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Report No. 1481
October 9, 2023

Ms. Kathleen Chase
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Department of Taxation and Finance
W. A. Harriman Campus
Building 9, Room 200
Albany, NY 12227

Re: Proposed Regulations Addressing New York Tax Reform

Dear Ms. Chase:

The Tax Section of the New York State Bar Association (the "Tax Section") is pleased to submit the recommendations set forth in this letter[1] relating to the proposed regulations published in the New York State Register on August 9, 2023 (the "Proposed Regulations"). The Proposed Regulations address the legislative changes to New York State's corporate tax framework effected by Part A of Chapter 59 of the Laws of 2014, together with amendments enacted by Part T of Chapter 59 of the Laws of 2015 and Part P of Chapter 60 of the Laws of 2016 (referred to collectively as "Tax Reform").

[1] This letter may be cited as New York State Bar Association Tax Section Report No. 1481, "Proposed Regulations Addressing New York Tax Reform" (October 9, 2023). The principal drafters of this letter are Jack Trachtenberg, Mary Jo Brady, Alysse McLoughlin, Elizabeth Pascal and Jennifer White. Helpful comments were received by Elizabeth Cha, Jiyeon Lee-Lim, Richard M. Nugent, Deborah Paul, Yaron Reich, Michael Schler, Irwin Slomka and Philip Wagman. This letter reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of its individual members, the NYSBA's Executive Committee or its House of Delegates.

We commend the New York State Department of Taxation and Finance (the "Department") for its process leading up to the formal proposal of the regulations into the State Administrative Procedure Act ("SAPA") process. As described in the Regulatory Impact Statement (the "RIS") submitted together with the Proposed Regulations, the Department engaged stakeholders in the rule development process from the outset. Insight gained from the frequently asked questions (FAQ) portion of the Department's dedicated corporate tax reform webpage, as well as from outreach events and internal discussions, informed the development of the draft regulations. The RIS noted that since 2015, more than 40 drafts of various portions of the proposed regulations have been posted for external review and comment and that industry representatives and individuals submitted over 80 sets of comments and suggestions.[2] As we have submitted a number of comments in reports over the years since the enactment of Tax Reform addressing various releases of draft regulations by the Department, the recommendations contained in this letter are limited to the effective date of the regulations when adopted.

I. Relevant Authority and Precedent Concerning the Effective Date of the Proposed Regulations

A. Background

Under SAPA, subject to exceptions not applicable here, no rule can become effective until it is filed with the secretary of state and the notice of adoption is published in the state register.[3] However there appears to be no caselaw – concerning tax or agency regulations – indicating that this provision prohibits retroactive regulations.

We note that over the last few decades, the Commissioner of Taxation and Finance (the "Commissioner") generally has adopted amendments to the Business Corporation Franchise Tax Regulations with prospective application.

1. *Investment capital regulations* – On November 16, 1989, the Commissioner adopted amendments to provisions concerning the nature and treatment

[2] RIS at p. 4-5.

[3] NY APA § 203.1.

of investment capital and investment income. Generally, the amendments made by these regulations apply to taxable years beginning on or after January 1, 1990.[4]

2. *Corporate limited partner regulations* – On October 17, 2006, the Commissioner adopted amendments providing guidance for corporations that are partners in partnerships. The amendments made by these regulations apply to taxable years beginning on or after January 1, 2007.

3. *Combined reporting regulations* – On December 17, 2012, the Commissioner adopted amendments updating rules addressing the changes to combined reporting made in Chapter 60 of the Laws of 2007. The amendments made by these regulations apply to taxable years beginning on or after January 1, 2013.[5]

We also draw attention to our Report No. 774[6] addressing proposed regulations which clarified that a taxpayer's second tier corporation did not constitute a subsidiary for purposes of the New York State Tax Law. The proposed regulations defined "subsidiary" in a manner which contradicted the then-current regulations as interpreted in *Matter of Racal Corporation and Decca Electronics, Inc.*[7] In *Racal*, the New York State Tax Appeals Tribunal (the "Tribunal") permitted

[4] The amendments which classify options as investment capital, and which classify as investment income the income from certain futures and forward contract transactions, income from certain short sales and premium income from certain unexercised covered call options, apply only to positions taken in taxable years beginning on or after January 1, 1990, except for any section 1256 contract which is marked to market pursuant to section 1256(a) of the Internal Revenue Code on the last business day of the taxpayer's taxable year immediately preceding its first taxable year beginning on or after January 1, 1990.

[5] In the RIS in the proposal of these regulations, the Department noted that it had issued a technical memorandum (TSB-M-08(2)C) that outlined and interpreted the provisions of the new 2007 law and that the proposed regulations "largely codif[y] the information contained in the TSB-M" although several changes were made in the regulations that represent "a departure from interpretations set forth in the TSB-M." As noted, these proposed regulations were adopted prospectively for tax years beginning on or after January 1, 2013, which is more than five years after the law change. The Department's explanation in the "Assessment of Public Comment" prepared in connection with these proposed regulations provides its reasoning for prospective application: "Since some of the amendments in the rule represent a departure from the interpretations taken in the TSB-M, the Department has, based upon this comment, provided that the amendments would apply to taxable years beginning on or after January 1, 2013."

[6] NYSBA Tax Section, Report No. 774, "Report on Definition of Subsidiary under New York State Tax Law," (Oct. 22, 1993).

[7] DTA 807361 (N.Y.S. Tax App. Trib. May 13, 1993).

a taxpayer to treat its second tier corporation as a subsidiary for purposes of the New York Tax Law. While the Tax Section believed that the proposed regulations were a reasonable interpretation of the statutory definition of "subsidiary," because the proposed regulations departed from current judicial interpretation of the law, we recommended that the proposed regulations, if adopted, should apply prospectively only and should not be applied to years prior to 1994. These regulations were adopted prospectively, effective January 19, 1994.[8]

B. Case Law

The New York State Court of Appeals addressed the retroactive application of a regulation in *Matter of Varrington Corp. v. City of New York Dept. of Fin.,*[9] stating that retroactivity of a tax rule, for a short period, is generally permitted and that the question turns on a "balancing of equities" by looking to see if there are any potentially harsh effects of applying the law retroactively to the taxpayer. *Varrington* addressed a temporary change and then reversal of New York City's longstanding policy of applying corporate income tax to foreign corporate limited partners based on a 1954 State Attorney General opinion, which had remained firmly settled and consistent from 1954 until 1988 when a Finance Letter Ruling (based on Department advisory opinion (TSB-A-88 [10]C)) issued to another taxpayer (i.e., not Varrington)) reversed the longstanding policy. In that year, Varrington filed for and received a refund of tax paid in 1984-1986 based on the 1988 ruling. New York City then reversed course in 1990, and adopted a regulation reflecting its longstanding position of applying corporate income tax to foreign corporate limited partners. The City sought to recoup the refund it issued to Varrington in 1988 during the short period when the policy was temporarily changed, and the Court agreed that the retroactive application of the 1990 regulation was permissible. The Court cited the longstanding City policy (as compared to the "blip on the screen" caused by the City Finance Letter Ruling) and noted the taxpayer's clear understanding of such policy, illustrated by its payment of tax in 1984-1986, indicated that there was no cognizable detrimental reliance on the temporarily altered policy.

[8] DTA 811316 (N.Y.S. Tax App. Trib. April 14, 1996).

[9] 85 N.Y.2d 28, 623 N.Y.S.2d 534, 647 N.E.2d 746 (1995).

In *Matter of Dominion Textile (USA) Inc.*[10]*,* the Tribunal applied *Varrington* and rejected the taxpayer's argument for retroactive application of a corporate tax regulation. The Tribunal recognized the rule cited in the *Varrington* Appellate Division case that "regulations interpreting tax statutes are retroactive to the effective date of the statute to which they relate unless the taxing authority limits such retroactive limitation...,"[11] and balanced that with the general principle that while "a taxing body does not have unfettered authority to make regulations retroactive and may not give retroactive effect to regulations that change settled law, particularly where it leads to harsh results for the taxpayer, … a taxing authority's retroactive application of the regulation will be upheld where the choice is a rational one supported by relevant considerations."[12] The Tribunal then found in *Dominion* two elements requiring that the regulation at issue not be given retroactive application:

(1) the Department specifically stated that the regulations were to be applied prospectively both in the Notice of Adoption in the New York State Register dated December 6, 1989, and in a special memorandum dated July 13, 1990 (TSB-M-90[4]C); and

(2) The statute involved in the case was ambiguous and the regulation represented a change in longstanding policy.

Specifically, the regulation at issue included "stock options" in the definition of investment capital and the Department had historically treated stock options as business capital. This interpretation had been upheld as valid both by the Tribunal and the Appellate Division. Until 1990 (the adoption of new investment capital regulations) then, the validated policy of the Department was to treat income from stock options as business income. In 1990, the Department decided to change its interpretation of the statute by promulgating a new regulation which treats income from

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[10] DTA No. 812248 (N.Y.S. Tax App. Trib. May 25, 1995).

[11] *Matter of Varrington Corp. v. City of New York Dept. of Finance*, 201 AD2d 282, 607 NYS2d 630 , *aff'd* 85 NY2d 28, 623 NYS2d 534 (internal cites omitted). *See also*, *In The Matter of the Petition of Sholom Drizin*, 811808, DTA No. 811808 (N.Y.S. Tax App. Trib. May 15, 1997). We note that the *Varrington* Appellate Division case and the *Sholom Drizin* decision cite I.R.C. Sec. 7805(b), which was amended in 1996 to generally limit the retroactive application of temporary, proposed, or final regulations relating to the Internal Revenue Code as part of the Taxpayer Bill of Rights 2, and is effective for regulations issued under statutes enacted after July 30, 1996. Taxpayer Bill of Rights 2, Pub. L. No. 104-168, §1101(a), 111 Stat. 1452.

[12] *Id.*

stock options as investment income. Accordingly, there was "a new and completely opposite interpretation of a patently ambiguous statute where both old and new interpretations [were] equally valid. This is clearly the type of situation which this Tribunal has held should not be given retroactive application in *Matter of Varrington Corp.* (*supra*)."[13]

The Tribunal also noted "[w]hile such reversal of policy did not prejudice petitioner, there may well have been any number of taxpayers who had higher investment allocation percentages than business allocation percentages to whom a retroactive application of the reversal in policy would have been grossly unfair, if not illegal. Thus, we find that the Division acted properly in giving the new regulation a prospective application only."[14]

The Appellate Division decision in *Hilton Hotel Corp. v. Comm'r of Finance*, 219 A.D. 2d 470 (2nd Dep't 1995) is also instructive on the issue of retroactive application of a new policy. At issue was a New York City utility tax assessment against the Waldorf-Astoria Hotel on the hotel's long-distance telephone call surcharges, which for nearly 50 years the City of New York had interpreted as not being taxable. The Department of Finance changed its interpretation and assessed the tax retroactively. On appeal, the Appellate Division held that it was arbitrary and capricious to retroactively apply the new policy. The court applied the three-part test for determining the non-retroactivity of a judicial decision enunciated by the Supreme Court in *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971).[15] A decision must be applied prospectively:

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[13] DTA No. 812248 (N.Y.S. Tax App. Trib. May 25, 1995).

[14] Some cases have found that requiring a taxpayer to pay more income tax does not result in detrimental reliance, because the taxpayer has no right to a benefit provided by a law or regulation (as long as penalties are not imposed). *See Bruce M. Montgomerie v. Tax Appeals Tribunal*, 740 NYS2d 141 (2002) ("There is also insufficient support for petitioners' assertion that they detrimentally relied on the prior rule such that it would be inequitable for them to be required to pay the correct amount of tax due under a proper interpretation of Tax Law former § 654 (*cf.,Matter of Hilton Hotels Corp. v Commissioner of Fin. of City of N.Y., supra*). Petitioners were not assessed a penalty as a result of the Department's actions and were put in no different position than if *McNulty* had been decided shortly before their returns were filed as opposed to shortly after. In any event, although we appreciate petitioners' argument, '[s]ince tax legislation is not a governmental promise' (*Matter of Varrington Corp. v City of New York Dept. of Fin*., 85 N.Y.2d 28, 33), petitioners had no vested right in the benefits of 20 NYCRR former 148.6 and cannot establish unjustifiable prejudice as a result (*see, id.*).").

[15] We note that the Supreme Court has ruled that the *Chevron* doctrine may not apply under certain fact patterns where there is not grave inequity or disruption. *See Ryder v. United States,* 515 U.S. 177 (1995). We believe that the *Chevron* doctrine, as adopted in New York cases and rulings, applies to the issues discussed herein. The Tribunal has stated that *Chevron* is not affected in cases involving questions of state law as opposed to federal law. *NewChannels*

(1) if it establishes a new principle of law, either by overruling clear past precedent on which litigants may have relied or by deciding an issue of first impression whose resolution was not clearly foreshadowed;
(2) the prior history of the rule at issue and the impact of retroactive application upon its purpose and effect should be considered; and
(3) any inequity that would be created by retroactive application must be weighed.[16]

As applied in *Hilton*, the Appellate Division held that for nearly 50 years the hotel industry had relied on government opinion letters not imposing the tax, and that there was no showing either that retroactive application would further the new rule or that prospective application would undermine its effect. The court held that the tax assessment should be cancelled.[17]

Similarly, in *Meredith Corporation v. Tax Appeals Tribunal*,[18] the Appellate Division reversed a Tribunal decision, reaffirming that taxpayers are entitled to rely on the Department's longstanding statutory interpretations:

> A taxpayer is entitled to rely on a longstanding statutory interpretation by the Department (*see Matter of Howard Johnson Co. v. State Tax Comm'n*., 65 NY2d 726, 727 [1985]). The

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Corporation; Upstate Community Antenna, Inc, Tax Appeals Tribunal, DTA Nos. 808420, 808458 (Sept. 23, 1993); *see also Principal Mutual Life Insurance Company* 815265, (ALJ 07/30/1998).

[16] Based on the three-part test, the Tribunal in *NewChannels Corporation; Upstate Community Antenna, Inc,* Tax Appeals Tribunal, DTA Nos. 808420, 808458 (Sept. 23, 1993) refused to give retroactive application to a new interpretation of the term "transmission business" for the purpose of imposing a franchise tax due to a contrary opinion previously given in the Division of Taxation's 1953 Opinion of Counsel. The Tribunal found the agency decision to retroactively apply the tax one of first impression that could not be foreseen, that retroactive application would not further the purpose of the new rule and prospective application would not undermine the new rule, and that the equities favored the taxpayer who had acted in good faith in relying on the 35-year-old policy.

[17] It has been noted that the *Varrington* Court of Appeals case did not cite the *Chevron* factors. The Division of Tax Appeals suggested there may be a different test for regulations, but it is not entirely clear: "The fact that the Court of Appeals in *Varrington* did not apply *Chevron* is more likely to be because *Varrington* dealt with the retroactivity of a regulation and not a judicial decision. Nonetheless, absent evidence of the Court's purpose for not applying *Chevron*, no conclusion can be drawn from the lack of such discussion." *Principal Mutual Life Insurance Company* 815265, (ALJ 07/30/1998). This determination was appealed but this issue was not considered by the Tribunal.

[18] 956 N.Y.S.2d 585 (3d Dep't 2012).

> Department can change established policy or reassess prior statutory interpretations so long as these changes are applied prospectively to taxpayers (*see Matter of Friesch-Groningsche Hypotheekbank Realty Credit Corp. v. Tax Appeals Trib. of State of N.Y.*, 185 AD2d 466, 468 [1992], lv denied 80 NY2d 761 [1992]; *see also Matter of National El. Indus. V. New York State Tax Comm'n.*, 49 NY2d 538, 547-548 [1980]). Retroactively applying a changed interpretation upon which a taxpayer was relying is "arbitrary and capricious" (*Matter of Howard Johnson Co. v State Tax Commn.*, 65 NY2d at 727).[19]

II. Discussion of Prospective Application Related to Certain Proposed Regulations

The cases summarized in Part I.B support the notion that prospective application of a regulation is required where there has been a change in longstanding policy. Some of the Proposed Regulations, including in particular those discussed in Parts II A - C below, involve modifications of longstanding policy. We note that since 2015 when draft regulations were first released, the Department's website consistently provided a disclaimer indicating that taxpayers should not rely on the draft regulations. Taxpayers thus logically would have continued to rely on established prior policy and practice and had to make reasonable judgments in taking filing positions since 2015. Taking this into account, we urge the Department to adopt and apply the provisions of the Proposed Regulations described in Parts II.A - C prospectively, consistent with the Department's policy of regulation adoption over the past few decades and in accordance with case law.[20]

However, we also note that, in the case of some of the provisions adopted as part of Tax Reform, different versions of the draft regulations preceding the Proposed Regulations have taken different approaches over time. If a taxpayer followed an approach set forth in a prior draft where the adopted regulation ultimately takes a different approach (e.g., in the case of sourcing for

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[19] *Id*.

[20] We note that adopting the Proposed Regulations with prospective application does not preclude the Department from taking the regulations' position on audit.

passive investment customer receipts and interest paid to a corporation directly by the Federal Reserve on reserves maintained at a Federal Reserve Bank), we encourage the Department upon audit to consider the equities in making adjustments, since the taxpayer's position reflects a reasonable effort to comply with the Tax Law based on available information; at the time the prior draft regulation was posted, it represented the Department's view of the most reasonable approach. In addition, we assume that, if a taxpayer took a reporting position that is ultimately adopted in the regulation, the Department upon audit would respect the use of such approach even if the draft regulations had previously suggested a different approach.

Also, we note that the Proposed Regulations described in Part II.D provide a new "billing address safe harbor" as administrative relief in response to taxpayer complaints that complying with the statutory rules for sourcing receipts from "other services and other business receipts" and digital products/services (i.e., identifying the customer location under the relevant statutory regimes) is overly burdensome. The billing address safe harbor generally allows for the sourcing of receipts to a business customer's billing address if the requirements of the safe harbor are met. As these Proposed Regulations do not involve a longstanding policy and we read the billing address safe harbor to be an elective, as discussed below, we recommend that the Department consider permitting taxpayers to avail themselves of this safe harbor for all open periods, as applicable.

A. Unusual Events

As we noted in Report No. 1466,[21] the Tax Law does not specifically authorize an exclusion from the apportionment factor 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."[22] The subsequent subsections relate to the items included with

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[21] NYSBA Tax Section, Report No. 1466, "Report on Draft Business Apportionment Factor Regulations," (Sept. 2, 2022).

[22] N.Y. Tax Law § 210-A(1).

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 to be included in the apportionment factor.[23] Consistent with this authority, an earlier version of the Draft Regulations issued on September 30, 2016, stated 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.[24] The Proposed Regulations, however, do not contain a similar exclusion. The RIS further explains that "[a]fter further considering the issue, the department determined that the unusual events rule was no longer appropriate because Tax Reform provided significantly more detailed sourcing rules, including guidelines for those transactions that might have been excluded under pre-reform policy. The proposed rule reflects this determination to eliminate the unusual events rule."[25]

In considering the impact of the Tax Reform, pursuant to which the Proposed 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.[26] 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

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[23] *See* 20 NYCRR § 4-4.1 (providing that business receipts includes only "gross income received in the regular course of the taxpayer's business"); and 20 NYCRR § 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).

[24] See related discussion at NYSBA Tax Section Report No. 1369, "Report on Draft Business Apportionment Factor Regulations" (May 26, 2017).

[25] RIS at p.11.

[26] *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).

the relevant statutory provisions are re-enacted without substantial change.[27] However, despite the Department's longstanding policy to exclude non-ordinary course receipts from the apportionment factor, we acknowledge that the Department may now choose to forgo an unusual events exclusion. Since the Proposed Regulations do not include an unusual events exclusion, the Tax Section encourages the Department to apply this change on a prospective basis only consistent with the principles described above.

B. P.L. 86-272

As we concluded in Report No. 1471[28] addressing draft regulations regarding P.L. 86-272, if the Proposed Regulations are finalized in substantially their current form, they should be given a prospective-only effective date. That would be necessary as a matter of due process and fundamental fairness, because such rules would constitute a significant change in the Department's longstanding interpretation that could not reasonably have been anticipated by the public. The Proposed Regulations present at least as compelling a case for prospective-only application as in *Hilton Hotel*. They would represent a new principle of law contrary to the longstanding policy of the Department. Retroactive application would not further the new interpretation nor would prospective-only application harm it. There would also be substantial inequities resulting from retroactive application by exposing businesses to unanticipated Article 9-A liabilities. Prospective application would also be consistent with the result in *South Dakota v. Wayfair, Inc.*[29] The South Dakota statute that the Court upheld as constitutional by its terms was only to have prospective application if the Court overturned *Quill Corp. v. North Dakota*,[30] which it did.

[27] We note that Proposed Regulation Sec. 4-2.1 includes sourcing rules for net gains from the sale of tangible personal property, which presumably would apply to non-inventory assets (*see* Proposed Regulation 4-2.1(b)(1) stating that adjusted basis is subtracted in computing gain). This is another example of a new policy, in this case that explicitly deviates from the statute, which requires sourcing receipts from tangible personal property on a gross basis. Tax Law section 210-A(2)(a). As we believe these Proposed Regulation are inconsistent with a plain reading of the statute, in our view they should apply prospectively.

[28] NYSBA Tax Section, Report No. 1471, "Report on Draft Regulations Regarding P.L. 86-272," (Dec. 19, 2022).

[29] 138 S. Ct. 2080 (2018).

[30] 504 U.S. 298 (1992).

The Tax Section urges the Department to apply these Proposed Regulations prospectively only. We note that Brian Hamer, counsel to the Multistate Tax Commission, and one of the drafters of the "Statement of Information Concerning Practices of the Multistate Tax Commission and Supporting States Under Public Law 86-272" upon which these Proposed Regulations are based, wrote that "[s]tates that adopt the revised statement's internet provisions should also consider announcing that they will apply those provisions on a prospective-only basis. Failure to do so may well discourage voluntary compliance, since sellers will fear that filing a return for the current year will cause tax authorities to examine prior years (and in many states, there is no statute of limitations for years that a taxpayer has not filed a return)."[31]

C. Contract Manufacturing

As the Tax Section did not previously address the draft regulations concerning contract manufacturing within the overall "qualified New York manufacturer" ("QNYM") statutory regime, we are focusing on this in greater depth here. Under Tax Reform, QNYMs receive the benefit of a zero percent tax rate on the business income base. The Proposed Regulations contain specific criteria for determining which party to a contract, where one party performs certain manufacturing tasks for the other, is, in fact, the manufacturer for tax purposes, in order to prevent both parties to the contract from claiming to qualify for the zero percent rate. These criteria may significantly limit a taxpayer's ability to qualify for the income tax benefits provided to QNYMs when utilizing contract manufacturers. The Proposed Regulations represent a distinct change in policy from the Department's prior interpretation of identical statutory language, and therefore should only be applied prospectively.

1. Tax Law

As noted above, for tax years beginning on or after January 1, 2014, the Tax Law provides significant benefits, including a zero percent income base tax rate, to QNYMs. The incentives, which were expanded beyond those previously provided, were "necessary to help existing New York manufacturers survive and attract new manufacturers to the State."[32]

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[31] Brian Hamer, "In the Wake of the MTC's P.L. 86-272 Project," *State Tax Notes*, Vol. 105, Aug. 8, 2022. p. 659.

[32] 2014-15 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support, page 20.

A QNYM is defined in Tax Law Sections 210(1)(a)(vi) and 210(1)(b)(2). The term "manufacturer" includes a taxpayer that is "principally engaged" in the production of goods by manufacturing, processing, etc. A taxpayer is principally engaged in manufacturing if more than 50 percent of the gross receipts of the taxpayer are derived from the sale of goods produced by manufacturing, processing, etc.[33]

A QNYM is a manufacturer that has property in New York that is described in Tax Law Section 210-B(1)(b)(i)(A)[34] that (i) has a New York adjusted basis of at least one million dollars, or (ii) constitutes all of the manufacturer's real and personal property in New York. The property must be depreciable pursuant to section 167 of the Internal Revenue Code ("IRC"), have a useful life of four years or more, be acquired by purchase pursuant to Section 179(d) of the IRC, with a situs in New York State and be "*principally used by the taxpayer* in the production of goods by manufacturing, processing…" (emphasis added) ("qualifying property").

The Tax Law is silent as to how the use of contract manufacturers may impact a taxpayer's ability to meet the applicable definitions.

2. <u>The Proposed Regulations</u>

Proposed Regulation Section 9-1.3 provides guidance addressing how the use of contract manufacturers may impact a taxpayer's ability to meet the statutory prescribed definitions. Specifically, it states that:

- In determining if the contracting company (defined as a corporation that contracts out its production activities) is a QNYM, it can consider the assets and employees used in the production activities only if it owns the assets being used by the production company (i.e., the contract manufacturer) and only its employees operate or use those assets; and
- Receipts earned by the contracting company from the sale of goods produced by the production company (i.e., the contract manufacturer) on behalf of the contracting company

[33] A taxpayer that does not satisfy the "principally engaged in" test may be a QNYM if it employs at least 2,500 employees in manufacturing, processing, etc. in New York, and has property in the state used in these activities with an adjusted New York basis of $100 million or more. Tax Law Section 210(1)(a)(vi).

[34] This section governs application of New York's Investment Tax Credit.

> are not receipts from the sale of goods produced by manufacturing activities and would not be included in the computation of the principally engaged test.

See Section 9-1.3(b). Conversely, a production company (i.e., a contract manufacturer) can only include the assets and employees in its analysis if the assets are owned by the production company and used only by its employees. *See* Section 9-1.3(c). Further, receipts paid by the contracting company to the production company for the manufacture of the goods produced by the production company on behalf of the contracting company are not receipts from the sale of goods produced by manufacturing activities unless the production company in fact is selling those goods (i.e., transferring title to those goods) to the contracting company. *Id*.

3. Comments

This Proposed Regulation indicates a clear change of policy regarding the Department's position on the use of contract manufacturers.

First, the Department issued a Technical Memorandum in 2015 to provide additional guidance on the benefits available to QNYMs. *See* TSB-M-15(3)C, (3)I, February 26, 2015.[35] In defining a "manufacturer," the memorandum provides that "a taxpayer that contracts out its production activities to another entity cannot consider those activities in determining its eligibility as a manufacturer. The contractor entity may include those activities when determining whether it meets the definition of a manufacturer." Notably, the Department's policy statement was less restrictive than the language found in the Proposed Regulation. For example, the Proposed Regulation asserts that property cannot be taken into account by the taxpayer as qualifying property if it is used *at all* by a contract manufacturer, and receipts from the sale of products made using that property cannot be counted favorably by the taxpayer under the eligible receipts component of the principally engaged in test. By comparison, the memorandum does not state that property used by contract manufacturers cannot be qualifying property, nor does it provide that use of contract manufacturers impacts the receipts component of the principally engaged in test.

[35] A TSB-M is an informational statement of existing Department policies or of changes to the law, regulations, or Department policies. It is accurate on the date issued 20 NYCRR 2375.6.

The Department has since issued several memorandums addressing various components of the application of the reduced rate, and none have provided additional guidance on these issues.

Second, the Proposed Regulations contradict guidance previously issued by the Department. Through an Advisory Opinion issued by the Department to Xerox Corporation ("Xerox"), the Department established a policy that manufacturing property owned by a contracting company and used by a contract manufacturer satisfied the "principally used" requirement. *TSB-A-98(24)C, December 2, 1998.* Xerox used subcontractors to produce component parts of copier machines and other equipment. Xerox purchased the tooling (i.e., dies and molds) to its exact tolerances, and provided the tooling to subcontractors free of charge for the exclusive use of manufacturing the parts. The parts were produced pursuant to Xerox's specifications and quality standards, and once complete were subject to qualification tests by Xerox. When the work order was complete the tooling was returned to Xerox. The Department determined that the property and use satisfied the principal use requirement, such that Xerox was found to be principally using the property in the production of goods by manufacturing. To date, the Advisory Opinion has not been withdrawn or revoked.

The Department considers its TSB-As and TSB-Ms to constitute audit policy and even for TSB-As which are specific to the petitioning taxpayer, the Audit Division and the Bureau of Conciliation and Mediation Services view themselves as bound by the policy set forth in the ruling.

In view of the change in policy that the new Proposed Regulation reflects, we believe that it should have only a prospective effective date.

D. Billing Address Safe Harbor

Included in the Proposed Regulations is a "billing address safe harbor," which relates to the sourcing of receipts from other services and other business receipts and receipts from digital products. The RIS explains that taxpayers had asserted that complying with the statutory sourcing rules was often time consuming and costly; and the RIS adds that commenters advocated for a safe harbor similar to one used by other states with similar customer sourcing rules that would allow taxpayers to source receipts to their customer's billing address, in lieu of using the rules of the hierarchy, if the taxpayer generally had more than 250 customers.[36] Initially, the Department did not propose the suggested safe harbor because, for business customers, the billing address generally does not reflect the primary rule of the respective statutory hierarchies. In response to feedback, the Department released draft regulations that included some administrative relief (an "inquiries safe harbor") and later replaced that with a safe harbor more closely aligned with commenters' suggestion that generally allowed taxpayers with more than 10,000 business customers to source receipts to such customers' billing address rather than performing the steps required by the hierarchy. The Department then eliminated the "inquiries safe harbor" and reduced the threshold number of business customers under the "billing address safe harbor" from 10,000 to 250. We presume the billing address safe harbor is elective since it is designated as a "safe harbor" and was intended to reduce administrative burdens and we encourage the Department to make this clear in the Draft Regulations. With this in mind, retroactive application would be appropriate for these Proposed Regulations.

Respectfully submitted,

Philip Wagman

Philip Wagman
Chair

cc: Amanda Hiller, Acting Tax Commissioner and General Counsel
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[36] RIS at p.13.