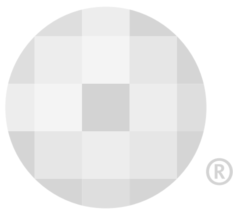
New, New York Group Reporting Rules: Substantial Intercorporate Transactions May Give Corporate Taxpayers a "New York State of Mind"

By Giles Sutton, Jamie C. Yesnowitz and Elizabeth Winchester

Giles Sutton, Jamie Yesnowitz and Elizabeth Winchester discuss New York's combined reporting requirements for related corporations, which apply to tax years beginning on or after January 1, 2007. They describe the 10-step analysis taxpayers must perform to determine if combined reporting is required, and if so, which corporations must be included.



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Introduction

In 2007, New York took steps to "fine-tune" its rules regarding the applicability of group filing for purposes of its corporation franchise tax. Section 211 of the New York Tax Law (the "Tax Law") was revised in an effort to give a level of certainty as to when combined reporting is required, and such revision addresses a long line of controversies that have been heard by the New York State Division of Tax Appeals and the Tax Appeals Tribunal[1] on this subject. Although regulations to further explain the statutory changes are still forthcoming, the Technical Services Bureau of the New York State Department of Taxation and Finance (the "Department") has provided some insight into their interpretation of the revised statute through two recent technical releases.[2] It appears that the law change, as well as the Department's interpretation of this change, moves New York from a separate reporting method with discretion to use combination, to a method closer to a true combined reporting state. In addition, since this law change has not been adopted for purposes of the New York City general corporation tax, corpora-

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tions may find themselves with divergent New York State and New York City corporate tax filings.

Historical Background

Prior to the 2007 amendment, for corporation franchise tax purposes, the Tax Law allowed either the taxpayer to elect, or the Department to force, combined reporting if certain criteria were satisfied.[3] A regulation expanded upon these criteria by outlining three specific conditions that must be met.[4] First, the corporations to be combined must be related through direct or indirect ownership of at least 80 percent.[5] Second, the corporations to be combined must also be engaged in a unitary business.[6] The third condition requires that by filing on a separate basis, the activities, business, income or capital of the taxpayers in New York is distorted. Distortion was presumed to occur if there are "substantial intercorporate transactions among the corporations."[7] Over the past few decades, the third condition has been the most debated and one the Department is specifically addressing in its latest technical guidance.[8]

> The 2008 Memo makes clear that while the statute adopting the substantial intercorporate transaction test is a qualitative facts and circumstances test, there are several quantitative measures that the Department will use to make a determination that the substantial intercorporate transaction test has been met.

The presumption of distortion due to significant intercompany transactions is rooted in the idea that, potentially, such transactions between related parties may not equitably reflect income reported to New York State. If one party's benefit from an intercompany transaction exceeded what it would receive in an open marketplace, the only way to counter this advantage was either to consolidate or combine the related parties, thereby eliminating the transaction, or to make applicable adjustments. Since the Tax Law and related Regulations did not stipulate what "substantial intercorporate transactions" entailed, this concept was open to interpretation. In 1992, the New York Tax Appeals Tribunal determined that transactions between related parties that were carried out at arm's-length did not distort either party's activities.[9] The arm's-length transactions were supported by a reasonable formula methodology that was consistently applied and documented over the course of several years, successfully rebutting the Department's attempt at forced combination. The arm's-length argument was further supported in 1996 when the Tribunal found in favor of Silver King Broadcasting of New Jersey.[10] Silver King collected a five-percent commission from a related brother-sister party for which there was no written contract. The Tribunal found that, based on similar industry transactions, the agreed upon commission rate constituted an arm's-length transaction even without documentation of the agreement. The Department could not show that Silver King's income was distorted through any particular activities or transactions, so Silver King was not forced to file a combined report. Thus, a precedent was set that distortion could be avoided through arm's-length transactions and that, depending on the circumstances, the burden of proof could fall on the Department rather than the taxpayer.

Although *Silver King* established that the taxpayer's arm's-length methodology did not need to be documented outright to be valid, the Tribunal has found that a reasonable basis must be present and consistently utilized. In *Tropicana Products Sales, Inc.,* tests of the taxpayer's methodologies were performed subsequent to a Notice of Deficiency submitted by the Department.[11] Since no formal documentation existed, these tests were applied in an attempt to provide a framework for the methodologies of the taxpayer's intercompany transactions. The Tribunal found that the tests could not be relied upon to prove that the transactions were made at arm's-length because of the means used to perform them. The burden of proof as to whether or not the transactions were actually made at arm's-length fell upon the taxpayer. In *Tropicana,* the expert used to perform the analysis could neither adequately defend his choices for testing, nor support the taxpayer's methodologies.

In a recent matter dealing with this topic, the Tribunal clarified its decision in *Tropicana*. In *Hallmark Marketing Corp.,*[12] the Tribunal found that Hallmark diligently made an effort to abide by prior court decisions, which in turn fulfilled their burden of "rebutting the presumption of distortion." Hallmark engaged unrelated experts to perform tests of their transactions and supply documentation that the methodologies employed by the taxpayer provided for arm's-length

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treatment. The burden of proof of distortion then fell to the Department. Despite voluminous documentation, the Tribunal found that the Department did not adequately find fault in the taxpayer's methodologies, nor did it find any specific instances of distortion that would require a combined report to be filed. With the Tribunal finding in favor of the taxpayer, Hallmark further established that, ***prior to the amendment of the Tax Law***, that the state's arguments pertaining to the distortion of activities, business, income or capital could be defeated by proving the arm's-length nature of the transactions in question.

Statutory Changes

The budget adopted by the New York State legislature and signed by former New York Governor Eliot Spitzer on April 1, 2007, will have an immediate impact on corporate taxpayers. Among other changes, the new budget for the 2007-2008 fiscal year included revisions to the combined reporting requirements for related corporations. This new legislation applies to tax years beginning on or after January 1, 2007.

Historically, as discussed above, the Department could not force combined reporting for a group of related corporations in situations where the taxpayer was able to show that the intercompany transactions were performed at arm's-length. In contrast, the new legislation no longer allows the transfer price to be taken into consideration when determining if a forced combination is necessary: Specifically, related corporations "shall make a combined report covering any related corporations if there are substantial intercorporate transactions among the related corporations, *regardless of the transfer price for such intercorporate transactions.*"[13] After years of litigation, the precedent most recently set in *Hallmark* no longer applies.

Another striking change in the newly worded Tax Law is the removal of the language "in the discretion of the commissioner" at the beginning of N.Y. Tax Law §211.4(a). This change puts a greater importance on the responsibility of the taxpayer to determine if the forced combination requirement applies, rather than leaving the burden of making such a determination on the Department. Remaining in the statute is a general provision allowing the Department discretion to require a combined report if the Department deems such a report necessary due to intercompany transactions or an agreement, understanding, arrangement or transaction resulting in an inaccurate or improper reflection of the taxpayer's activity, business, income or capital in New York State, in order to properly reflect the taxpayer's tax liability.[14] As a result, taxpayers must wade through the vague language of the Tax Law to determine if a combined report is required. However, even if the taxpayer finds that a combined report is not required under the facial provisions of the new statute, the Department may, nonetheless, require a combined report under the independent, historic, "proper reflection" language if the Department deems such a report necessary.

Perhaps the most important element of the new legislation is the attempt at identifying the types of transactions that will be examined in the context of measuring "substantial intercompany transactions."[15] These activities include, but are not limited to: (i) manufacturing, acquiring goods or property, or performing services for related corporations; (ii) selling goods acquired from related corporations; (iii) financing sales of related corporations; (iv) performing related customer services using common facilities and employees for related corporations; (v) incurring expenses that benefit, directly or indirectly, one or more related corporations; and (vi) transferring assets, including accounts receivable, patents or trademarks, from one or more related corporations.[16] "Substantial" being a relative term, the Tax Law emphasizes this language without providing any quantitative sense of what it will be held to mean.[17] As discussed below, the Department has spent significant time and effort in addressing this issue in technical guidance.

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The Department's Technical Guidance

Regulations specifying the details of the application of the new legislation are to be available in the future, but in the interim, the Department's Technical Service Bureau has published two Corporation Tax Memoranda in an effort to assist taxpayers (referenced in this article as the "2007 Memo" and the "2008 Memo," respectively).[18] While the 2008 Memo issued by the Department begins to flesh out some of the issues raised by the legislation, there clearly are areas of continued uncertainty.[19] The issuance date of the 2008 Memo is relevant in that the 2008 Memo is retroactively effective for tax years beginning on or after January 1, 2007.[20]

In superseding the 2007 Memo, the 2008 Memo intends to: (1) define what constitutes a substantial intercompany asset transfer; (2) identify items excluded when determining the necessary amounts to determine whether the taxpayer has substantial intercorporate receipts or substantial intercorporate expenditures; (3) provide new information relating to combined reporting of real estate investment trusts (REITs), regulated investment companies (RICs), and insurance companies subject to Article 33 of the Tax Law; and (4) clarify an example provided in the 2007 Memo.[21]

Defining Intercorporate Terms of Art

The 2008 Memo defines key terms that are used in the Tax Law to assist the taxpayer in applying the new legislation. The definition of "related corporation" is no different from that found in an existing Department regulation: requiring that at least 80 percent of the capital stock of a corporation is owned or controlled, directly or indirectly.[22] The more important definition included in the 2008 Memo is for the term "substantial intercorporate transactions," which had been absent from the previous Tax Law and Regulations. The 2008 Memo makes clear that while the statute adopting the substantial intercorporate transaction test is a qualitative facts and circumstances test, there are several quantitative measures that the Department will use to make a determination that the substantial intercorporate transaction test has been met. These objective tests relate to: (i) intercorporate receipts; (ii) intercorporate expenditures; and (iii) intercorporate transfers of assets.[23]

Related Corporation

Under the 2008 Memo, a "related corporation" means: (1) any corporation substantially all the capital stock of which is owned or controlled either directly or indirectly by the taxpayer; (2) any corporation that owns or controls, directly or indirectly, substantially all the capital stock of the taxpayer; and (3) any corporation the capital stock of which is owned or controlled, directly or indirectly, by interests that own or control, directly or indirectly, substantially all the capital stock of the taxpayer.[24] Although the term "taxpayer" is not defined in the 2008 Memo, under the Tax Law, a "taxpayer" is defined as a corporation subject to Article 9-A of the Tax Law (the corporation franchise tax).[25]

Items Included in and Excluded from the Calculations

The first consideration to be reviewed by a taxpayer is to determine which items are considered in the calculations. Materiality and economic substance of all intercompany transactions are considered, as well as whether the transactions were influenced by the taxpayer's desire to affect the membership of the combined group.[26] Each year, similar transactions should be treated in a consistent manner.[27] Each of the three types of intercorporate transactions is tested separately to determine if "substantial" transactions are present.

Substantial Intercorporate Transactions

The 2008 Memo overlays the analysis of intercompany transactions with a "facts and circumstances" test of *all* activities and transactions between related *corporations* and the taxpayer.[28] The 2008 Memo illustrates the type of transactions to be examined, specifically:

- manufacturing, acquiring goods or property, or performing services for related corporations;
- selling goods acquired from related corporations;
- financing sales of related corporations;
- performing related customer services using common facilities and employees for common customers of the related corporations;
- incurring expenses that benefit, directly or indirectly, one or more related corporations; and
- transferring assets, including accounts receivable, patents or trademarks from one or more related corporations.[29]

As can been seen, the scope of what constitutes an "intercorporate transaction" is quite broad. It should be noted, however, that dividends are not considered in the determination of whether substantial intercompany transactions are present.[30] Further, in general, loans and interest between related corporations are also considered in determining if there are substantial intercorporate transactions.[31]

Substantial Intercompany Receipts and Expenditures

If at least 50 percent of a corporation's ***recurring*** receipts and/or expenditures (including expenditures for inventory), are from one or more related corporations, the requirement for substantial intercorporate transactions will automatically be met.[32] In addition, if expenditures incurred by a corporation directly or indirectly benefit a related

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corporation, they must be considered for these purposes.[33] However, if any of these transactions make up between 45 and 55 percent of the corporation's recurring receipts and/or expenditures, a ***multi-year test*** must be performed to determine whether the 50-percent threshold has been reached.[34]

Multi-Year Test

In situations where, in a particular tax year, a corporation's intercorporate receipts or expenditures during the tax year are between 45 and 55 percent, then the ***substantial intercompany transactions*** requirement will be met where 50 percent or more of a corporation's total receipts or expenditures, included in the computation of ***entire net income***[35] (excluding nonrecurring items), during the tax year and the prior two tax years, in aggregate, are from one or more related corporations.[36] It is important to note that the multi-year test analyzes the current tax year, as well as the prior two tax years, to determine if the substantial intercorporate transaction requirement is met.[37] If 50 percent of a corporation's receipts and/or expenditures are from one or more related corporations for those three ***aggregated periods***, than the requirement will be met.[38] If a corporation involved in the transaction(s) did not exist for the prior two tax years, the test must be computed using the number of months that the corporation did exist.[39]

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Substantial Intercompany Transfers of Assets

The third type of transaction which needs to be analyzed is the "substantial" transfer of assets to a related corporation (including through incorporation). In the 2008 Memo, the Department made radical changes to previously issued guidance on this topic in the 2007 Memo.[40] Pursuant to the 2008 Memo, a transfer of assets to a related corporation satisfies the substantial intercompany transactions requirement if the corporations are engaged in a unitary business, and 20 percent or more of the transferee's gross income, including dividends received, is derived directly from the transferred assets.[41] Only assets transferred to the transferee for stock or paid-in-capital of the transferee are counted for purposes of the 20-percent test.[42] Transfers of cash to another corporation for stock or paid-in capital are not counted for purposes of the 20-percent test.[43] In line with the January 1, 2007 effective date of the combined reporting legislation, the effective date for this test is for assets transferred on or after January 1, 2007.[44] Note that since the actual or stated value of the assets transferred is not used to determine if the substantial intercorporate asset transfer test has been met, the substantial intercompany transfer of assets test is an "income generation" test, not an "asset value" test.

For purposes of this test, taxpayers must first divide the portion of gross income (including dividends received) for a tax year that is derived directly from the transferred assets by the transferee's gross income (including any dividends received) for the tax year.[45] If, in the tax year of the transfer, and for tax years subsequent to the transfer, 20 percent or more of the transferee's gross income is from the transferred asset(s), the "substantial intercorporate transaction" test will be deemed satisfied.[46] As such, it is important to note that the intercompany asset test is used to determine intercompany receipts.

The Duration of the Asset Transfer Test

The period subject to the "intercorporate asset transfer test" includes each tax year in which an asset could be depreciated or amortized, regardless of whether the actual recovery period for depreciation or amortization was reduced or disallowed as a result of the transfer.[47] If no depreciation or amortization recovery period exists, the asset is included in the test for the length of time the asset is reflected on the transferee's books and records.[48] Finally, there is a "distortion" rule embedded within the test. If the gross income computed by the taxpayer for purposes of the test does not "properly reflect" the income of the taxpayer because of certain items of income or expense that have a "distortionary" effect on gross income, then the Department can adjust gross income to "accurately reflect" the "proper" amount of gross income.[49]

When Is Income Derived from a Transferred Asset?

Gross income is deemed to be derived from a transferred asset if the asset, as actually used by the transferee, directly produces income. Assets which, depending on how they are utilized, may be deemed to directly produce income include: (1) intangibles (patents, copyrights and trademarks); (2) real property; and (3) accounts receivable.[50] Gross income from transferred assets that generate income only when ***used in combination with other***

assets is not considered to be "directly derived" from transferred assets.[51] Further, income earned from *income* produced by a transferred asset is ***not*** considered to be derived from the transferred asset.[52] Certain examples are provided to apply these principles:

- A corporation transfers a lathe to another related corporation, income from selling products made by the lathe, which is one machine among many on a production line, is not considered to be income directly from the lathe.[53]
  - The answer is the same even if all the assets on the production line were transferred.
  - However, if the transferee sells equipment transferred, any gain on the sale of such equipment is considered to be directly derived from the transferred asset.[54]
- Rental income derived from a transferred asset ***is*** considered income derived directly derived from a transferred asset.[55]
- If a transferred patent is used by the transferee in its production process, income from the sale of items produced by that production process ***is not*** gross income derived directly from the transferred patent. Note, however, if the transferee sells the patent, any gain on the sale of the patent is gross income derived directly from the patent.[56]

Further, there are other unique rules pertaining to transferred assets. For example, if the asset transferred is an ownership interest in another asset, any income distributed to the transferee as a result of the transference of the ownership interest is income derived directly from the transferred asset.[57] Also, if more than one asset is transferred to a related corporation, the gross income test will be computed using the combined gross income derived "directly" from all transferred assets.[58]

When Does a Series of Transactions Constitute an Asset Transfer?

Whether any transfer of assets in exchange for stock or paid-in-capital constitutes a "substantial intercorporate asset transfer" will depend on the facts and circumstances of the transaction.[59] Gross income that is distorted by certain items of income or expense can be adjusted by the Department for purposes of the asset transfer test to accurately reflect the value of the gross income. The Department appears to be relying on step transaction and economic substance principles in making such determinations.[60]

Other Considerations Regarding Intercorporate Transactions

In determining whether the "substantial intercorporate transactions" requirement has been met, the Department will consider the materiality of the transactions.[61] Further, for purposes of determining whether there have been "substantial intercorporate transactions," economic substance, and the motivation of the taxpayer in undertaking the transaction will be taken into account.[62] In addition, there is a requirement that transactions be treated consistently from year to year.[63] However, it is important to note that ***service functions*** are not considered in determining whether there are substantial intercorporate transactions ***when the service functions are incidental to the business of the corporation providing such services***.[64] The 2008 Memo delineates services covered such as, but not limited to, accounting, legal and personal services.[65]

The 10-Step Analysis to Determine Combination

In addition to defining terms, the 2008 Memo describes the 10-step process necessary to determine if a combined report is required, and if so, which corporations must be included. It should be noted that many of the steps themselves contain multiple steps. As such, the phrase "10-Step Analysis" may be a euphemism for what appears to be an even more comprehensive process. The mechanics of each step is described below:

1. Each corporation must identify the corporations to which *it* is related, using the 80-percent direct or indirect capital stock ownership or control test.[66] When one or more related corporations are *taxpayers*, all the corporations related to such *taxpayers* must be identified.[67] Repeat this process in an iterative manner until all related corporations have been identified.[68] Taxpayers with no related corporations must file on a separate basis.[69] Completion of this process determines the "Step 1 group of related taxpayers,"[70] which represents the largest possible group that could be affected by the forced combination reporting rules.
2. Identify all of the *related corporations* that have *substantial* intercorporate transactions with any taxpayer identified in step 1. These *related corporations* and *taxpayers* constitute the "Step 2 tentative combined group."[71] In practice, the Step 2 tentative combined group will generally

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be substantially smaller than the group from the first step.

3. Add to the "Step 2 tentative combined group" every related corporation that has "substantial intercorporate transactions" with any *corporation* identified in Step 2. The result of this process is the "Step 3 tentative combined reporting group.[72]
4. Add to the "Step 3 tentative combined reporting group" every *related corporation* that has *substantial intercorporate transactions* with *any* corporation identified in Step 3. The process is repeated until repeating the process would add no more *corporations* to the group. The resulting group constitutes the "Step 4 tentative combined group."[73] Depending on how many times this must be done, the size of the group could increase considerably.
5. Identify each *related corporation* not in the "Step 4 combined group" that has *substantial intercorporate transactions* with another *related corporation* not in the "Step 4 tentative combined group." These resultant groups should be compared and then combined into one group with common members.[74] The 2008 Memo under Step 5 designates the name "unattached related group" to this combined group, and notes that there may be more than one unattached related group.[75]
6. If there are *substantial intercorporate transactions* between any *one corporation* in an "unattached related group" and the "Step 4 tentative combined group," then all corporations in that unattached related group are included in the combined group. This process must be repeated for each unattached related group. As each unattached related group is included in the combined group as a result of this process, the "substantial intercorporate transaction" analysis must be repeated for the newly expanded "combined group" and each, still to this point, unattached related group. The result of this iterative process is the "Step 6 tentative combined group."[76]
7. If there are *substantial intercorporate transactions* between any *one corporation* in the "Step 6 tentative combined group" and an unattached related group,[77] then all *corporations* in the *unattached related group* are included in the combined group. This process must be repeated for each *unattached related group.* As unattached related groups are added to the combined group, this analysis must be repeated between the expanded group and each *unattached related group.* The resulting group is the "Step 7 tentative combined group."[78]
8. Add to the "Step 7 tentative combined group" each related corporation that has *substantial intercorporate transactions* with the "Step 7 tentative combined group."[79]
9. Repeat the processes set forth on Steps 4, 6, 7 and 8 *until no more corporations can be added to the "tentative combined group."*[80]
10. Eliminate from the "tentative combined group" those corporations that are formed under the laws of another country (alien corporations),[81] corporations that are taxable pursuant to a different article of the Tax Law (or would be taxable under a different Article if subject to tax),[82] ***and*** corporations that compute their business allocation percentage using a statutory method that is different from the taxpayer's method.[83] REITs and RICs are also eliminated from the tentative combined group, unless the REIT or RIC is required to file a combined report under N.Y. Tax Law §§209.5 or 209.7 with a taxpayer that is required to be included in tentative combined group. If two or more like corporations are eliminated, it is possible that such corporations will constitute a combined group if they have substantial intercorporate transactions.[84]

It is important to note, however, that the "substantial intercorporate transactions" to be evaluated in the 10-Step Analysis do not necessarily need to take place between each of the related corporations for combined reporting to be imposed by the Department. As noted earlier, the Department could require (or permit) combined reporting where substantial intercorporate transactions do not exist, where a combined report is necessary to properly reflect tax liability due to intercompany transactions or other agreement, understanding, arrangement or transaction.[85]

Comments Regarding the Application of the New Combined Reporting Rules

The application of these new combined reporting rules is based on control (the stock ownership test) and a convoluted examination of the amount, type and location of intercorporate transactions within the related party group. Traditional unitary "flow of value" or "contribution and dependency" concepts are not utilized. Further, the formal required analysis is backstopped by discretionary authority in the hands of the Department to require a combined report to "properly

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reflect" a taxpayer's liability. However, it appears from the language of the 2008 Memo that such discretionary authority can only be used in situations where intercompany transactions or an agreement, understanding, arrangement or transaction has caused the taxpayer to improperly reflect its New York tax liability.[86] There appear to be many traps for the unwary within these rules, and as such, practitioners should ensure that they understand the following issues:

- Key definitional terms such as:
  - related corporation;
  - taxpayer;
  - substantial intercorporate transactions:
    - substantial intercorporate receipts;
    - substantial intercorporate expenditures;
    - substantial intercorporate asset transfers;
- when gross income is deemed to be derived directly from an asset transfer;
- the application and mechanics of the multi-year test;
- what intercompany service transactions are excluded from the analysis; and
- how to apply these terms in the context of a discretionary, equitable analysis (business purpose, economic substance, clear reflection of income and step transactions).

It appears that intent of the 10-Step Analysis is to ensure that entities that are not contributing to business done in New York are not included in the income and apportionment factors of the ultimate New York combined group. This approach does not reflect traditional mandatory combined reporting. In contrast, the multi-step iterative intercorporate transaction tests are intended to reach every related corporate entity that is economically important to the taxpayer doing business in New York. Thus, it creates a novel approach that can ensure a broad reach from a tax base perspective without unwanted factor dilution. Further, note the language used in the 10-Step Analysis is geared towards corporations and may prove difficult to apply to partnership structures owned by corporate groups. Finally, the 2008 Memo provides seven examples pertaining to the application of the 10-Step Analysis.[87] The examples are helpful in illustrating the application of the 10-Step Analysis, but are not always easy to work through.

Looking Forward

New York State appears to have accomplished several objectives through the amendment of N.Y. Tax Law §211.4. The Department looks to reduce the strain on their resources in fighting combination cases and to provide more certainty to taxpayers in determining when a corporate group must be combined. Also, many techniques have been used by corporations to isolate related entities as a way of reducing their overall state tax liability, and the Department is attempting to eliminate these opportunities. This last point would appear to be the driving force behind the change, as the timing was suspiciously close to the taxpayer-favorable ruling in *Hallmark*. While ample time on both sides has been spent debating the ambiguities of the prior version of the Tax Law, it seems unlikely that the amendment will lighten anyone's load significantly. Taxpayers will be forced to undertake additional work to determine the correctness of their reporting group and possibly assemble a different combined group from what they use for other state filings. The Department will likely increase their scrutiny when auditing corporations due to the additional documentation necessary to fully comply with the changes. The Department may even find that the new changes create additional requests for administrative ruling requests as taxpayers attempt to make sense of the still somewhat vague statute or look for other ways to "plan" around it. It seems likely that arguments over whether affiliates are engaged in a unitary business will increase significantly as well.

The newly enacted legislation in New York creates a significant administrative burden for many taxpayers. Even seemingly simple groups of corporations may find that their required group for New York tax purposes is entirely different from that used for their federal or other state returns. This may be particularly difficult for taxpayers who also file in New York City, which, as of yet, has not decided to follow the Tax Law. Until the amendment, the New York City combined group rules were generally the same as those governing New York State, easing the burden of most taxpayers. Now corporations could have entirely different tax results for purposes of their New York State and New York City corporate tax returns.

Taxpayers engaging in intercompany transactions may have had greater assurance taking the position of filing on a separate basis in tax years prior to 2007, since documented, reliable transfer pricing studies substantiated the position. Depending on the substance of these transactions, they will likely no longer be able to take such a position under the new legislation. For some, this change may have a

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significant state income tax impact. In addition, depending on how well internal records are maintained, the task of interpreting the tests and steps outlined in the 2008 Memo could be overwhelming. Many taxpayers may not be fully aware of the impact these interpretations will have on them. Due to the potential enormity of this task, not every taxpayer will vigilantly follow the steps for determining whether substantial intercorporate transactions exist, or what corporations comprise the combined reporting group. It is yet to be seen how these issues will be handled by the Department.

As the filing deadline for the 2007 tax reports for calendar year taxpayers has passed, the guidance provided in the Department's memoranda may prove to be less effective than the Department intended. The most immediate impact has already been felt as taxpayers attempted to determine their 2007 tax liabilities for extension purposes. It is likely that some taxpayers did not take the amended statute and Department interpretations into consideration when making estimated payments for the third and fourth quarters. For many taxpayers, determining their anticipated liability under the new law before the initial filing deadline was very difficult, and ultimately may result in imposition of the underpayment penalty and interest applicable when the New York corporation franchise tax returns are completed on extension and the actual liability is determined.

Perhaps when the anticipated regulations are finally released by the Department, such regulations will provide further clarification and some of the burdens felt by taxpayers will be reduced. Until then, taxpayers should prepare to spend extra time and effort in determining their combined group posture in New York.

Endnotes

* The views expressed in this article are those of the authors and do not necessarily reflect the views of any organization or firm with which the authors are associated.

[1] The New York State Division of Tax Appeals is a two-tiered, independent and impartial administrative body designed to resolve tax and licensing disputes. At the lower tier, administrative law judges adjudicate controversies between taxpayers and the New York State Department of Taxation and Finance. Decisions by the administrative law judges may be appealed to the New York State Tax Appeals Tribunal. While decisions of the Tax Appeals Tribunal are final and binding on the Department, taxpayers may appeal adverse Tribunal determinations to the New York State Appellate Division's Third Department of the New York State Supreme Court. The Division of Tax Appeals' Web site is *www.nysdta.org.*

[2] New York State Department of Taxation and Finance, TSB-M-07(6)C (June 25, 2007), as modified by TSB-M-08(2)C (March 3, 2008).

[3] N.Y. Tax Law §211.4(a).

[4] N.Y. Comp. Codes R. & Regs. tit. 20, §6-2.1.

[5] N.Y. Comp. Codes R. & Regs. tit. 20, §6-2.2(a).

[6] N.Y. Comp. Codes R. & Regs. tit. 20, §6-2.2(b). The unitary business determination is based on a review of whether the activities engaged in by a corporation are related to the activities of other corporations in the group, and whether the corporation is engaged in the same or related lines of business as the other corporations in the group.

[7] N.Y. Comp. Codes R. & Regs. tit. 20, §6-2.3(a).

[8] See the heading "Statutory Changes" of this article, *infra,* for a discussion of the Department's latest technical guidance in TSB-M-07(6)C (June 25, 2007) and TSB-M-08(2)C (March 3, 2008).

[9] *Standard Mfg. Co.,* New York Division of Tax Appeals, Tax Appeals Tribunal, DTA No. 801415, Feb. 6, 1992.

[10] *Silver King Broadcasting of N.J., Inc.,* New York Division of Tax Appeals, Tax Appeals Tribunal, DTA No. 812589, May 9, 1996.

[11] *Tropicana Products Sales, Inc.*, New York Division of Tax Appeals, Tax Appeals Tribunal, DTA Nos. 815253 and 815564, June 12, 2000.

[12] *Hallmark Marketing Corp.,* New York Division of Tax Appeals, Tax Appeals Tribunal, DTA No. 819956, July 19, 2007.

[13] N.Y. Tax Law §211.4(a) (emphasis added).

[14] N.Y. Tax Law §211.4(a)(4), (5).

[15] N.Y. Tax Law §211.4(a).

[16] *Id.*

[17] While the statute does not define this term, the definition of "substantial intercorporate transactions" has been provided in TSB-M-08(2)C, discussed below, under its definition of "key terms."

[18] New York State Department of Taxation and Finance, TSB-M-07(6)C (June 25, 2007) ("2007 Memo"), as modified by TSB-M-08(2)C (March 3, 2008) ("2008 Memo"). By its terms, TSB-M-08(2)C supersedes and replaces TSB-M-07(6)C.

[19] This level of uncertainty is shown by the fact that the 2008 Memo contained significant changes from the 2007 Memo. For example, the substantial intercompany transaction calculation contained in the 2007 Memo was changed considerably in the 2008 Memo, issued just two weeks prior to the 2007 New York corporation franchise tax filing deadline, as the test to determine when substantial intercompany transfer of assets exist was revamped, The substantial intercompany transfer of assets test was changed from a test looking at whether the asset transfer constitutes 10 percent of the total assets of either the transferor or transferee, to a test focusing on whether such transfer constitutes 20 percent of the transferee's gross income (as discussed below).

[20] 2008 Memo at 1.

[21] *Id.*

[22] Pursuant to N.Y. Comp. Codes R. & Regs. tit. 20, §6-2.2(a).

[23] 2008 Memo at 2.

[24] 2008 Memo at 1-2.

[25] N.Y. Tax Law §208.2. Further, to be a taxpayer subject to Article 9-A, the corporation must have nexus with New York.

[26] 2008 Memo at 5.

[27] *Id.*

[28] 2008 Memo at 2.

[29] *Id.*

[30] 2008 Memo at 2. Note, however, that as discussed below, dividends received will be considered for purposes of the 20- percent gross income test in determining whether there has been a substantial intercorporate asset transfer.

[31] *Id.* However, if the intercorporate note in question constitutes subsidiary capital under N.Y. Tax Law §208.4, the interest paid or received on such loan does not constitute an intercorporate transaction.

[32] 2008 Memo at 2.

[33] 2008 Memo at 3. It is important to understand that this rule does not look to the

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volume of intercompany transactions but, instead, at transactions that *benefit* another corporation. Further, the value of this "benefit" is measured at both ends. Specifically, the test is met if the amount of these transactions equals 50 percent or more of the benefactor's expenditures, or conversely, 50 percent or more of the beneficiary corporation's direct or indirect expenditures. The term "direct or indirect expenditures" is not defined in the 2008 Memo,

[34] 2008 Memo at 2-3.

[35] The term "entire net income" is defined as total net income from all sources, which is presumably the same amount required to be reported for federal purposes (or would have been required to be reported if not an S corporation or other exempt entity), subject to various modifications and exclusions. N.Y. Tax Law §208.9.

[36] 2008 Memo at 3.

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] In the 2007 Memo, the Department created a test based on the total assets of either the related-party transferor or transferee. If the parties involved in the transfer were engaged in a unitary business and the transferred assets constituted 10 percent or more of either party's total assets at the time of the transfer, the transaction would have been considered substantial. 2007 Memo at 4. In addition, if at least 50 percent of the transferee's income in subsequent years resulted from the transferred asset(s), the substantial intercorporate transaction requirement would have been considered to have been met. If the transferred assets were real and personal property and/or intangible property that is not self-created, the valuation would be determined in accordance with the rules applicable to the New York capital base tax.

[41] The 2008 Memo does not define a unitary business, or how to determine if dividends are directly or indirectly derived from transferred assets. As discussed above, *see* N.Y. Comp. Codes R. & Regs. tit. 20, §6-2.2(b), which defines the term "unitary business." Note for Code Sec. 351 transaction, the determination of whether a substantial intercompany transfer of assets has taken place should be fairly straight-forward. Further, only assets transferred in exchange for stock or accounted for as additional paid-in-capital of the transferee are taken into account for purposes of this test.

[42] 2008 Memo at 3.

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] 2008 Memo at 3-4.

[47] 2008 Memo at 4. For example, an asset with a 15-year amortization period that is transferred must be included in the test for each tax year within that period. The result can be a significant amount of testing and recordkeeping. Assets not subject to depreciation or amortization, such as accounts receivable, would be included in the test for the length of time such assets are reflected on the transferee's books and records. *Id.* Note that for purposes of this test, "gross income" is defined under Code Sec. 61. *Id.*

[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] *Id.*

[54] *Id.* No guidance is provided on the netting of gains and losses for the disposition of related party asset transfers.

[55] 2008 Memo at 5. In contrast, if the rental income is deposited into an interest-bearing bank account, the interest is not considered to be income directly derived from the transferred asset. *Id.*

[56] *Id.* Again, no guidance is provided regarding the netting of post-transfer disposition gains and losses.

[57] *Id.*

[58] *Id.*

[59] *Id.*

[60] *Id.*

[61] *Id.* Note that neither the statute nor the 2008 Memo provide a definition of "materiality."

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *Id.* Note, however, that none of these terms are further defined in the Memo.

[66] 2008 Memo at 6; N.Y. Comp. Codes R. & Regs. tit. 20, §6-2.2(a)(2). As noted above, the definition of related corporation incorporates a "substantially all" test that is satisfied by an 80-percent ownership or control test.

[67] *Id.* Again, the term taxpayer is defined in N.Y. Tax Law §208.2.

[68] *Id.*

[69] *Id.*

[70] *Id.*

[71] *Id.*

[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] *Id.* Note that Step 5, which determines unattached related groups, does not result in the creation of a "Step 5 tentative combined group."

[76] *Id.*

[77] Note that in an example explaining the operation of Step 7 contained in the 2008 Memo, the phrase "unattached unrelated group" is used instead of "unattached related group."

[78] *Id.*

[79] *Id.*

[80] 2008 Memo at 7. Note that this repetitive testing procedure appears to be an open-ended commitment, and must be revisited in detail each year as operations and corporate entity structures change.

[81] N.Y. Tax Law §211.4(a)(5).

[82] N.Y. Comp. Codes R. & Regs. tit. 20, §6-2.5(c). An example is a corporation subject to the New York banking corporation tax.

[83] N.Y. Tax Law §211.4(a)(3). Examples of such corporations include transportation companies (trucking companies, rail companies and airlines).

[84] 2008 Memo at 7. As a result of applying Step 10, separate transportation groups and manufacturing groups that are commonly owned may emerge. However, regardless of such common ownership, such divergent operating groups may not be included in the same New York combined group.

[85] 2008 Memo at 7; N.Y. Tax Law §211.4(a)(5).

[86] *Id.*

[87] 2008 Memo at 7-9.

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