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New York State Significantly Changes its Combination Rules

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For decades, New York has had somewhat unique rules for combined corporate returns. With the enactment of so-called "corporate loophole closers" in April of this year,[1] New York's state-level combined return rules have become even more distinctive. Specifically, the preconditions to New York State (as opposed to City) combination have been significantly modified. These new rules sweep into New York State combined reports a much broader array of out-of-state affiliates.[2]

Corporate taxpayers need to take note that these new combination rules are effective immediately, for tax years beginning on or after January 1, 2007. Accordingly, corporations should promptly assess the application of the new New York State rules to their groups, and reflect the resultant changes in their current estimated tax computations, and in their 2007 financial reporting.

Unfortunately, most corporations' New York filings are now further complicated because New York City has thus far declined to conform to the State's changes. Corporations may find that the composition of their New York State combined group differs significantly from that of their New York City group because as described in more detail below, the New York State (but not City) law revised the test for evaluating intercorporate transactions that mandate the filing of a combined return.

Taxpayers should keep in mind that the new State combination rules apply only to general business corporations taxed under New York's Article 9-A; a different set of combination rules continues to apply to banking corporations.[3] There are, however, new amendments governing the State (but not City) classification of corporations as banking

[1] Ch. 60 (S. 2110, A. 4310), Laws 2007, enacted April 9, 2007.

[2] N.Y. Tax Law Article 9-A, § 211.4, as amended by Ch. 60 and applicable to general business corporations. Similar changes apply to insurance corporations under N.Y. Tax Law Article 33.

[3] N.Y. Tax Law §1462(f).

corporations,[4] so the composition of State combined groups may change as a result of the new classification rules too. There are also new State (but not City) mandatory combination rules for certain REITs and RICs that are owned by 9-A corporations.[5] New York's variegated schemes now make it even more exciting to figure out which entities belong in which return in each jurisdiction.

Historically, both New York State and New York City premised combination on three factors: (1) common ownership, defined by 80% of the vote; (2) a unitary business; and (3) "distortion" – specifically a determination that failure to file on a combined basis would understate the income of a New York taxpayer – generally tested under Internal Revenue Code § 482 principles.[6] The regulations issued under the prior statute[7] provide that distortion would be presumed whenever there were "substantial intercorporate transactions," with the burden then falling on the taxpayer or the government (depending upon who was resisting combination) to prove the absence of distortion. The distortion requirement frequently led to significant controversies, and extensive (and expensive) litigation featuring dueling experts on intercorporate transfer prices.[8] It also vexed the Department when taxpayers prevailed with their transfer pricing analyses.

Reacting to the contentiousness of the distortion requirement, the 2007 State legislation seeks to substitute a bright line test for mandatory combination. The key feature of the legislation is the codification of the previously presumptive "substantial intercorporate transactions" standard ("SubIT") as now mandating combination. Specifically, the statute now provides that[9] "'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. It is not necessary that there be substantial intercorporate transactions between any one corporation and every other related corporation. It is necessary, however, that there be substantial intercorporate transactions between the taxpayer and a related corporation or collectively, a group of such related corporations."[10] The statute further provides that, in testing for SubIT, "[a]ctivities and transactions that will be considered include, but are not limited to," six types of activities, among them "incurring

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[4] N.Y. Tax Law §1452(a)(9).

[5] N.Y. Tax Law §209.5.

[6] *Standard Manufacturing v. State Tax Comm.*, 114 AD 2d 138 (3d Dept. 1986), aff'd 69 NY 2d 635 (Ct. Apps. 1987); *Campbell Sales Co. v. State Tax Comm.*, 68 NY 2d 617 (Ct. Apps 1986).

[7] N.Y.C.R.R. §6-2.3(b), (c).

[8] *See, e.g.,*; *Hallmark Marketing Corporation*, DTA # 819956 (NYS Tax Apps. Trib. July 19, 2007) *Tropicana Product Sales Co. v. State Tax Comm.,* DTA ## 815253, 815564 (NYS Tax Apps. Trib. June 12, 2000).

[9] As originally proposed, the Governor's bill said combination "will not be permitted or required..." in the absence of SubIT. That language was deleted, however, and the text now says affected corporations with SubIT "shall" combine.

[10] N.Y. Tax Law § 211.4(a).

expenses that benefit, directly or indirectly, one or more related corporations," and "transferring assets, including such assets as accounts receivable, patents or trademarks from one or more related corporations."[11]

Given the significance of this amendment questions immediately arose regarding, *inter alia*, the types of transactions that "count"; the measure of "substantial"; and the constellation of corporations whose intercompany transactions are to be tested. The New York State Department of Taxation and Finance responded fairly quickly to the new law by providing some initial guidance in a Technical Services Bureau Memorandum issued in June.[12] While the June TSB-M answers some questions, at times controversially, it raises others. And while this is certainly an area where taxpayers need to "stay tuned," there are several important features of the June TSB-M that merit immediate attention.

Unfortunately, the new legislation appears to do less to end controversy than to move the ball. The June TSB-M illustrates that by prescribing a new "ten-step" procedure for applying the SubIT test to affiliated corporations. In a nutshell, the ten-step procedure addresses three primary functions: (i) identifying 80% affiliates eligible for combination; (ii) testing transfers among individual related corporations to identify subgroups which, among themselves, have SubIT; and (iii) linking subgroups to other corporations and to one another by retesting for SubIT between the subgroups and other affiliates as each new subgroup is established. Theoretically, one might summarize this approach as treating every subgroup with internal SubIT as if that group became a single entity whose transactions with affiliates then are required to be retested for substantiality.[13]

In addition to the ten-step procedure, the TSB-M sets forth additional guidance on applying the new statute. Drawing from the existing regulations that articulated the SubIT presumption, the June TSB-M pegs "substantiality" at 50% or more of a corporation's "receipts" or 50% or more of a corporation's "expenditures," in each case excluding extraordinary items. In the case of expenditures directly or indirectly benefiting a related corporation, the June TSB-M tests whether the expenditures are either 50% or more of the expenditures of the corporation incurring such costs, or 50% or more of the direct and indirect expenditures of the benefited corporation. The June TSB-M also creates a rolling 3-year test for situations in which intercorporate receipts or expenses fall within the 45%-55% range in a single year. How this test coordinates with changes in corporate affiliation, and how the percentage thresholds are applied across the three-year spectrum, have yet to be clarified.[14]

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[11] *Id.*

[12] TSB-M-07(6)C, June 25, 2007 (the "June TSB-M"). A TSB-M is "an informational statement of changes to the law … accurate on the date issued," but subject to being superseded by subsequent changes in policy. June TSB-M, p.7.

[13] Example 4 of the June TSB-M illustrates this, in its Steps 7 and 8.

[14] Where a corporation was not in existence for the two prior tax years, the June TSB-M applies this test based on the number of months it did exist.

The June TSB-M further interprets the statute's "transferring assets" category of tested transactions to mean that an asset transfer ("including through incorporation") can constitute SubIT if the assets are 10% or more of the transferor's or transferee's total assets at the time of transfer.[15] "Total" suggests gross asset value, as does the prescribed valuation methodology; but that detail is not spelled out. An asset transfer of sufficient size may require combination in the year of transfer. Note, however, that the 10% test is applied "at the time of transfer,"[16] so timing may be crucial.

For the years subsequent to an asset transfer, the June TSB-M states there will be SubIT if 50% or more of the transferee's income is from the transferred asset. At this point it is unclear when this "rule" takes effect, how long it applies following the transfer, how loans or cash contributions may affect the calculation or how subsequent sales and reinvestments are treated.

The June TSB-M contains a number of other interesting nuggets informing the combination inquiry. It reminds taxpayers that, even in the absence of SubIT, combination can be permitted or required where distortion in fact exists. It posits that transactions with otherwise non-combinable corporations (alien corporations, or Article 32 banks) can be used to establish SubIT, even though those corporations ultimately will not be included in the group.[17] It states that dividends, and interest from subsidiary capital, do not count in measuring SubIT, but that subsidiary loans still count as assets. It continues the regulations' previous willingness to ignore the provision of legal, accounting and similar intercompany services, if these are incidental to the business of the provider. And it glancingly addresses the treatment of group members who use a different tax year than "the parent." Such corporations are to report their activities for their taxable years ending during the parent's tax year.[18]

Strikingly, the June TSB-M cautions that these new rules may not be the bright-line, mandatory test that was intended in order to reduce controversy in this area. Lest taxpayers use the new rules to create combination, "the Department will consider the materiality of the transactions and whether the transactions have economic substance, including the extent to which the motivation of the taxpayer in undertaking the transactions was to affect the membership of the combined group."[19] As an example of this, the June TSB-M states that the creation (or activation) of a corporation ("Corporation K") to buy office supplies from Corporation A and sell them "at a slight markup" to Corporation C may not enable Corporation A and Corporation C to join in a

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[15] June TSB-M, p. 4.

[16] *Id.*

[17] N.Y. Tax Law §211.5, also included in Ch. 60, codifies the exclusion of alien corporations from Article 9-A combined reports.

[18] June TSB-M, pp. 2-3.

[19] June TSB-M, p. 5.

combined report with Corporation K if the SubIT among Corporation A, Corporation K, and Corporation C "lack economic substance."[20]

According to the June TSB-M regulations are in the works. The State tax department has also informally promised another TSB-M offering more guidance. And rumblings at the City level suggest there may be further legislation addressing its conformity to the new State rules. In the meantime, corporate groups should promptly and carefully evaluate their intercompany dealings to determine whether the new law mandates new or different combinations for New York State purposes.■

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[20] June TSB-M, examples 5 and 6.