Report No. 1334

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON DRAFT AMENDMENTS TO REGULATIONS REGARDING CORPORATIONS SUBJECT TO ARTICLE 9-A TAX

DECEMBER 3, 2015

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REPORT ON DRAFT AMENDMENTS TO REGULATIONS REGARDING CORPORATIONS SUBJECT TO ARTICLE 9-A TAX[1]

I. INTRODUCTION

This report comments on draft amendments to regulations under Tax Law Article 9-A prepared by the New York State Department of Taxation and Finance ("Department"), dated September 2, 2015, principally relating to activities that will subject a corporation to the tax ("draft nexus amendments"). The amendments are intended to provide guidance in interpreting certain provisions in the 2014 and 2015 New York State budget legislation ("Budget Bill") that, among other things, expanded the list of activities that will cause a corporation to be subject to Article 9-A for tax years beginning on or after January 1, 2015. The most significant of those legislative changes is the addition of the activity of "deriving receipts from activity in this state" – generally referred to as "economic nexus" -- as a basis for taxability. The Department has requested comments on the draft nexus amendments by December 3, 2015.

The Tax Section appreciates the Department's openness in making the draft amendments widely available on its web site for comment before they are formally proposed pursuant to Article 2 of the State Administrative Procedures Act. We commend the Department for having prepared generally clear and comprehensive guidance for businesses and practitioners in this entirely new area of the Tax Law. This report offers the Tax Section's comments and recommendations on certain of the draft amendments.

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[1] The principal drafters of this report were: Irwin M. Slomka, Jack Trachtenberg, Lindsay M. LaCava, Paul R. Comeau, Christopher Doyle, Leah Robinson, Jennifer S. White and Kara M. Kraman. Helpful comments were received from: David R. Sicular, Stephen B. Land, Maria T. Jones, Peter L. Faber, Arthur R. Rosen, Michael L. Schler, Kimberly S. Blanchard, David R. Hardy and Peter J. Connors. This report reflects solely the views of the Tax Section and not those of the NYSBA Executive Committee or House of Delegates.

II. BACKGROUND

The 2014 Budget Bill meaningfully increased the reach of Article 9-A through the imposition of what is intended to be a "bright line" economic nexus threshold for corporations that do not otherwise do business in New York, based on the activity of "deriving receipts from activity in this state." Under the new law, a corporation is considered to be "deriving receipts from activity" in the State if it has New York receipts during the taxable year of at least $1 million ("$1 million threshold").[2] The computation of New York receipts for this purpose is based on the receipts that a corporation must include in the New York numerator of its apportionment factor under the revised apportionment provisions contained in Tax Law § 210-A. If a corporation has more than $10,000 of New York receipts in a taxable year, and the total New York receipts of related corporations in its unitary group are at least $1 million, the corporation is considered to be "deriving receipts from activity" in New York and is subject to tax. The legislation also substantially incorporated into Article 9-A the economic nexus provisions applicable to credit card corporations under former Article 32, which are generally based on the corporation having issued credit cards to at least 1,000 customers in the State or having at least 1,000 merchant customer contracts with merchant locations in the State.

III. DISCUSSION

A. Draft Sec. 1-3.2 – Foreign Corporations Subject to Tax (when economic nexus is deemed to exist)

1. Draft Regulation

The draft amendments retain the provision that a foreign (*i.e.*, non-New York) corporation will generally be subject to Article 9-A (*i.e.*, have "nexus") if it is doing business, employing capital, owning or leasing property, or maintaining an office in the State. Consistent

[2] Tax Law § 209.1(a).

with the corporate tax reform legislation, the draft amendments provide that a foreign corporation also will be subject to tax if it "derives receipts from any activity in New York State." As noted above, generally a foreign corporation will be deemed to derive receipts from activity in New York State if it has at least $1 million of apportioned receipts within the State.

The draft amendments contain a new regulation section 1-3.2(a)(5) that addresses the portion of a foreign corporation's taxable year for which nexus will be deemed to exist:

> (i) A foreign corporation engaged in New York State in any of the [nexus creating activities] is subject to tax: (a) for any taxable year or part of a taxable year during which it engages in any of the [nexus creating activities]; and (b) for any subsequent taxable year during which it engages in any of the [nexus creating activities].

Draft section 1-3.2(a)(5) also provides that a foreign corporation deriving receipts from activity in New York State (*i.e.*, a foreign corporation that reaches the $1 million threshold) will be subject to tax from the date of its first New York receipt, as well as in subsequent taxable years in which the $1 million threshold is again met from the beginning of each such subsequent taxable year:

> (ii)(a) A foreign corporation deriving receipts from activity in New York State . . . is deemed to be deriving receipts for all of its taxable year or part of its taxable year, under clause (a) of subparagraph (i) of this paragraph, from the date of its first receipt derived from activity in New York State.
>
> (iii) (a) A foreign corporation deriving receipts from activity in New York State . . . in its first taxable year is deemed to be deriving receipts in the subsequent taxable year, under clause (b) of subparagraph (i) of this paragraph, from the beginning of the subsequent taxable year.

2. <u>Comments</u>

(a) <u>The Subsequent Year(s) Nexus Rules</u>

Read as a whole, draft section 1-3.2(a)(5) appears to provide that a foreign corporation will continue to have nexus from the beginning of one or more subsequent taxable years if the

corporation meets the $1 million threshold in a prior taxable year. In this regard, the Tax Section has three comments:

First, it is unclear whether the draft regulation contemplates that the foreign corporation's continuing nexus will be deemed to exist from the beginning of only the immediately subsequent taxable year or in all subsequent taxable years. Clause (b) of subparagraph (i) refers to "*any* subsequent taxable year," while clauses (a) and (b) of subparagraph (iii) refer to only "*the* subsequent taxable year." This should be clarified. The Tax Section believes that the most appropriate rule would be to limit the deemed subsequent table year nexus to only the immediately subsequent taxable year. Thereafter, only if the foreign corporation actually engages in nexus creating activities in the subsequent year would the presumption of nexus again roll forward to the next immediately subsequent year.

Where there is a gap of one or more years in which the corporation has less than $1 million in New York receipts (and it has no other nexus-creating activities), the question arises whether the "first year" rule should again apply. If the first year rule were to apply, then in the year that the foreign corporation again meets the $1 million threshold, it would be treated as being subject to tax as of the date of its first New York receipts in that year. Alternatively, the first-year rule could apply only if the gap in nexus was for a longer duration, for example at least three years.

Subparagraph (i) of draft section 1-3.2(a)(5) appears to acknowledge that nexus must be determined on a year-by-year basis since it provides that a foreign corporation will have nexus in a subsequent taxable year only if it engages in nexus-creating activities in that subsequent taxable year.

The Tax Section presumes that a foreign corporation will be relieved of its tax filing and payment obligations (and would be entitled to a refund of any estimated taxes paid in a subsequent taxable year) if in that subsequent year it does not meet the $1 million threshold and does not otherwise have nexus in New York State. Language that would make this clear would be helpful.

(b) The Need for a Tax Filing and Refund Procedure

The draft amendments do not contain tax filing and refund procedures when a foreign corporation meets the economic nexus threshold in one year but not in the subsequent year. When a foreign corporation has made estimated tax payments for the subsequent year, current Department policy would appear to require the filing of a tax return to obtain a refund of those payments.[3] However, if a corporation has no tax filing obligation, the filing of a tax return would appear to be an inappropriate mechanism since the corporation will not be considered a New York taxpayer for that year.

The Tax Section suggests the adoption of a safe harbor rule that protects a foreign corporation from having to make tax filings in a subsequent taxable year unless and until the corporation equals or exceeds the $1 million threshold. Estimated payments could still be required or permitted, but a refund procedure should be set forth to allow for the refund of such payments if the corporation ultimately does not have nexus with New York for a subsequent taxable year. One suggestion would be to devise a simple claim form for the corporation to report the lack of sufficient New York receipts and to report the amount of estimated taxes to be refunded.

[3] *See* N.Y.S. Dep't of Taxation and Fin. Notice, N-09-2.

B. Draft Sec. 1-3.2 – Foreign corporations subject to tax (nexus through partnerships and limited liability companies)

1. Draft Regulation

The draft amendments to an existing regulation (renumbered section 1-3.2(6)) provide that every foreign corporate general partner of a partnership that derives New York receipts of more than $1 million, as calculated under the Article 9-A apportionment rules, will be subject to tax, even if the corporate partner's pro rata share of those receipts is less than $1 million in the taxable year.

New draft section 1-3.2(8) also provides that every corporation that is a member of a limited liability company ("LLC") treated as a partnership for tax purposes that has either traditional or economic nexus will be subject to Article 9-A.

2. Comments

(a) Taxation of Corporate General Partners Based on Economic Nexus

Under the 2014 Budget Bill, if a partnership is, among other things, "deriving receipts from activity in this state" (*i.e.*, meets the $1 million threshold) then:

> any corporation that is a partner in such partnership shall be subject to [Article 9-A] as described in the regulations of the commissioner.[4]

It is well-settled in New York that a corporate *general* partner and certain corporate *limited* partners in a partnership that does business in New York are considered to have nexus with the State.[5] In the case of corporate limited partners, the existing regulations provide that a foreign corporate limited partner is considered to have nexus with New York if it is "engaged,

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[4] Tax Law § 209.1(f).

[5] 20 NYCRR § 1-3.2(a)(5) and (6); *People ex rel. Badische Anilen & Soda Fabrik v. Roberts*, 152 N.Y. 59 (1897).

directly or indirectly, in the participation or dominion and control of the partnership business." The existing regulations specify that such "participation or dominion and control of the partnership business" exists where, among other things, the limited partner has at least a 1% limited partnership interest or has a basis in the partnership for federal income tax purposes of more than $1 million.[6]

The draft amendments on the taxation of corporate general partners would extend the regulation to corporate general partners in a partnership that meets the $1 million threshold. The consequence of this change would be significant for it means that a corporate general partner having less than $1 million of New York receipts would be subject to tax. This would have the effect of applying the $1 million "bright-line" nexus threshold for corporate general partners at the partnership level. Corporate limited partners would not be affected by this rule.

We recognize that amended Tax Law section 209.1(f) can be read to allow the Department to promulgate regulations that subject to tax *any* corporate partner, general or limited, in such a partnership. Under this reading, the Department has considerable latitude to enact a regulation that would subject all corporate general partners to tax in any taxable year where the partnership meets the $1 million threshold, as the draft amendments provide. On the other hand, the language of section 209.1(f) certainly does not mandate subjecting to tax a foreign corporate general partner with a distributive share of less than $1 million of New York receipts. Had the Legislature intended this result, it could easily have provided clearly that for corporate general partners the $1 million threshold is applied at the partnership level, not at the partner level. Moreover, the amendments lead to the somewhat surprising result that a corporate

[6] 20 NYCRR § 1-3.2(a)(6)(i)(a).

general partner that derives New York receipts indirectly through a partnership is treated more harshly for economic nexus purposes than a corporation that directly derives New York receipts equal to the partner's distributive share of the partnership's receipts.

We believe that it makes sense to take a more limited approach to corporate general partners. Under one possible alternative, the Department could subject a corporate general partner to economic nexus only where the sum of the partner's distributive share of New York receipts and its own New York receipts meets the $1 million threshold for the taxable year.

Under another possible alternative to the draft regulation, if the Department were to apply a $1 million threshold at the partnership level, it should still consider adopting by regulation an additional *de minimis* rule at the corporate general partner level. For example, in order for a corporate general partner in a partnership with at least $1 million of New York receipts to have economic nexus, the regulations could provide that the general partner must derive at least $10,000 of New York receipts from the partnership during its taxable year. Although we use $10,000 as an example of what we consider a reasonable additional limitation at the partner level – representing 1% of the statutory $1 million threshold – the Department could consider greater or lesser *de minimis* amounts. This alternative approach would still cause some corporations having less than $ 1million of New York receipts to be taxable. However, it would avoid subjecting to tax those corporate general partners that derive substantially less than $1 million in New York receipts from a partnership.

If the Department is attempting with this amendment to address tax avoidance situations – for instance, when a foreign corporation transfers its New York receipts-generating activities to a partnership and then has multiple related corporate general partners, each deriving less than

$1 million in New York receipts -- the Department should be able to do so in other ways. For one thing, the statute already permits the aggregation of the New York receipts of unitary corporations in ascertaining whether the $1 million threshold is met.[7] Furthermore, if the Department determines that the use of multiple corporate partners has no valid business purpose or economic substance other than tax avoidance, and their principal purpose is to avoid or evade the triggering of the $1 million threshold, the Department has the authority to disregard the multiple corporate partner structure.

(b) Related Tax Filing Obligations of Partnerships

We have questions regarding the impact that this amendment would have on partnerships that derive at least $1 million of New York receipts, but that do not have traditional nexus with the State. Currently, a partnership that has any amount of income, gain, loss or deduction from New York State sources is required to file a New York Partnership Return, an information return that principally serves the purpose of determining how the distributive shares of partnership income are sourced by the distributee nonresident corporate and individual partners for New York State corporate and personal income tax purposes.[8] This is done through the computation of a three-factor apportionment formula based on the gross income, property and payroll of the partnership. A partnership's New York source income, gain, loss or deduction is currently determined under sourcing rules applicable to nonresident individuals.[9] With certain exceptions, a partnership's gross income factor of its three factor apportionment formula is not computed

[7] We note that Tax Law section 209.1(d), which provides for the aggregation of the New York receipts of members of a unitary group in determining whether the $1 million threshold is met, could be susceptible to constitutional challenge on the grounds that a unitary business relationship alone does not satisfy the Commerce Clause "substantial nexus" requirement or the Due Process Clause "rationally related to in-state activities" requirement.

[8] Tax Law § 658(c); 20 NYCRR §§ 151.4; and 158.9.

[9] 20 NYCRR § 158.9(a).

using the Article 9-A market-based sourcing methods, but is sourced based on the location of the office, branch or agency of the partnership where its sales are negotiated or consummated or from where its services are performed.[10]

It appears that the Department will now require that a partnership with New York source income report as part of its New York Partnership Return whether it has at least $1 million of New York receipts using the Article 9-A sourcing rules, at least where it has corporate general partners, and to make that information available to those partners. In that case, it is possible that partnerships will now be required to compute two different versions of the gross income factor in their New York Partnership Returns, one for income sourcing purposes by the partners and the other (using Article 9-A sourcing rules) for corporate partners to determine whether they have economic nexus. If that is what the Department intends, we recommend that the Department amend personal income tax regulation section 158.9 ("New York State Partnership Returns") to make that clear.

(c) Taxation of LLC members

We suggest that the Department reconsider the approach in the draft regulations that would tax *all* corporate members of an LLC having traditional or economic nexus with the State that for both federal and New York State income tax purposes is treated as a partnership.

The underlying basis for the state taxation of a foreign corporate *partner* is the application of the aggregate principle of taxation. Under that principle, a partnership is considered an aggregation of its partners. The partner is considered to have an undivided interest in each of the partnership's assets, liabilities and items of income, gain, loss and deduction, and

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[10] 20 NYCRR § 132.15(f).

to directly participate in the partnership's business activities. Under the 2014 Budget Bill, a corporation that is a partner in a partnership is generally required to compute its tax using the aggregate method of taxation as prescribed under the Article 9-A regulations, unless another method is required or allowed under those regulations.[11] A related basis for taxing a corporate partner is that an agency-type relationship is deemed to exist between the partnership and the partner.[12]

The existing Article 9-A regulations generally apply the aggregate principle to the taxation of corporate partners, as well as to a "managing member of a limited liability company which is treated as a partnership for Federal income tax purposes."[13] The application of the aggregate principle is generally used to determine *how* a corporate partner should calculate its income, gain, loss and deduction from a partnership, and not as a means of imposing *nexus* on a corporate partner.

An LLC that is treated as a partnership under the Internal Revenue Code is treated as a partnership under the Tax Law, and therefore is considered a flow-through for income tax purposes. The draft amendments provide that every corporate member in such an LLC is subject to tax. The Tax Section considered whether new Tax Law § 209.1(f) (pertaining to the taxation of corporate partners) not only supports this approach for all corporate members but would allow

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[11] Tax Law § 210.3.

[12] We note that the state court decisions have not been uniform with regard to nexus over nonresident limited partners in a partnership. *See, e.g.*, *Lanzi v. Alabama Dep't of Revenue*, 968 So. 2d 18 (Ala. Civ. App. 2006) and *UTELCOM, Inc. v. Bridges*, 77 So. 3d 39 (La. Ct. App. 1st Cir. 2011) (holding that a nonresident limited partner is not subject to tax), and *Wirth v. Commonwealth*, 626 Pa. 124 (2014), *cert. denied*, 135 S. Ct. 1405 (2015) and *CRIV Invs., Inc. v. Dep't of Revenue,* 14 Or. Tax 181 (1997) (holding that a nonresident limited partner is taxable).

[13] 20 NYCRR 3-13.2(a)(2).

the Department to revisit existing regulation (20 NYCRR § 1-3.2(a)(6)) which limits the taxation of certain corporate limited partners in a partnership.

On the other hand, it is not clear that the existing law supports the imposition of Article 9-A tax on all corporate members of an LLC taxable as a partnership, regardless of the member's involvement in the LLC's activities or the member's ownership percentage or income from the LLC. We also question whether the imposition of nexus on every member, including a corporation having a membership interest in an LLC that meets the $1 million threshold, would satisfy both the Commerce Clause "substantial nexus" requirements and the Due Process Clause requirement that a tax must be rationally related to the taxpayer's in-state activities. [14] One difference between a general partner and a member is that a general partner is considered to have an ownership interest in the partnership's assets, whereas under most state LLC statutes (including New York) an LLC member has no ownership interest in an LLC's assets.[15] In light of these concerns, the Tax Section favors an approach that generally conforms the taxation of foreign corporate LLC members with the existing rules regarding the taxation of foreign corporate partners.

Corporate limited partners in a partnership are not deemed to have nexus by reason of the partnership's activities unless certain minimal standards are met. We do believe it makes good sense to apply the same approach to corporate members of an LLC that is treated as a partnership

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[14] We note that the New York State Tax Appeals Tribunal, citing *Varrington Corporation v. Department of Finance*, 85 NY2d 28 (1995), has upheld the taxation of a foreign corporate member in an LLC taxable as a partnership having New York source income under Article 9-A. In doing so, the Tribunal rejected the corporate member's claim that it had insufficient contacts with the State because it was not subject to personal jurisdiction in New York. *Matter of Shell Gas Gathering Corp., et al*, DTA Nos. 821569 & 821570 (N.Y.S. Tax Appeals Trib., Sept. 23, 2010).

[15] *Compare* N.Y. Partnership Law § 51.1 ("a partner is co-owner with his partners of specific partnership property holding as a tenant in partnership") with N.Y. Limited Liability Company Law § 601 ("A member has no interest in specific property of the limited liability company").

for income tax purposes. One consequence of this distinction is that the nexus exception contained in the existing Article 9-A regulations for a foreign corporate partner in a portfolio investment partnership would not apply to LLCs.[16] The policies underlining the portfolio investment partnership exception apply to LLCs as well as to partnerships, and we see no reason why they should not be entitled to the same treatment. In sum, we do not believe LLC members should be subject to more rigorous nexus standards than limited partners in partnerships.[17]

We believe the Department should be able to subject to tax a managing member in all cases, except perhaps where the LLC's only connection with the State is that it meets the $1 million threshold, in which case we urge the Department to consider an additional *de minimis* threshold amount at the member level as we suggest above regarding corporate general partners. On the other hand, we recommend that the Department reconsider its draft amendments imposing nexus on all non-managing members of an LLC taxable as a partnership regardless of the nature of the membership interest and the member's involvement in the LLC's activities.

The Tax Section recognizes that the Department may have legitimate concerns regarding income earned by LLCs taxable as partnerships in the State escaping *any* New York tax. We also believe there are benefits to conformity in the State tax treatment of partnerships and LLCs that are similarly treated as pass-through entities for federal income tax purposes.

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[16] 20 NYCRR § 1-3.2(a)(6)(i).

[17] The Department has already recognized the similarity between limited partners and certain LLC members in the sales tax context. In *Technical Memorandum*, "New Policy Relating to Responsible Person Liability Under the Sales Tax Law," TSB-M-11(17)S (N.Y.S. Dep't of Taxation & Fin., Sept. 19, 2011), the Department provided similar relief from *per se* sales tax liability to both limited partners and certain LLC members who demonstrate that they are not under a duty to act on behalf of the partnership or LLC in complying with their New York sales tax obligations.

Since, except for managing members, the nature of a membership interest in an LLC may be considered more closely analogous to a limited partnership interest (which may confer nexus in certain instances) than to a general partnership interest (which usually confers nexus), one alternative approach would be to look for guidance in the existing Article 9-A regulations for when nexus is considered to exist with respect to a foreign corporate limited partner in a partnership. The existing regulations consider, among other things, whether the limited partner holds at least a one percent limited partnership interest or has a basis in the partnership for federal income tax purposes of more than $1 million.[18] A similar rule could be applied to non-managing corporate members. If the Department were to adopt nexus rules for corporate members similar to those for corporate limited partners, we would favor further conformity with the treatment of corporate limited partners by extending the election now available to certain foreign corporate limited partners to take into account for Article 9-A purposes only their distributive share of items of receipts, income, gain, loss and deduction to non-managing members of the LLC.[19]

Alternatively, the Legislature could enact legislation, modeled on the existing Tax Law provisions applicable to New York S corporations, conditioning pass-through treatment on an election by the LLC members. The existing provisions require that in order to allow New York S corporation pass-through treatment for an eligible S corporation, all of its shareholders must consent to be taxed on their New York source income from the S corporation.[20] Otherwise, the nonresident shareholders of an S corporation that conducts business in New York are not taxed on their distributive shares of S corporation income, deduction, gain or loss, and the S

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[18] *See* 20 NYCRR 1-3.2(6)(i).

[19] See 20 NYCRR 3-13.5.

[20] Tax Law § 660(a).

corporation is subject to Article 9-A. Similar legislation made applicable to LLCs taxable as partnerships for federal income tax purposes could condition New York pass-through treatment on the agreement of all the LLC's members to be taxed on their distributive shares of New York source income from the LLC.

C. Draft Sec. 1-3.2 – Foreign corporations subject to tax (receipts not considered derived from New York activities)

1. Draft Regulation

The draft amendments provide that a corporation will not be deemed to be deriving receipts from activity in New York if the only receipts included in the numerator of its apportionment fraction are:

> (i) interest income and net gains received by a corporation from securities issued by government agencies, including but not limited to securities issued by the government national mortgage association, the federal national mortgage association, the federal home loan mortgage corporation, and the small business administration, (ii) interest income from federal funds, or (iii) interest and net gains from sales of debt instruments issued by other states or their political subdivisions.

Draft Regulation § 1-3.2(f)(5).

2. Comments

The first two types of receipts referenced in (i) and (ii) of this provision are sourced using the mandatory 8% rule, pursuant to which 8% of such receipts are automatically sourced to New York. We agree that a corporation should not be deemed to be deriving receipts from activity in New York for economic nexus purposes if the only receipts included in the numerator of its apportionment fraction are sourced to New York pursuant to the mandatory 8% rule, particularly because it is questionable whether such a corporation has sufficient nexus with New York under the Due Process Clause of the U.S. Constitution to be subject to tax in New York.

The Due Process Clause requires some "minimum connection" between the state and the person, property, or transaction it seeks to tax and is concerned with the fairness of the governmental activity. Accordingly, a Due Process Clause analysis focuses on "notice" and "fair warning" and requires that an out-of-state company has purposefully directed its activities at the taxing state.[21] A corporation that sources a portion of its receipts to New York solely because of the mandatory 8% rule may not have directed any activities at New York (i.e., there is no connection between the taxpayer's New York activities or customer base and the receipts included in the numerator of its apportionment fraction).

Because of these Due Process concerns, we recommend that this provision be expanded to include *all* types of receipts that are sourced using the mandatory 8% rule, specifically: (1) interest income from asset-backed securities;[22] (2) net gains from sales of asset-based securities sold through a registered securities broker or dealer or through a licensed exchange;[23] (3) net gains from sales of corporate bonds sold through a registered securities broker or dealer or through a licensed exchange;[24] (4) interest income from reverse repurchase agreements and securities borrowing agreements;[25] (5) interest income from federal funds;[26] and (6) net gains from "other financial instruments" if the purchaser or payor is a registered securities broker or dealer or the transaction is made through a licensed exchange.[27]

We also believe the regulations should address the situation where a foreign corporation has less than $1 million of New York receipts without receipts sourced to the State under the

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[21] *See Quill v. North Dakota*, 504 U.S. 298 (1992).

[22] Tax Law § 210-A.5(a)(2)(C).

[23] *Id.*

[24] Tax Law § 210-A.5(a)(2)(D).

[25] Tax Law § 210-A.5(a)(2)(E).

[26] Tax Law § 210-A.5(a)(2)(F).

[27] Tax Law § 210-A.5(a)(2)(H)(ii).

mandatory 8% sourcing rule, but has at least $1 million of New York receipts when the mandatory 8% receipts are included. Since we assume that the mandatory 8% receipts would not otherwise constitute New York receipts under the revised apportionment provisions in Tax Law section 210-A, those receipts should not be included in determining whether the $1 million threshold is met.

D. Draft Sec. 1-3.2(a)(3) – (Impact of economic nexus determinations with respect to corporation protected under P.L. 86-272)

1. <u>Draft Regulation</u>

Draft regulation section 1-3.2(a)(3) would retain current language confirming that a corporation protected from state income tax by virtue of 15 U.S.C. sections 381-384 ("P.L. 86-272") continues to be protected from tax under Article 9-A. However, the draft regulation adds language requiring that the "receipts, net income, net gains, net losses, and net deductions, [and the protected corporation's] proportionate share of the unitary group's assets and liabilities of the protected corporation are included in the group's computations." The regulation confirms that inclusion of these amounts in the unitary group's amounts would not have the effect of subjecting the protected corporation to tax directly.

In addition, draft regulation section 1-3.2(f), which describes computations of the $1 million threshold, also contains language indicating that the receipts of a P.L. 86-272 protected corporation that meets the unitary and ownership requirements must be included in the unitary group's $1 million threshold computation. The draft reiterates that inclusion of such amounts in the unitary group's amounts would not have the effect of subjecting the protected corporation to Article 9-A directly.

Section 1-3.2(g) provides four examples that demonstrate application of the regulations to corporations that may claim the protections of P.L. 86-272 (*see* Examples (6), (7), (9), and (13)). Examples (6), (7), and (9) address eligibility for P.L. 86-272 protection; example (13) addresses the inclusion of a protected corporation's receipts in the unitary group's economic nexus threshold computation.

2. Comments

Because the New York Court of Appeals decision in *In re Disney Enterprises, Inc. v. Tax Appeals Tribunal of the State of New York*, 10 N.Y.3d 392 (2008) allows the activities of a P.L. 86-272-protected company to be included in the computation of a related taxpayer's Article 9-A tax on a combined basis, we need not comment on the constitutionality of such approach. Our comments reflect deference to that decision, though we recognize that the position could be challenged by other taxpayers in the future.

The examples in section 1-3.2(g) are helpful and we commend the Department for its continued use of examples for illustration purposes. Example (9) involves an out-of-state corporation that leases space in New York to display its wares "occasionally" and for "short terms" of time. The example concludes that the corporation has exceeded the protections of P.L. 86-272. We recommend that the Department also include an example where a foreign corporation's non-solicitation activities would be considered *de minimis* and therefore not invalidate P.L. 86-272 protection.

Finally, example (13) addresses the scenario when a unitary group of corporations does not meet the $1 million threshold but for one or more unitary affiliates that are protected by P.L. 86-272. While this example is helpful, we recommend that the Department also include an

example wherein the vast majority of the group's receipts comprising the $1 million threshold come from a P.L. 86-272 protected unitary affiliate. For example, where a P.L. 86-272 protected corporation has more than $1 million in New York receipts, but all other unitary group members in total have less than $50,000 in New York receipts, it would be reasonable to conclude that the *de minimis* amount of New York receipts of the other unitary group members should not cause the $1 million threshold to be triggered for the unitary group.

E. Draft Sec. 1-3.3 — Activities Deemed Insufficient to Subject Foreign Corporations to Tax

1. Draft Regulation

Both the current and prior iterations of Article 9-A include a list of connections and activities within New York State that will not cause a foreign corporation or an alien (*i.e.*, non-U.S.) corporation to be subject to tax. *See* Tax Law sections 209.2 and 209.2-a, respectively, both before and after the 2014 corporate tax reform amendments. The current version of regulation section 1-3.3 tracks and amplifies the pre-reform provisions, and the draft amendments are intended to conform the regulatory language to the amended statute.

2. Comments

Among other conforming changes, the draft amendments would, consistent with the amended statute, delete section 1-3.3(a)(6) which contains the "fulfillment services" exemption. The remaining subdivisions are renumbered. We recommend that the Department refrain from renumbering the remaining subdivisions to make research and citation easier and more consistent for the Department, taxpayers and tax practitioners. This can easily be accomplished by inserting "(Reserved)" or "(Deleted)" under subsection (6).

The draft amendments also include a new regulation section 1-3.3(b)(2) to conform to the new statutory rules regarding the application of Article 9-A to alien corporations. Draft

regulation 1-3.3(b)(2) states that an alien corporation will not be subject to the tax unless it is treated as a "domestic corporation" under IRC section 7701 (*e.g.*, a "stapled-stock" entity, or a corporation treated as a domestic corporation under the inversion rules of IRC section 7874(b)), or if it has "effectively connected income" for the taxable year. Although we agree with the scope of this amendment, we believe the proposal can be made clearer in the following respects.

First, the use of the IRC definition of "domestic corporation" in Regulation section 1-3.3(b)(2)(i) may be confusing. The regulations already define a "domestic corporation" in section 1-2.5(a)(2): "The term domestic corporation means a corporation incorporated by or under the laws of the State or colony of New York State." The IRC section 7701(a)(3) and (4) definition of a "domestic corporation" -- to which the amended statute refers -- is far more expansive and encompasses all corporations created in, or under the laws of, the United States. Further, even a corporation formed outside of the United States may be treated as a domestic corporation for federal income tax purposes in certain circumstances. Thus, the amendments would introduce inconsistent definitions of the term "domestic corporation" into the regulations.

The Legislature undoubtedly intended that non-U.S. corporations that are treated as "domestic corporations" for federal purposes be treated as non-alien foreign corporations and not as New York domestic corporations for purposes of Article 9-A. A statement at the end of the proposed subdivision clarifying this point would be helpful to avoid confusion.

We also recommend that draft regulation section 1-3.3(b)(2)(ii) include a cross reference to the IRC section 882 definition of "effectively connected income" ("ECI"). It should also include language clarifying that ECI is income from a trade or business activity conducted *anywhere* in the United States, and is not limited to New York, which we assume is what the Department intends.

The following replacement language is suggested:

> (ii) it has during the tax year income that is effectively connected with the conduct of a trade or business anywhere within the United States as determined under section 882 of the Internal Revenue Code.