consulting Corp is not required to make inquiries as it qualifies for the inquiries safe harbor. As no special rules for determining where the benefit is received apply to the services offered by Consulting Corp, it must apply the general rule for determining where the benefit is received. Since Consulting Corp does not have exact information about where the benefit is received, it can reasonably approximate based on customer information where the benefit is received by including 1/12 of its receipts from QRS in New York receipts. One hundred percent of such receipts are included in everywhere receipts.

[17] Draft Regulations, Part 1 § 1-2.8(i) (N.Y.S. Department of Taxation & Finance August 2022) (stating that "a corporation will not be deemed to be deriving receipts from activity in the state if the only New York receipts are. . . interest income from Federal funds.").

[18] N.Y. Tax Law § 209.1(b); TSB-M-21(3)C (Dec.28, 2021). Note that different nexus thresholds apply to combined groups.

> If it shall appear that the apportionment fraction determined pursuant to this section does *not result in a proper reflection of the taxpayer's business income or capital within the state*, the commissioner is authorized in his or her discretion to adjust it, or the taxpayer may request that the commissioner adjust it, by (a) excluding one or more items in such determination, (b) including one or more other items in such determination, or (c) any other similar or different method calculated to effect a fair and proper apportionment of the business income and capital reasonably attributed to the state. The party seeking the adjustment shall bear the burden of proof to demonstrate that the apportionment fraction determined pursuant to this section does not result in a proper reflection of the taxpayer's business income or capital within the state and that the proposed adjustment is appropriate.[19]

The statute addresses three important elements that are critical to determining if an adjustment to the BAF is appropriate:

- The metric to measure is the "taxpayer's business income or capital within the state,"
- The standard to authorize an adjustment is when the standard statutory business apportionment factor "does not result in a proper reflection" of the taxpayer's in-state income or capital, and
- The only statutory procedural restriction is that the "party seeking the adjustment shall bear the burden of proof to demonstrate" that the requirements to adjust the BAF have been satisfied.

The Department's Draft Regulations attempt to interpret the statutory language but raise important issues about all three elements of the statutory scheme. Each of these issues is discussed below.

2. The Draft Regulations

Draft Regulation Section 4-1.6 includes five subsections: (1) *authority* to adjust the BAF, (2) *methods* to adjust the BAF, (3) *procedures* under which taxpayers may request and obtain permission to adjust the BAF, (4) *standards* to adjust the BAF, and (5) *examples*.

i. Metric to Determine Distortion

Draft Regulation Section 4-1.6 adds a new metric that must be analyzed to determine whether the statutory apportionment formula properly reflects the taxpayer's presence in the state. Specifically, Draft Regulation Section 4-1.6(a) states that "the BAF may not result in a proper reflection of the taxpayer's *activities*, business income or business capital in the State and the commissioner, in their discretion or at the request of the taxpayer, is authorized to adjust the BAF

[19] N.Y. Tax Law § 210-A(11) (emphasis added).

in order to properly and fairly reflect the taxpayer's *activities* within New York."[20] Furthermore, Draft Regulation Section 4-1.6(b) refers to cases "[w]hen it appears that the BAF does not fairly and properly reflect the *activities*, business income or business capital of the taxpayer in New York State."[21] The statute however does not mention the taxpayer's activities but focuses solely on whether there is a proper reflection of the taxpayer's income and capital. Thus, in a case in which the statutory scheme properly reflects income or capital within the state, the addition of the word "activities" creates the potential for deviating from the statutory scheme even where no distortion is present (at least measured by the statutory criteria).

ii. Standard to Authorize Adjustment

The Tax Law uses the term "proper reflection" to define distortion. Draft Regulation Section 4-1.6 incorporates a different standard. Specifically, Draft Regulation Section 4-1.6(d) provides that "[t]he party seeking to vary the BAF must demonstrate that application of the statutory formula attributes income or capital to the State *out of all proportion to the business transacted by the taxpayer in the State*."[22] The language emanates from the United States Supreme Court *Hans Rees* precedent, which established the standard for Constitutional distortion.[23] This is a very high standard which requires a great deal of distortion ("out of all proportion"), whereas "proper reflection" may reasonably be interpreted to provide for a different approach where a much lower but still real amount of distortion is present. This draft regulatory language is in contrast to the statutory language, which requires a showing that the BAF "not result in a *proper reflection* of the taxpayer's business income or capital within the state."[24]

iii. Procedural Restrictions on Adjustments to the BAF

The Draft Regulations impose procedural hurdles not found in the statute that restrict the taxpayer's ability to request an adjustment to the BAF. Specifically, Draft Regulation Section 4-1.6(c)(1) states that the "taxpayer may not vary the statutory BAF on an original report for a taxable year *without the consent of the commissioner*."[25] Further, the Draft Regulations require that the taxpayer's request "must be submitted in writing and must be submitted separately from the report to which it relates and must set forth *full information on which the request is based*."[26] The Draft Regulations state that a taxpayer cannot use an adjusted BAF *without the prior consent* of the commissioner. To the extent that the commissioner provides consent after the initial returns have been filed, the *taxpayer may amend its returns*. To the extent that the commissioner denies the request, the taxpayer may request *reconsideration during an audit or file an amended report* using the adjusted BAF, if an audit has not commenced. None of these limitations are contained in the statute.

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[20] Draft Reg. § 4-1.6(a) (emphasis added).

[21] *Id.* at § 4-1.6(b) (emphasis added).

[22] *Id.* at § 4-1.6(d) (emphasis added).

[23] *Hans Rees' Sons v. State of N. Carolina ex rel. Maxwell*, 283 U.S. 123 (1931).

[24] N.Y. Tax Law § 210-A(11) (emphasis added).

[25] Draft Reg. § 4-1.6(c)(1) (emphasis added).

[26] *Id.* at § 4-1.6(c)(2) (emphasis added).

3. Comments

i. The Draft Regulation Specifies a Non-Statutory Metric to Determine Distortion

The Department's use of the metric of the taxpayer's "activities" to determine distortion is itself arguably distortive. The statute specifically identifies the business income and business capital of the taxpayer as the proper metrics to determine whether an adjustment to the BAF is appropriate and requires the Department to determine whether the taxpayer's "income or capital" are properly reflected in New York. While the taxpayer's business income and capital may track the taxpayer's activities, the metrics are not the same and may produce contrary results in certain contexts. For example, the Tax Law requires taxpayers to source receipts to the location of their market, which is a destination sourcing approach. The market or destination sourcing approach is diametrically opposite to the pre-New York tax reform "location of performance" approach, which is an origination sourcing approach that tracks the taxpayer's business activities. As a result, the location of the taxpayer's business activities may be the direct opposite of or deviate significantly from the sourcing outcome required under the Tax Law's market sourcing approach. To put it differently, where "income" and "activities" align, the draft regulatory change is surplusage but where they do not align the draft regulatory change opens the door to reallocating income where the statutory allocation method already properly reflects income and capital within the state. The Department's reference to a taxpayer's "activities" is therefore arguably in conflict with the statute because it permits an adjustment to a BAF that already properly reflects income and capital within the state. The Department could eliminate this potential conflict by removing the word "activities" from the sentences of Proposed Regulation Sections 4-1.6(a) and (b) cited above.

ii. The Draft Regulation Incorporates a Non-Statutory Standard to Authorize Adjustment

The Draft Regulations limit the circumstances where the BAF can be adjusted to those cases where the result produced by the statutory allocation scheme is "out of all proportion" to the business transacted in the state. The Tax Law provides a different standard to determine whether an adjustment to the BAF is appropriate. Specifically, Tax Law Section 210-A(11) provides for adjustments to the BAF if the statute "does not result in a proper reflection" of the taxpayer's business income or capital attributable to New York. Thus, in cases where the statutory allocation method does not properly reflect the taxpayer's income and capital within the state, but the results of applying that method are not "out of all proportion" to a proper reflection, the Draft Regulations would apparently remove discretion where the statute provided for it. Presumably the availability of relief in these situations was intended by the statute. New York authorities have recognized that statutory alternative apportionment authority extends to situations where the statute produces an improper apportionment even when the statutory apportionment method does not produce unconstitutional distortion.[27] Presumably, the same standard of review should apply here and

[27] *See, e.g.*, *Matter of A.E. Bruggemann & Co., Inc. v. State Tax Comm'n*, 42 A.D.2d 459 (App. Div. 3d Dep't 1973); *Matter of Bayerische Beamtenkrankenkasse AG*, DTA No. 824762 (N.Y. Tax App. Trib. Sept. 11, 2017); *Matter of Moody's Corp. & Subs.*, DTA. Nos. 828094, 828203 (N.Y. Div. Tax App. Oct. 24, 2019); *Matter of All Transport Inc.*, DTA No. 811493 (N.Y. Div. Tax App. Jan. 25, 1996); N.Y. Adv. Op. No. TSB-A-09(5)C (Mar. 9, 2009).

adjustment should be available in cases where the statutory method does not properly reflect income and capital, even if not unconstitutional.

The Department could eliminate this discrepancy by removing the sentence from the Draft Regulations requiring the party seeking an adjustment to the BAF to prove that the taxpayer's business income or capital are "out of all proportion to the business transacted by the taxpayer in the State."

iii. The Draft Regulation Imposes Non-Statutory Procedural Restrictions on Adjustments to BAF

The Draft Regulations place limitations on the taxpayer's ability to request that the Department exercise its statutory authority to adjust the BAF which go beyond the scope of the statute. The statute states that the party seeking to vary the statutory BAF bear the burden of proof, which contemplates a neutral approach since the burden is on the party wishing to alter the statutory BAF. However, the Draft Regulations impose procedural restrictions on taxpayers that request alternative apportionment factors, in the form of a "pre-filing" requirement. That is, the Draft Regulations prohibit taxpayers from requesting an adjustment to the BAF on an original return without Department consent. This "pre-filing" requirement is not found in the statute. Moreover, the Draft Regulations prohibit taxpayers from requesting an adjustment to the BAF on an amended return unless: (1) the Department grants consent to adjust the BAF after the taxpayer files its original return, or (2) the Department denies consent and no audit has commenced. To the extent that the Department does not timely respond to a taxpayer request for an adjustment to the BAF (i.e., before the expiration of the statute of limitations to file an amended return), the taxpayer has no mechanism under the requirements of the Draft Regulations to pursue the statutorily prescribed adjustment to its BAF.

This result is contrary to the statute, which clearly contemplates that a taxpayer may claim alternative apportionment on an original return. New York case law provides that, even if a taxpayer does not comply with a regulatory timing rule, the taxpayer is still permitted to use a substantive tax calculation rule when the taxpayer meets all relevant substantive criteria.[28] Specifically, the New York Tax Appeals Tribunal has held that the Department acts arbitrarily when it: (1) agrees the taxpayer meets the substantive requirements to use a discretionary tax calculation method, but (2) refuses to permit the taxpayer to use the method because the taxpayer did not follow a procedural timing regulation.[29] In addition, the Tax Law grants the Division of Tax Appeals ("DTA") the same authority as the Department to apply alternative allocation.[30] The DTA could, therefore, consider a request for alternative apportionment after the taxpayer's return was filed and the Department audits such return (even if alternative apportionment was not considered by the Department during the audit). This demonstrates that the Tax Law does not contain a pre-filing consent requirement and the Tax

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[28] *See Matter of Autotote Limited*, TSB-D-90(4)C (N.Y.S. Tax App. Trib. Apr. 12, 1990).

[29] *Id.*; *see also Matter of Exhibit Group*, DTA No. 811850 (N.Y.S. Tax App. Trib. Oct. 19, 1995); *Matters of Direct Pro, Inc. & Direct Worldwide, Inc.*, TAT(H) 97-6(GC), 97-7(GC) (N.Y.C. Admin. Law Div. Feb. 23, 1999).

[30] N.Y. Tax Law § 2006(12).

Law's procedures clearly contemplate consideration of alternative apportionment after a taxpayer's return has been filed.

Although the Department has the authority to adopt procedural rules, it cannot do so in a way that frustrates the statute. Where taxpayers satisfy the statutory requirements, they may claim alternative apportionment. If the Department imposes a pre-filing consent, this would impermissibly narrow the authority provided under the Tax Law and would be inconsistent with the enabling statute.[31]

If the Department proceeds with the approach of the draft regulation to require pre-filing consent for use of alternative apportionment on an original return, the Tax Section believes a balanced approach should be taken to protect both the interests of the state and the rights of taxpayers. For example, a process similar to the process utilized in Connecticut[32] could be considered. In Connecticut, a taxpayer may petition for an alternative method of apportionment by filing with its return (prepared in accordance with the statutory method) a statement of its objections to the statutory apportionment method and the proposed method of apportionment as it believes proper and equitable under the circumstances, accompanied by supporting details. The Connecticut Department of Revenue, within a reasonable amount of time thereafter, must notify the taxpayer whether the proposed alternative method is accepted as reasonable, and, if accepted, adjust the return and tax accordingly. New York could adopt a similar regime but require that taxpayers petition for the alternative apportionment before the filing of a return. The Department would then be given a reasonable amount of time to review the request and if the Department does not accept or deny the alternative method within an established time frame, the taxpayer would be entitled to file its return using the alternative apportionment method. The Department would then reserve the right to audit the return. This approach would give the Department the notice and review period it desires, while ensuring that taxpayers can exercise their statutory right to use alternative apportionment if consent is not timely provided.

C. Sourcing Gain from the Sale of an Intangible

1. Statutory Language

The Tax Law sources receipts from the *use* of intangibles to New York if the intangibles are "used" in New York: "[r]eceipts of royalties from the use of patents, copyrights, trademarks, and similar intangible personal property within the state are included in the numerator of the apportionment fraction."[33] Intangible personal property is *used* in New York "to the extent that the activities thereunder are carried on in the state."[34]

The Tax Law does not have a specific sourcing rule for the *sale* of intangible personal property. Instead, these receipts would fall into the catchall, "[r]eceipts from other services and other business receipts," and be sourced to New York if "the location of the customer is within the

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[31] *See, e.g., N.Y. State Superfund Coal., Inc. v. N.Y. State Dep't of Envtl. Consv'n.*, 961 N.E.2d 657 (N.Y. 2011).

[32] Conn. Gen. Stat. § 12-221a.

[33] N.Y. Tax Law § 210-A.3(b).

[34] *Id.*

state."[35] The Tax Law uses a hierarchy of determining factors to establish whether the location of the customer is within New York for this purpose, the first of which is whether "[t]he benefit is received in this state."[36]

2. The Draft Regulations

The Draft Regulations state that "[r]eceipts from the use in New York State of patents, copyrights, trademarks, licenses, and similar intangibles are included in New York receipts."[37] The Draft Regulations further state that "[a] patent, copyright, trademark, license, and similar intangible such as a license is used in New York State to the extent that the activities thereunder are carried on in New York State. If, after exercising due diligence, a corporation lacks sufficient information in its books and records to determine where the activities are carried on, it may use a reasonable method to estimate such location based on third party information (if available) or population."[38] Examples are provided outlining scenarios where intangible personal property is considered "used" in New York:

> Example 1: Network Corp sells a license to broadcast its network to Cable Corp for a set fee. Under the licensing agreement, Cable Corp is allowed to bundle Network Corp's network with other content and sell the bundle to individual subscribers for a monthly fee set by Cable Corp. Even though the content is digitally delivered to Cable Corp by Network Corp, the delivery means is incidental to the sale of a license to distribute, broadcast or sublicense. As such, Network Corp's receipts are apportioned under this section to the location where the license is used, which is presumed to be the location where the network is available for viewing. Network Corp's books and records indicate the location of Cable Corp's viewers. The amount of New York receipts is determined by multiplying such receipts by a fraction, the numerator of which is the number of subscribers in New York State and the denominator of which is the total number of subscribers within and without New York State.
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> Example 2: Network Corp sells a license to distribute its movie to Streaming Corp for a set fee. Under the licensing agreement, Streaming Corp is allowed to add the movie to its library of movies and other programming offered by the streaming service. Streaming Corp sells monthly subscriptions to view all of its content to individual viewers for a fee set by Streaming Corp. Although the movie is digitally delivered by Network Corp to Streaming Corp, the means of delivery is incidental to the sale of a license to distribute, broadcast or sublicense the movie. As such, Network

[35] *Id.* at § 210-A.10(a).

[36] *Id.* at § 210-A.10(a)-(b).

[37] Draft Reg. § 4-2.3(b)(1).

[38] *Id.* at § 4-2.3(b)(3).

> Corp's receipts are apportioned under this section to the location where the license is used, which is presumed to be the location where the movie is available for viewing. If Network Corp's books and records do not indicate the location of Streaming Corp's viewers, it must use a reasonable method to approximate the subscriber location.[39]

For purposes of sourcing receipts from the *sale* of intangible personal property, the Draft Regulations outline "special rules" to determine where the "benefit is received."[40] The special rules state that "[w]ith respect to the net gains (not less than zero) from the sale of intangible property. . . the benefit of such sale is presumed to be received at the location *where the value of the intangible was accumulated*."[41] "Intangible property" is defined to include goodwill, copyrights, patents, trademarks, trade names, brand names, licenses, and trade secrets.[42] The phrase *where the value accumulated* is not further defined. The Draft Regulations also state that if a corporation meets the specific criteria to apply a special rule, but does not have sufficient information to apply the rule, the corporation should use the rules for reasonable approximation to apply the special rule. If the corporation does not have sufficient information to apply the rules for reasonable approximation to the special rule, then the special rule no longer applies.[43]

The Draft Regulations do not contain an example in Section 4-4.3(e)—the section that addresses gains from dispositions of intangibles—to illustrate the location where value is accumulated. The issue is, however, raised in Draft Regulation Section 4-1.6(e)(3). That section describes the power of the Commissioner to include in the BAF receipts from the sale of partnership interests (which in the first instance are statutorily excluded from the factor) when inclusion of such receipts is required to avoid a distortion of income. The example under Section 4-1.6(e)(3) describes the sale of a partnership interest when it comprised 75 percent of the taxpayer's receipts for the tax year and accordingly was included in apportionment under the Commissioner's discretionary authority, "to properly reflect the taxpayer's business income." In doing so, the receipts or net gain from each asset held by the partnership was computed using the applicable sourcing provisions under Tax Law Section 210-A. Because the assets of the partnership in the example consisted, in part, of goodwill, the example states that the corporation must source the portion attributable to goodwill to New York "if the value was accumulated in New York State, based on the partnership's average business allocation percentage from previous years."[44]

3. Comments

The Tax Law does not explicitly state the sourcing rule for receipts from the sale of intangible personal property. The Tax Law only provides a sourcing rule for receipts from the *use*

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[39] *Id.* at . § 4-2.3(b)(3).

[40] *Id.* at § 4-4.3(a).

[41] *Id*. at § 4-4.3(e) (emphasis added).

[42] Draft Reg. § 4-4.3(e).

[43] *Id*. at § 4-4.3(a).

[44] *Id*. at § 4-1.6(e)(3).

of intangible personal property in New York, and a catchall sourcing provision for all other business receipts.[45] However, the Draft Regulations clarify that for sales of intangible personal property, receipts are sourced to New York if the value of the intangible was accumulated in New York.[46]

The Department's approach for sales transactions (i.e., to look to where the value of the intangible is "accumulated") is not found in the Tax Law and can result in a different allocation than a license of the same intangible to the same party. Moreover, the Department's approach may not result in receipts being sourced to the location of the customer, or to where the benefit is received, as is required by Tax Law Section 210-A.10(a)-(b). For example, if activities are performed in California that result in the granting of a patent and the non-U.S. rights to the patent are sold by the developer to a buyer in Ireland, looking to where the value of the patent accumulated (i.e., California) recognizes neither the location of the customer nor where the customer will receive the benefit of the patent (i.e., outside of the U.S.).

It would be helpful for the Department to cross reference Draft Regulation Section 4-4.3(e) in its Section 4-1.6(e)(3) example (and cross reference the Section 4-1.6(e)(3) example in Draft Regulation Section 4-4.3(e)) (and to confirm that the method used in the example is in fact a proper method for allocating gains from direct sales of intangibles under the regulations), as these are the only sections currently providing guidance on where the value of intangible personal property is accumulated. Without such cross references, a reader of Section 4-4.3(e) may not realize there is a potentially relevant example in Section 4-1.6(e)(3), and a reader of Section 4-1.6(e)(3) may not appreciate that the example is potentially relevant to the rules in Section 4-4.3(e).

According to the example in Section 4-1.6(e)(3), to determine the portion of the net gain from the intangible (i.e., goodwill) that is sourced to New York, taxpayers must refer to the partnership's average business allocation percentage from previous years. Because the value of goodwill fluctuates, we do not believe the example is unreasonable in its use of the partnership's average business allocation percentage from previous years to show the accumulation of value over time. However, we believe that such a lookback approach may not be clear in its application or appropriate in all cases for the reasons set forth below.

First, the example does not state how many prior years are relevant to the determination of an average BAF. It would be helpful for the Department to provide additional guidance on the number of previous years that should be considered in determining the average BAF. Each taxpayer's facts will differ with respect to how the business operated, as well as when and how the goodwill was generated. It may be appropriate, therefore, for the Department and taxpayers to have some degree of flexibility in making this determination. In other words, even where using prior year's BAF is appropriate, there is still a need for guidance to determine how many years need to be averaged and possibly how those years need to be weighted.

Second, as noted, the only example provided regarding how the value of an intangible accumulates is with respect to goodwill. We note that the approach of using an average BAF based

[45] N.Y. Tax Law §§ 210-A(3), 210-A(10).

[46] Draft Reg. § 4-4.3(e).

on activities in previous years may not be appropriate for other types of intangibles. While certain intangibles, such as goodwill, workforce in place and trade name are inseparable or virtually so from the operating business (or a division thereof), other types of intangible assets, such as copyrights and patents, are more specialized and an average BAF sourcing approach may not make sense. For example, a start-up company may have only immaterial business receipts from past periods yet still sell a patent or license. Even when the company is a going concern, the company's BAF for past years may reflect revenues derived from sources other than the patent or license being sold so as to render the metric distortionary. Assuming a "value accumulated" approach is proper for sourcing gains from sales of intangibles, additional guidance here would be helpful.

D. Passive Investment Customers

1. Statutory Language

The Tax Law provides that receipts from the provision of services are to be sourced to the location of the customer, with a hierarchy of methods being applicable to determine the location of the customer for such purposes.[47] The first step in the hierarchy directs that receipts are considered to be at the location of the customer based on where the benefit of the service is received.[48] A taxpayer can only move onto the next method in the hierarchy if the previous method or methods cannot be used. Accordingly, if it can be determined where the benefit of the service is received, none of the other hierarchical methods will be considered.[49]

2. The Draft Regulations

The Draft Regulations provide specific guidance for the sourcing of receipts received by investment managers (for example) for services rendered by such managers to so-called "passive investment customers," which the Draft Regulations define as "a customer that is an unincorporated entity, such as a limited partnership, general partnership, limited liability company, limited liability partnership, or trust, that pools capital from passive investors for the purpose of trading or making investments in stocks, bonds, securities, commodities, loans, or other financial assets, but that does not otherwise conduct a trade or business."[50] For the most part, the Draft Regulations mimic the Tax Law in this area, providing general guidance as to the sourcing of receipts from services. The Draft Regulations, however, depart from the Tax Law by providing special rules for the sourcing of receipts received for services provided to passive investment customers. According to the Draft Regulations, the benefit of such services is "presumed to be received at the location where the contract is managed by the passive investment customer."[51] The Draft Regulations provide that the "[l]ocation where a contract is managed by the customer means

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[47] N.Y. Tax Law § 210-A(10)(a).

[48] *Id*. at § 210-A(10)(b).

[49] The following methods in the hierarchy apply to source receipts: (a) to delivery destination; (b) in the same way as those receipts were sourced in the preceding year; or (c) by multiplying the amount of those receipts by a fraction, the numerator of which is the total of the taxpayer's current year New York receipts from services and other business activities and the denominator of which is the total of everywhere receipts from services and other business activities. *Id*.

[50] Draft Reg. § 4-4.1(b)(3).

[51] *Id.* at § 4-4.4(c)(2).

the primary location at which an employee or other representative of a customer serves as the person with responsibility for monitoring or managing the day-to-day execution of the contract of sale with the corporation."[52]

3. Comments

The Department has indicated that its approach in this area is modeled after the Model General Allocation and Apportionment Regulations of the Multistate Tax Commission (the "MTC"). The Tax Section acknowledges that the MTC approach is used by other states and is not an outlier. However, for the reasons discussed below, we believe the better approach is for investment management receipts to be sourced to the location of the owners in the pass-through entity (i.e., the investors) based on the characteristics of such owners as individual or business entities.

We believe the guidance in the Draft Regulations concerning the sourcing of service receipts received from passive investment customers should be revised because it will generally result in application of the sourcing rules in a manner contrary to the Tax Law, at least in the context of investment management services. In our view, the Draft Regulations do not source passive investment customer receipts for investment management services to the location where the benefit of the services is received, but rather results either in such receipts being sourced to the location where the taxpayer performs its services (a result that is contrary to the Tax Law's market sourcing regime) or alternatively may result in an allocation to a third jurisdiction depending on how the term "managing the contract is defined" and how the passive investment customer is structured.

When the Tax Law was overhauled to implement tax reform in 2015, the provisions concerning the sourcing of receipts from services were revised so that such receipts were no longer sourced to the location where the services were performed, but instead were sourced to the location of the customer.[53] This change was enacted to remove the provisions of the Tax Law that discouraged companies from locating their operations in New York. As noted in the legislative history:

> The State's current corporate franchise tax structure, which dates back to the 1940's, is outdated, unduly complex and vulnerable to aggressive tax avoidance techniques. It violates basis tax policy principles by taxing similarly-situated taxpayers differently, *and in some instances it creates disincentives to increasing a corporation's activities in New York. . .*
>
> *New York's current sourcing rules fail to acknowledge the shift to a service-based economy. Companies that generate significant receipts from services can incur greater tax liability if they increase their activity in New York. This reform proposal would source a business's receipts to the location of its customers. This assigns*

[52] *Id.* at § 4-4.1(e).

[53] N.Y. Tax Law § 210-A.10(a).

> *income to various states based on where the customers are located and eliminates factors that would increase tax if a company increased its activity in New York. This removes a previous disincentive to locating in New York. . .*
>
> This reform proposal addresses the above issues by modernizing the tax code to make it more reflective of the current business environment, and creates clarity and certainty for the most commonly disputed areas. This certainty, *combined with the elimination of impediments to businesses wishing to expand their New York activity, will make New York's corporate tax system more competitive with other states.*[54]

This legislative history makes it evident that the sourcing of services to the location of a taxpayer's customers was designed to encourage, or at least not harm, service providers locating their operations in New York. Accordingly, pursuant to New York's general sourcing rules for services, the customer is located in New York only to the extent that the benefit of the service is received in New York.[55] Furthermore, because the Tax Law does not differentiate between "passive investment customers" and other customers, this rule is statutorily applicable to companies that provide investment services to passive investment customers.

While the Draft Regulations claim they source receipts from passive investment customers to the location where the benefit is received by such passive investment customers, in practice they often fail to do so. It is common that companies in the business of providing investment services to multiple investors facilitate the making of such investments by creating investment vehicles through which such investors can invest. Some of these investment vehicles satisfy certain requirements and thus can be, and are, structured as regulated investment companies ("RIC") or as publicly traded pass-through entities ("PTP"). Other such investment vehicles cannot or do not attempt to meet the RIC or PTP requirements.

The Tax Law, even prior to tax reform, had in place sourcing rules mandating that fees for investment services provided to RICs and PTPs—for such purposes, defined as investment companies—are sourced according to the location of the RIC and PTP investors.[56] Even if these rules cannot be directly extended to non-RIC and non-PTP investment vehicles, the move to customer sourcing as part of the 2015 reforms should produce a similar result for these investment vehicles, for the reasons discussed below.[57]

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[54] 2014-15 New York State Executive Budget Revenue Article VII Legislation Memorandum in Support, p. 5 (emphasis added).

[55] N.Y. Tax Law § 210-A.10(b).

[56] *Compare* former N.Y. Tax Law § 210.3(a)(6) *with* current N.Y. Tax Law § 210-A.5(d).

[57] In its first draft of the sourcing regulations, the Department expanded the definition of investment company beyond the statutory definition that applies only to RICs and PTPs, to provide that any non-corporate entity "that pools capital from passive investors and that trades or makes investments in stocks, bonds, securities, commodities, loans, or other financial assets, but that does not otherwise conduct a trade or business" was considered an investment company thereby resulting in application of the RIC/PTP company rules to these types of companies. The Tax Section commented that this interpretation improperly expanded the definition of investment company beyond the statutory definition. NYSBA Tax Section Report 1369, May 26, 2017. In that report, it should be noted,

In addition, we note that the Draft Regulations contain special rules for sourcing receipts from "intermediary transactions" defined as transactions "where the business customer (intermediary) derives value from a service or other business activity at the location of the consumer rather than the location of the customer itself."[58] Intermediary transactions are to be sourced based on the location of the consumer, and not the location of the customer.[59] These Draft Regulations, which are not directly derived from the Tax Law, nevertheless highlight the notion that the benefit of a service may be received at the location other than the taxpayer's direct customer. As such, when a taxpayer performs services to a customer such as a RIC, PTP or an intermediary, the Tax Law and the Department's Draft Regulations require a look-through sourcing method.

Many of these non-RIC and non-PTP investment vehicles meet the definition of passive investment customer set forth in the Draft Regulations and may be managed by the investment advisors at the location where the investment advisor performs its operations. However, where these investment vehicles are formed and managed by investment advisors as a mechanism for providing investment services to investors, the benefit of the investment activities is not received at the location where the investment vehicles are managed (i.e., generally the location of the investment managers) but rather are received at the location where the underlying investors in the investment vehicles are located. Accordingly, a rule presuming that the benefit is received where "the contract is managed by the passive investment customer" results in a sourcing of receipts that appears to be incompatible with the benefit received regime. Moreover, defining the "location where a contract is managed by the customer" as "the primary location at which an employee or other representative of a customer serves as the person with responsibility for monitoring or managing the day-to-day execution of the contract of sale with the corporation" is unclear. If the Draft Regulations are intending to get at the location of the passive investment customer's investment manager or general partner, both of which are typically controlled by the same persons, taxpayers will be able to eliminate a sourcing of receipts to New York by relocating such operations outside the state.

As written, the draft passive investment customer rules disregard the rule of general applicability set forth in the Draft Regulation that it is sometimes appropriate to source receipts from services on a proportional basis. "Where the customer receives the benefit in New York and at least one other location, the corporation should source the receipts based on the percentage of value derived by the customer in each location where the benefit is received."[60] Under this approach, the benefit received by a passive investment customer should arguably be deemed received where the owners of the passive investment customer are located, with such benefit determined based upon whether such owners are individual customers or business customers.

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however, that the Tax Section limited its comments to the unwarranted expansion of the definition of investment company, not to whether the result of such expansion resulted in the sourcing of income where the benefit was received as required by the statute.

[58] Draft Reg. §§ 4-4.1(d), 4-4.8. *See also* Draft Reg. § 4-3.8, which contains sourcing rules for receipts intermediary transactions related to the sale of digital products.

[59] *Id.* at §§ 4-3.8, 4-4.8.

Even where application of the draft passive investment customer rules does not result in presuming the benefit of the investment management services to be located where the services are performed, such as in situations of passive investment customers that are not affiliated with the investment manager, the Draft Regulations still do not source the receipt in accordance with market-based principles. An investment manager earns its receipts from its provision of investment services, whose benefit is, we believe, received by the parties whose funds are being invested. We note that when an investment services provider engages a subadvisor, the subadvisor's customer would, in our view, appropriately be considered a business customer and not a passive investment customer. As such, the revenue would be sourced, based on the location where the investment services provider received the benefit of the service, not where the subadvisor manages itself or its contract with the advisor.

While many situations concerning the provision of services to a pass-through entity may result in a benefit to the owners of the pass-through entity, such benefit is more direct with respect to the ownership of an interest in a passive investment vehicle, which is not conducting any business activities on its own, but instead is merely acting as a vehicle through which its owners provide funds to the investment manager to invest. Accordingly, the benefit of investment management services should be presumed to be received where the owners of the pass-through entity are located. This can be contrasted with non-investment advisory services (e.g., legal or accounting services) provided to a pass-through entity, where the benefit to the entity may be more direct and arguably attenuated with respect to the owner of the pass-through. Such service providers typically view either the passive investment customer or perhaps the investment manager as the client or customer. By contrast, the investment manager itself typically has a direct client relationship with the investors in its funds (which is often one of its most important business relationships).

Application of the proposed passive investment customer rules in the Draft Regulations may result in the sourcing of receipts to where the taxpayer performs its services in New York, instead of based on where the benefit of the investment services is received. Again, we acknowledge that the Department's proposed approach is used by other states. However, for the reasons discussed above, we believe that in this case, the approach more consistent with the statutory benefit received regime is for such investment service receipts to be sourced to the location of the owners in the pass-through entity based on the characteristics of such owners as individual or business entities. In this regard, we note that neighboring states with large numbers of investment managers (i.e., New Jersey and Connecticut), as well as California, all apply a sourcing rule that looks to investor location.

E. Digital Products, Other Services and Other Business Receipts

1. Statutory Language

The Tax Law provides that receipts from the sale of "digital products" are included in the numerator of the BAF using the following hierarchy of sourcing methods:

> (1) [t]he customer's primary use location of the digital product; (2) [t]he location where the digital product is received by the customer, or is received by a person designated for receipt by the customer; (3) [t]he apportionment fraction determined pursuant to this subdivision for the preceding taxable year for such digital product; or (4) [t]he apportionment fraction in the current taxable year for those digital products that can be sourced using the hierarchy of sourcing methods in subparagraphs one and two of this paragraph.[61]

Taxpayers are required to exercise due diligence under each method before rejecting it and proceeding to the next method in the hierarchy.[62]

The Tax Law similarly provides that receipts from other services and other business activities (i.e., receipts from those services and activities not otherwise addressed by the Tax Law) are included in the numerator of the taxpayer's New York BAF "if the location of the customer is within the state."[63] The Tax Law further provides that determinations of whether receipts are included in the numerator of the taxpayer's BAF are made according to the following hierarchy of methods:

> (1) [t]he benefit is received in this state; (2) [d]elivery destination; (3) [t]he apportionment fraction for such receipts within the state determined pursuant to this subdivision for the preceding taxable year; or (4) [t]he apportionment fraction in the current taxable year determined pursuant to this subdivision for those receipts that can be sourced using the hierarchy of sourcing methods in subparagraphs one and two of this paragraph."[64]

2. The Draft Regulations

The Draft Regulations establish specific rules as applied to "intermediary transactions" involving the sale of digital products, digital services, and other services and other business receipts.[65] Specifically, "intermediary transactions" are defined as "transactions[s] where the business customer (intermediary) derives value from [the product or service] at the location of the consumer [i.e., the customer's customer] rather than the location of the customer itself."[66] The Draft Regulations outline detailed requirements that must be met in order for a transaction to be treated as an intermediary transaction. Generally, the transaction must necessitate a relationship between the corporation (taxpayer) and the consumer:[67]

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[61] N.Y. Tax Law § 210-A(4)(c).

[62] *Id*. at § 210-A(4)(b).

[63] N.Y. Tax Law § 210-A (10)(a).

[64] *Id*. at § 210-A(10)(b).

[65] The intermediary transaction rules do not apply to licenses of intangibles where the delivery of a licensed product is deemed to be incidental. *See supra* note 40, Example 1.

[66] Draft Reg. §§ 4-3.1(f), 4.4-1(d).

[67] *Id*.

> To be considered an intermediary transaction, the service or other business activity, pursuant to the explicit or implicit terms of a contract or other agreement between the corporation and intermediary, must meet the requirements of subparagraphs (i) or (ii) of this paragraph.
>
> (i) it must be provided by the corporation, at the direction of the intermediary, directly to the consumer;
>
> (ii) it must be sold by the corporation to the intermediary, who then passes on the service or other business activity to the consumer, provided the corporation must be obligated under the agreement to perform a substantial portion of the service or other business activity after the property that the service or other business activity relates to is delivered by the intermediary to the consumer.[68]

Intermediary transactions are to be sourced based on the location of the consumer, and not the location of the customer.[69]

The Draft Regulations assert that, as applied to business customers, the primary use location of a digital product or service, or the location where the benefit is received for other services and other business receipts, can be "the location of a third party (e.g. the consumer) only in the case of an intermediary transaction."[70] For this purpose, "a third party does not include the customer's employees, agents, officers, partners. . . , managing members. . . , or shareholders[.]"[71]

3. Comments

Under the Draft Regulations, unless the criteria to qualify as an intermediary transaction apply, the benefit received and/or primary use location of a service or digital product, respectively, can never be at the location of a third party (consumer, or otherwise). Since the Tax Law has established a customer-based sourcing regime, we do not think it is unreasonable to conclude that the location of a taxpayer's direct customer may typically be the location at which service, other business and digital product receipts should be sourced. Nonetheless, in determining customer location, the Tax Law instructs taxpayers to determine where the benefit of the service is received and where the digital product is primarily used. We believe there will be circumstances where the benefit received and primary use locations will be somewhere other than at the location of the direct customer, even when the intermediary transaction criteria in the Draft Regulations are not met. Our view, discussed above, as to how investment management receipts from passive investment customers should be sourced is one such example.

[68] *Id.* at § 4-4.8(d)(1).

[69] *Id.* at §§ 4-3.8, 4-4.8.

[70] *Id*. at §§ 4-3.4(b)(2), 4-4.4(b)(2).

[71] *Id.* at § 4-4.4(b)(2).

F. Application of Digital Product Rules to Cryptocurrency

1. Statutory Language

The Tax Law does not include a definition of nor a receipt classification for cryptocurrency, nor does it provide guidance on the sourcing of income relating to the sale or recognition of cryptocurrencies and similar assets in exchanges or barter transactions.

2. The Draft Regulations

The Draft Regulations define "digital product[s]" broadly to generally include:

> [A]ny property of whatever nature delivered through the use of wire, cable, fiber-optic, laser, microwave, radio wave, satellite or similar successor media, or any combination thereof (hereinafter referred to as digitally delivered). Digital product includes, but is not limited to, an audio work, audiovisual work, visual work, electronic book or literary work, graphic work, electronic database, game, information or entertainment service, website, digital application, or cryptocurrency or similar asset digitally delivered. In addition, digital product includes computer software by whatever means delivered, including physical media. Further, digital product includes the storage of any property that constitutes a digital product.[72]

While the Draft Regulations do not specifically define or otherwise address cryptocurrency, they do clarify that the aforementioned category of "digital product[s]" include "intangible assets such as cryptocurrencies."[73]

According to the Draft Regulations, net gains from cryptocurrencies are included in the New York State BAF.[74] Net gains for these purposes mean "gross proceeds minus the adjusted basis in the digital asset."[75] As a digital product, receipts from the "sale of, rental of, license to use, or granting of remote access to" cryptocurrencies are sourced to the "location where the customer derives value from the digital product or digital service according to the hierarchy of methods set forth in [the Tax Law]" and as further delineated in the Draft Regulations.[76] The hierarchy of methods must be applied sequentially as follows:

> (1) A corporation must apportion the receipt to the customer's primary use location.

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[72] Draft Reg. § 4-3.1(c).

[73] *Id*. at §§ 4-3.1(c), 4-3.2(f).

[74] *Id*. at § 4-3.2(f).

[75] *Id.*

[76] *Id*. at § 4-3.2(a).

> (2) It may abandon such primary use method only if, after exercising due diligence, it lacks sufficient information to apply that method, in which case it must use the location where the digital product or service is received by the customer.
>
> (3) If, after exercising due diligence, a corporation cannot apply the methods described in paragraphs (1) and (2) of this subdivision, it must then source the receipts from that digital product or service in the same way as those receipts were sourced in the preceding taxable year.
>
> (4) Lastly, if the corporation cannot apply the methods described in paragraphs (1), (2) and (3) of this subdivision after exercising due diligence, it must source the receipts from that digital product to New York by multiplying the amount of those receipts by a fraction, the numerator of which is the total of New York receipts for the current taxable year from the corporation's other digital products and digital services apportioned using the methods in described in paragraphs (1) and (2) of this subdivision, and the denominator of which is the total of the everywhere receipts for the current taxable year from the corporation's other digital products and digital services apportioned using the methods described in paragraphs (1) and (2) of this subdivision.[77]

Under the general rules, primary use location is determined by customer type.[78] An individual customer's primary use location is presumed to be at the customer's billing address.[79] The primary use location for business customers is presumed to be in New York "to the extent the information in the corporation's books and records. . . indicate that the customer's use of the digital product or digital service is in New York."[80] Where a corporation does not have adequate information to determine where a digital product or digital service is primarily used by the customer, the corporation is instructed to use reasonable approximation.[81]

3. Comments

The Draft Regulations do not distinguish between types of cryptocurrencies such as fungible and non-fungible tokens, security tokens, utility tokens, and the various subsets of assets within each category of digital assets. Each asset type grants distinct rights to its holders such as rights to services and/or products, membership rights, and property rights, and may have unique payment terms and redemption restrictions. These qualities differentiate cryptocurrencies from

[77] *Id*. at § 4-3.2(b)(1)-(4).

[78] Draft Reg. § 4-3.4(a), (b).

[79] *Id*. at § 4-3.4(a).

[80] *Id*. at § 4-3.4(b).

[81] *Id*. at § 4-3.4(b)(3).

traditional digital products defined under the Draft Regulations (i.e., audio work, visual work, electronic books, etc.).

The Draft Regulations also do not differentiate between the nature of the activities relating to the generation, recognition, or sale of the cryptocurrency. According to the Draft Regulations, the sale of a cryptocurrency on an exchange would be sourced according to the same principles as would a reward from a proof of stake, proof of work, mining, barter exchange, custody arrangements, and/or DeFi services. Each of these examples are vastly different with respect to the nature of the taxpayer activity, services provided, and type of reward, and warrant additional specificity in the Draft Regulations.

Classifying cryptocurrencies as digital products may also have implications for sellers who may have otherwise qualified for certain treatment under provisions relating to financial institutions and other specialized industries. This may include taxpayer reliance on safe harbor sourcing percentages for eligible financial transactions, alternate sourcing methodologies for regulated financial institutions, and investment income classifications. More guidance is requested as to the potential implications on taxpayer eligibility under the above and other relevant New York State regulatory provisions resulting from the classification of cryptocurrencies as digital products.

Clarifying that cryptocurrencies fall under the category of digital products is an oversimplification which does not adequately account for the variety of assets and blockchain participants currently in the market. The cryptocurrency industry is rapidly evolving and new products with unique attributes are developed daily. Defining cryptocurrency to include asset types, rights and/or entitlements may provide more structure for taxpayers and may better account for market innovation, as would offering receipt classifications in accordance with the nature of the activities relating to the cryptocurrency. Lastly, sourcing all cryptocurrencies as digital products, under a primary use location analysis, may create ambiguity and misrepresent a taxpayer's market. Indeed, the hierarchy to determine primary use location is inadequate to account for nuances particular to cryptocurrencies. More specifically, consider that in many transactions involving cryptocurrencies, buyers and blockchain participants remain anonymous. This makes determining the location of any customer often an impossibility for sellers and crypto marketplaces/exchanges. According to the Draft Regulations, where a location is not readily known, taxpayers may resort to a reasonable approximation method. However, how can taxpayers make this determination when buyers and blockchain participants remain anonymous?

As a result of the Draft Regulations and considering the inherent anonymity of the cryptocurrency market, many taxpayers will be required to use a lower hierarchy methodology to approximate customer location for large swaths of receipts (e.g. sales on exchanges, mining and staking rewards, etc.,). These are not only difficult for taxpayers to formulate and administer consistently but may also lead to potentially large discrepancies in receipt sourcing determinations for similar transactions concerning different cryptocurrency assets and/or exchanges, or where buyer location is known. In this regard, the Draft Regulations fail to provide any explicit discretion to apply statistical methods to approximate customer locations.

G. Items Included in the Business Apportionment Factor

1. Statutory Language

The Tax Law states that "only those receipts, net income, net gains, and other items described in this section that are included in the computation of the taxpayer's business income. . . for the taxable year" should be included in a taxpayer's apportionment factor.[82] "Business income" is defined as "entire net income minus investment income and other exempt income."[83]

2. The Draft Regulations

The Draft Regulations state that the BAF "includes only those receipts, net income, net gains, and other items described in section 210-A and the applicable regulations in this Subchapter that are included in the computation of entire net income for the taxable year."[84] The Draft Regulations go on to exclude particular types of receipts from the BAF, including income from investment capital and gross income included in business income pursuant to the eight percent of entire net income limitation on gross investment income.[85] The Draft Regulations also state as a general rule of apportionment that all business receipts must be taken into account.[86] To illustrate that all receipts must be apportioned, the Draft Regulations provide the following example:

> Corporation B sells all the assets of one of its divisions for a gain, which is properly reported as business income. The assets sold consisted of real property, tangible personal property, and goodwill. The portion of the gain attributable to the sale of tangible personal property shall be apportioned to New York State using the rules for net gains from the sale of tangible personal property in section 4-2.1 of this Part, the portion attributable to the sale of real property shall be apportioned to New York State using the rules for net gains from the sale of real property in section 4-2.2 of this Part, and the portion attributable to the sale of goodwill shall be apportioned to New York State using the rules for other services and other business receipts in Subpart 4-3 of this Part.[87]

A previous version of the Draft Regulations, consistent with prior regulations and case law noted below, excluded from the BAF receipts that were generated from activities outside of the taxpayer's ordinary course of business (i.e., "unusual events").[88] The Draft Regulations as currently written do not contain a similar exclusion.

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[82] N.Y. Tax Law § 210-A.1.

[83] *Id*. at § 208.8.

[84] Draft Reg. § 4-1.2(a).

[85] *Id.* at § 4-1.2(b)(1)-(6).

[86] *Id.* at § 4-1.2(d).

[87] *Id.* at § 4-1.3(b) (Example 1).

[88] Draft Regulations § 4-1.1(b) (N.Y.S. Department of Taxation & Finance September 30, 2016). *See* NYSBA Tax Section Report 1369, May 26, 2017.

3. Comments

The Tax Law does not specifically authorize an exclusion from the BAF for receipts from unusual events. The Tax Law first explains that the apportionment factor is determined by including "only those receipts, net income, net gains, and other items described in this section that are included in the computation of the taxpayer's business income."[89] The subsequent subsections relate to the items included with respect to particular types of receipts or income and there is no specific reference to an exclusion for "unusual events."

Prior to the 2014 enactment of Tax Law Section 210-A, former Tax Law Section 210.3(a)(2) also did not provide for any exclusion from the apportionment factor for sales outside the ordinary course of business; however, regulations and case law specifically provided for such exclusions on the basis that non-ordinary course receipts do not constitute business receipts and only business receipts are including in the apportionment factor.[90] An earlier version of the Draft Regulations issued on September 30, 2016, took an opposite approach to the current version, stating that business receipts from sales of real, personal, or intangible property that arise from unusual events are not included in New York receipts or everywhere receipts.[91]

In considering the impact of the 2015 tax reforms, pursuant to which the Draft Regulations have been drafted, one should consider the legislative re-enactment doctrine, which generally presumes that the Legislature was aware of the Department's existing regulations at the time the law was amended.[92] Under this canon of statutory construction, the courts generally conclude that the Legislature intended to codify the existing regulatory interpretation of a statutory provision if the relevant statutory provisions are reenacted without substantial change. This may support an interpretation of the Tax Law that retains the unusual events exclusion because the legislature did not make any changes to its treatment of business receipts when tax reform was adopted in 2015.[93] In any event, despite the Department's long-standing policy to exclude non-ordinary course receipts from the apportionment factor, we acknowledge that the Department may choose to forgo an unusual events exclusion. However, if the Department chooses to do so, the Tax Section encourages the Department to apply this change on a prospective basis only.

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[89] N.Y. Tax Law § 210-A(1).

[90] *See* Draft Reg. § 4-4.1 (providing that business receipts includes only "gross income received in the regular course of the taxpayer's business"); Draft Reg. § 4-4.6(e) (stating that receipts from sales of capital assets are not business receipts and are not included in the receipts factor of the business allocation percentage). *See also In re International Nickel Inc. and Inco Alloys International Inc.*, No. 810675 (N.Y. Tax App. Trib. Oct. 19, 1995) (holding that receipts from a pension fund reversion could not be included in the taxpayer's receipts factor as such receipts did not represent "business receipts" received in the ordinary course of business).

[91] *See* related discussion at NYSBA Tax Section Report 1369, May 26, 2017.

[92] *See Cottage Sav. Ass'n v. Comm'r,* 499 U.S. 554, 561 (1991); *National Elevator Indus. Inc. v. New York St. Tax Comm.,* 65 A.D.2d 304, *rev'd on other grounds,* 49 N.Y.2d 538 (1980).

[93] As with the pre-2015 Tax Law, the statue provides that only business receipts are included in a taxpayer's apportionment fraction. N.Y. Tax Law § 210-A. The pre-2015 Tax Law did not define the term "business receipts" and neither does the post-reform statute. N.Y. Tax Law §210-A; N.Y. Tax Law §210 (2014).