July 10, 2024

Via Electronic Mail: DOFRules@finance.nyc.gov

NYC Department of Finance
Legal Affairs Division
375 Pearl Street
30th Floor
New York, NY 10038

Re: Business Corporation Tax Regulations

Dear Sir or Madam:

MFA[1] appreciates the opportunity to provide feedback to the New York City Department of Finance (the "**Department**") as it develops regulations for the business corporation tax,[2] including, in particular, rules relating to the "allocation approach…for income that flows from a partnership to a corporate partner" and the "allocation of income from passive investment customers".[3] MFA represents the global alternative asset management industry, of which over 800 New York City-based fund managers, in total, manage over $3 trillion in gross assets.[4] Institutional investors—like pension plans, university endowments, and charitable foundations—rely on MFA members to meet financial obligations, diversify their investment portfolios, and manage risk.

For regulatory, tax, and other reasons, our members may structure their management companies as business entities classified for federal and state income tax purposes as corporations or partnerships with corporate partners. The business corporation tax regulations will ultimately dictate how those members (and the Department) measure taxable in-City fund management activities. For this reason, we are deeply concerned with the Department's consideration of "a departure from the allocation approach used by New

[1] Managed Funds Association (MFA), based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 180 member fund managers, including traditional hedge funds, credit funds, and crossover funds, that collectively manage over $3.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

[2] Unless otherwise indicated, all "Section" and "Regulation" references are to the New York City Administrative Code, Title 11 (Taxation and Finance), as amended, and the Rules of the City of New York promulgated thereunder.

[3] N.Y.C. DEP'T OF FIN., BUSINESS CORPORATION TAX (2024), https://www.nyc.gov/site/finance/business/business-corporation-tax.page.

[4] *Number of Hedge Fund and Fund-of-Funds Firms By US City*, HEDGE FUND ALERT, June 28, 2023, at 4.

York State for income that flows from a partnership to a corporate partner" under which "[a]ny items of income or gain from a partnership will be allocated under the statutory and regulatory rules of the unincorporated business tax (UBT) and will not be included in the receipts factor of a corporate partner."[5] We respectfully urge the Department to reconsider such a departure from the allocation approach used by the State, which departure, we believe, lacks statutory grounding and would frustrate, rather than advance, the goals of the 2015-2016 New York City corporate tax reform.[6]

Executive Summary

Although we commend the Department for soliciting public comment prior to beginning the City Administrative Procedure Act (CAPA)[7] process to formally propose and adopt the regulations, we fundamentally believe that,

1. The Department lacks the statutory authority to promulgate a regulation in direct conflict with the customer-based sourcing rules for corporations, as well as other clear and unambiguous statutory provisions.
    a. The Department's proposed allocation approach is inconsistent with statutory economic nexus principles.
    b. The Department's proposed allocation approach is inconsistent with statutory investment capital principles.
    c. The Department's proposed allocation approach is inconsistent with statutory interest expense attribution principles.
    d. The Department's proposed allocation approach is likely to create uncertainty with respect to partnership losses and certain exemptions.
2. Even if the Department possessed the requisite statutory authority, the Department should avoid promulgating such a regulation on public policy grounds.
    a. The Department's proposed allocation approach disincentivizes City-based fund managers from locating or expanding operations in the City.

[5] N.Y.C. DEP'T OF FIN., BUSINESS CORPORATION TAX (2024), https://www.nyc.gov/site/finance/business/business-corporation-tax.page.

[6] N.Y. Laws 2015, S. 2009-B, c.60.

[7] N.Y.C. ADMIN. CODE § 45-1041 *et seq.*

b. The Department's proposed allocation approach undermines the "regulations regarding the special allocation of income from passive investment customers" and raises horizontal equity concerns.

1. The Department lacks the statutory authority to promulgate a regulation in direct conflict with the customer-based sourcing rules for corporations, as well as other clear and unambiguous statutory provisions.

The Department contends that Section 11-654(4-a), which provides that "[a] corporation that is a partner in a partnership shall compute tax…using any method required or permitted in regulations of the commissioner of finance,"[8] affords "the Department a high degree of flexibility regarding how to include a partnership's distributive share in the corporate partner's income."[9] On that basis, with respect to corporate partners, the Department suggests that it may eschew the customer-based sourcing rule otherwise applicable to corporations subject to business corporation tax in Section 11-654.2(10)(a)[10] in favor of separately allocating partnership income subject to the place of performance sourcing rule applicable for UBT purposes in Section 11-508(c)(3)(C).[11]

However, any regulatory flexibility afforded by Section 11-654(4-a) is necessarily constrained by other clear and unambiguous statutes to the extent both statutes (and the regulations promulgated thereunder) "may be read together, without misdirecting the one, or breaking the spirit of the other."[12] Here, where a statue enacted by the Legislature is in conflict with an agency-promulgated regulation, the analysis is even more straightforward: "It is a fundamental principle of administrative law that an agency cannot promulgate rules or regulations that contravene the will of the Legislature. If any agency regulation is 'out of harmony' with an applicable statute, the statute must prevail."[13] In the context of the Department's

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[8] N.Y.C. ADMIN. CODE § 11-654(4-a).

[9] N.Y.C. DEP'T OF FIN., BUSINESS CORPORATION TAX REGULATIONS, ALLOCATION OF FLOW-THROUGH INCOME FROM PARTNERSHIPS 1 (2024), https://www.nyc.gov/assets/finance/downloads/pdf/24pdf/bct-regs-write-up.pdf.

[10] N.Y.C. ADMIN. CODE § 11-654.2(10)(a) ("Receipts from services…and other business receipts not addressed in such subdivisions shall be included in the numerator of the receipts fraction if the location of the customer is within the city.").

[11] N.Y.C. ADMIN. CODE § 11-508(c)(3)(C) ("…charges for services performed shall be allocated to the city to the extent that the services are performed within the city.").

[12] *Foley v. Bratton*, 709 N.E.2d 100, 102 (N.Y. 1999).

[13] *Weiss v. City of New York*, 731 N.E.2d 594 (N.Y. 2000) (citation omitted); *see also Weil, Gotshal & Manges v. O'Cleireacain*, 634 N.E.2d 195, 198 (N.Y. 1994) ("Since we find the regulation at issue in clear conflict with the conceded legislative intent, we need not reach the question of deference."); *N.Y.C. Campaign Fin. Bd. v. Ortiz*, 38 A.D.3d 75, 84-85 (N.Y. App. Div. 2006)("Again, fundamental principles of statutory interpretation instruct us that where there is a conflict between a statute and an administrative rule or regulation promulgated pursuant to that statute, the wording and the meaning of the statute prevails.").

proposed allocation approach, there are several statutory provisions that would be inconsistent with such an approach and, therefore, must be read to limit the Department's authority.

Fundamentally, the Department's proposed allocation approach is an inappropriate exercise of regulatory authority when viewed in context with the customer-based sourcing rules applicable for business corporation tax purposes and the Legislature's reform purpose in enacting such rules. In particular, the Department's proposed allocation approach usurps the Legislature's command that "general business corporations…be subject to the *same* corporate tax, and *all* [corporate] taxpayers…source their business receipts to the location of their customers.[14] Instead, the Department's proposed allocation approach would see *some* corporate taxpayers (which are not corporate partners) subject to customer-based sourcing rules and *others* (to the extent they are corporate partners) subject to place of performance sourcing rules. General business corporations would not in fact be subject to the same corporate tax rules, and all corporate taxpayers would not in fact source their business receipts to the location of their customers. Accordingly, we respectfully urge the Department to reconsider such a departure from the allocation approach used by the State.[15]

a. The Department's proposed allocation approach is inconsistent with statutory economic nexus principles.

Section 11-653(1)(a) provides that, "[f]or the privilege of…deriving receipts from activity in the city,…every domestic or foreign corporation…shall annually pay a tax, upon the basis of its business income…"[16] "A corporation is deriving receipts from activity in the city if it has receipts within the city of one million dollars or more in a taxable year."[17] Section 11-653(1)(b) continues by clarifying that, "[*f*]*or purposes*

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[14] 2015-16 NEW YORK STATE EXEC. BUDGET, REVENUE ARTICLE VII LEGISLATION, MEMORANDUM IN SUPPORT 47 (2015) (emphasis added), https://www.budget.ny.gov/pubs/archive/fy1516archive/eBudget1516/fy1516artVIIbills/REVENUE_ArticleVII_MS.pdf

[15] The Department's proposed allocation approach may take on an even more immediate importance to the extent applied retroactively to the date of the corporate tax reform statutory amendments, as is the case with the corresponding State regulations. In such case, corporate taxpayers would have had no notice of the City's departure from the allocation approach used by the State, which departure could materially affect City tax liabilities. More so than the corresponding State regulations, retroactive application of the City regulations would deprive corporate taxpayers of any meaningful opportunity to have complied as, by comparison, corporate taxpayers were at least offered the opportunity by the State to take return positions before adoption of the final State regulations in reliance on prior draft and proposed regulations, and such reliance could justify, based on a totality of the circumstances, penalty relief. *See* NEW YORK STATE DEP'T OF TAXATION & FIN., ASSESSMENT OF PUBLIC COMMENT 20 (Dec. 11, 2023), https://www.tax.ny.gov/pdf/rulemaking/dec1123/corpreform/sapa/APC.pdf.

[16] N.Y.C. ADMIN. CODE § 11-653(1)(a).

[17] N.Y.C. ADMIN. CODE § 11-653(1)(b).

of this section, the term 'receipts' means the receipts that are subject to the allocation rules set forth in in section 11-654.2,"[18] the customer-based sourcing rules applicable for business corporation tax purposes.

Section 11-653 then turns to similar principles that apply in respect of corporate partners. Section 11-653(1)(f) provides that, "[i]f a partnership is…*deriving receipts* from any activity in the city, any corporation that is a partner in such partnership shall be subject to tax under this subchapter as described in the regulations of the commissioner of finance."[19] For purposes of Section 11-653 generally, the word "receipts" (and, by extension, the phrase "deriving receipts") is defined specifically by reference to the customer-based sourcing rules in Section 11-654.2. Accordingly, Section 11-653(1)(f) contemplates that a corporate partner must consider its distributive share of partnership receipts under the customer-based sourcing rules in Section 11-654.2, in the context of an economic nexus determination (*i.e.*, whether such share of partnership receipts, cumulatively with other receipts, equals or exceeds one million dollars).

The statutory economic nexus principles in Section 11-653, therefore, contemplate that economic nexus is determined at the corporate partner-level, taking into account the partnership's activities on an attributional—rather than on an entity—basis. The Department's proposed allocation approach is manifestly incompatible with the statutory economic nexus principles in Section 11-653 because it would mean that nexus would be determined by the location of the partnership's customers, but the corporate partner's tax would be determined by the location of the partnership's workforce, based on the position that the phrase "deriving receipts" has multiple meanings in the statute, which the Legislature quite obviously did not (and, indeed, *could not*) intend.

Moreover, if the Department intends corporate partners' economic nexus determinations to be made under customer-based sourcing rules applicable for business corporation tax purposes, but corporate partners' computation of tax, at least in part, under place of performance sourcing rules applicable for UBT purposes, economic nexus determinations may be toothless in certain cases, for example, where an out-of-City partnership with corporate partners performs services at its commercial domicile but, in doing so, derives receipts from the in-City market (*i.e.*, where there is economic nexus, but no tax due).

In conclusion, under the Department's proposed allocation approach, an agency-promulgated regulation would be overriding the mandate of the customer-based sourcing rules applicable for business corporation tax purposes, a clear and unambiguous statute. Although Section 11-653(1)(f) grants authority to the commissioner to prescribe regulations applying the economic nexus and allocation rules to a corporate partner, those rules must be consistent with the statute, as noted above.

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[18] *Id.* (emphasis added).

[19] N.Y.C. ADMIN. CODE § 11-653(1)(f) (emphasis added).

b. **The Department's proposed allocation approach is inconsistent with statutory investment capital principles.**

Section 11-652(6)(a) provides that, for business corporation tax purposes, "'business capital' means all assets, other than investment capital and stock issued by the taxpayer…"[20] "Investment capital" is defined as "investments in stocks that," among other things, "are clearly identified in the taxpayer's records as stock held for investment…"[21] In other words, the business corporation tax treats every financial instrument as "business capital" in the first instance, other than stock properly identified as "investment capital". Corporations are instructed to determine "[t]he amount of investment capital and business capital…by taking the average value of the gross assets included therein…" and then allocate income from those assets separately.[22]

By contrast, Section 11-501(j) provides that, for UBT purposes, "'[b]usiness capital'…mean[s] all assets of the unincorporated business other than investment capital,…except that cash on hand and on deposit shall be treated as investment capital or as business capital as the taxpayer may elect."[23] "Investment capital" is defined as "investments of the unincorporated business in stocks, bonds and other securities,…not held for sale to customers in the regular course of business…"[24] In other words, the UBT treats stocks, bonds, and other securities as "investment capital," unless held for sale to customers in the regular course of business, and all other assets as "business capital". Unincorporated businesses are instructed to determine "investment capital…by taking the average value of the gross assets included therein" and then allocate income from those assets separately.[25]

These statutory investment capital principles contemplate two independent regimes—one for unincorporated businesses, without respect to any of an unincorporated business's corporate partners, and one for corporations, including corporate partners, without respect to the UBT regime. Otherwise, as is the case with the Department's proposed allocation approach, corporate partners would be forced to consider two additional, separate sub-categories of post-allocation income (unincorporated business "business income" and unincorporated business "investment income") on their business corporation tax returns to the extent that the corporate partners' incomes arise both from unincorporated businesses' activities and from the corporate partners' standalone activities. This outcome, where substantially similar types of

[20] N.Y.C. ADMIN. CODE § 11-652(6)(a).

[21] N.Y.C. ADMIN. CODE § 11-652(4)(a)

[22] N.Y.C. ADMIN. CODE § 11-654(2), (3).

[23] N.Y.C. ADMIN. CODE § 11-501(j).

[24] N.Y.C. ADMIN. CODE § 11-501(h).

[25] N.Y.C. ADMIN. CODE § 11-508(a), (f).

income mandate different allocation methods, or even deductions and exemptions,[26] depending on whether an unincorporated business or a corporate partner generated the income, is without justification. Moreover, the treatment of cash would become fundamentally uncertain because an unincorporated business may elect to treat cash as investment capital *or* business capital, whereas a corporate partner may not.[27]

More fundamentally, the Department's proposed allocation approach runs counter to nearly a decade's worth of reliance upon guidance issued by the Department that the City's statutory investment capital principles should be consistent with the State's. For example, the Department has issued investment capital identification guidance "consistent with [identical guidance in] New York State Department of Taxation and Finance Technical Memorandum TSB-M-15(4)C, 5(1)."[28] In this guidance, Finance Memorandum 15-3, the Department provides that,

> [i]f the corporation is a partner in a partnership and the corporation is using the aggregate method to compute its tax, the corporation's proportional part of the stock owned by the partnership may qualify as investment capital *if the statutory requirements for investment capital are satisfied at the partnership level*. In particular, *the partnership must follow the identification procedures specified in this memorandum for the stock to qualify as investment capital*.[29]

In other words, this guidance provides that corporate partners are to treat the proportional part of the stock owned by partnerships of which they are partners as investment capital to the extent that the statutory requirements for investment capital *for business corporation tax, rather than UBT, purposes* are satisfied at the partnership-level; hence the instruction that the "partnership must follow the identification procedures specified in this [business corporation tax] memorandum for the stock to qualify as investment capital."[30] The same rules apply for State Corporation Franchise Tax purposes.[31] Accordingly, the Department's

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[26] *Compare* N.Y.C. ADMIN. CODE §§ 11-509, -510 *with* N.Y.C. ADMIN. CODE §§ 11-652, -653; *see* Section I.d.

[27] *See* N.Y.C. ADMIN. CODE § 11-501(j).

[28] N.Y.C. DEP'T OF FIN., FIN. MEMORANDUM 15-3, INV. CAPITAL IDENTIFICATION REQUIREMENTS FOR THE CORPORATE TAX OF 2015 2 (July 17, 2015) ("[A] taxpayer that satisfies the investment capital identification requirements for Article 9-A taxpayers set forth in that memorandum also satisfies the investment capital identification requirements for Subchapter 3-A taxpayers set forth below."); *see also* N.Y.C. DEP'T OF FIN., FIN. MEMORANDUM 16-3, ADDITIONAL INV. CAPITAL IDENTIFICATION PERIODS FOR CERTAIN NON-DEALERS UNDER THE BUS. CORP. TAX (CORPORATE TAX OF 2015) (Feb. 26, 2016).

[29] *Id.* (emphasis added).

[30] *Id.*

[31] *See* NEW YORK STATE DEP'T OF TAXATION & FIN., TECHNICAL MEMORANDUM TSB-M-15(4)C, (5)I, INV. CAPITAL IDENTIFICATION REQUIREMENTS FOR ARTICLE 9-A TAXPAYERS 3 (July 7, 2015); *see also* NEW YORK STATE DEP'T OF TAXATION &

proposed allocation approach would be in conflict with the aggregate principles that apply generally to the statutory investment capital regime under the business corporation tax.

c. The Department's proposed allocation approach is inconsistent with statutory interest expense attribution principles.

Section 11-652(5)(a) provides generally that "investment income" may be reduced by "any interest deductions allowable in computing entire net income which are directly or indirectly attributable to investment capital or investment income."[32] Alternatively, in lieu of reducing "investment income" by directly or indirectly attributable interest expense, "taxpayer[s] may make a revocable election to reduce…total investment income…by forty percent."[33] Consistent with the broader statutory scheme, the Department for the better part of the past decade has applied aggregate principles for expense attribution purposes. In this guidance, Finance Memorandum 16-2, the Department provides that,

> A corporate partner using the aggregate method to determine its tax with respect to its interest in a partnership must include its distributive share of each partnership item of receipts, income, gain, loss and deduction and the corporation's proportionate part of each asset and liability from that partnership, after the elimination of all inter-entity transactions and activity, when computing income amounts and the attribution of interest deductions or making the 40% safe harbor election.[34]

The guidance continues by specifically instructing corporate partners to include, in accordance with aggregate principles, their distributive shares of:

- Total interest deductions in computing the total amount of interest deductions subject to attribution;[35]
- Interest deductions directly traced by the partnership in computing directly attributable interest expense;[36] and

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FIN., TECHNICAL MEMORANDUM TSB-M-15(4.1)C, (5.1)I, ADDITIONAL INV. CAPITAL IDENTIFICATION PERIODS FOR CERTAIN NON-DEALERS FOR SPECIFIED CIRCUMSTANCES THAT OCCUR ON OR AFTER OCT. 1, 2015 (Jan. 7, 2016).

[32] N.Y.C. ADMIN. CODE § 11-652(5)(a).

[33] N.Y.C. ADMIN. CODE § 11-652(5)(b).

[34] N.Y.C. DEP'T OF FIN., FIN. MEMORANDUM 16-2, DIRECT AND INDIRECT ATTRIBUTION OF INTEREST DEDUCTIONS UNDER THE BUSINESS CORPORATION TAX (CORPORATE TAX OF 2015) 4 (Feb. 26, 2016).

[35] *Id.* at 5.

[36] *Id.* at 6.

- Each partnership item of receipts, income, gain, loss, and deduction and proportionate part of each asset and liability from the partnership in computing indirect interest expense attribution ratios.[37]

Again, the Department's proposed allocation approach runs counter to nearly a decade's worth of reliance upon guidance issued by the Department that contemplates that statutory interest expense attribution principles are applied on an aggregate basis. Now, the Department's proposed allocation approach negates this guidance and jeopardizes the substantial reliance interest that corporate partners placed on the ability to directly trace or indirectly attribute interest expense to (or otherwise elect to reduce by forty percent) investment income by looking-through partnerships of which they are partners. The Department's proposed allocation approach would presumably treat unincorporated business interest expense and interest income as business capital and business income, respectively, and once again create a new, separate sub-category of post-allocation income on corporate partners' business corporation tax returns. This result, where similarly situated corporate taxpayers are subject to different interest expense attribution regimes, depending on whether an unincorporated business or a corporate partner (on a standalone basis) generated the expense, is without justification.

d. The Department's proposed allocation approach is likely to create uncertainty with respect to partnership losses and certain exemptions.

There are numerous other statutory provisions the stability and predictability of which would be imperiled by the Department's proposed allocation approach. As examples, we highlight two. *First*, the Department's proposed allocation approach would create uncertainty for the treatment of partnership losses and conflict with the statutory business corporation tax net operating loss regime. For business corporation tax purposes, the starting point in the computation of "entire net income" is federal taxable income, which reflects "total net income from all sources," including partnerships.[38] Accordingly, a corporate partner's distributive share of partnership loss is reflected in "entire net income" without any statutorily enumerated subtraction modification to remove partnership loss from the business corporation tax base. The Department's proposed allocation approach necessitates such a subtraction modification, however, because partnership loss would be separately allocable pursuant to place of performance sourcing rules applicable for UBT purposes, to the same extent as partnership income, and therefore would need to be removed from the business corporation tax base to avoid double counting.

Further confusion is likely to flow from circumstances where separately allocable partnership loss creates or increases a corporate net operating loss. Section 11-654.1 provides that "[a] net operating loss shall be the amount of a business loss incurred in a particular tax year multiplied by the business allocation

[37] *Id.* at 7.

[38] N.Y.C. ADMIN. CODE § 11-652(8).

percentage for that year as determined under subdivision three of section 11-654 of this subchapter."[39] Far from contemplating two independent post-allocation loss carryforward and carryback attributes, the definition of "entire net income" and the statutory business corporation tax net operating loss regime conceive of only one post-allocation loss attribute, subject to customer-based sourcing rules applicable for business corporation tax purposes. Here, too, inconsistency, complexity, and confusion abound under the Department's proposed allocation approach, inasmuch as post-allocation loss computed under place of performance sourcing rules may offset income computed under customer-based sourcing rules, and *vice versa*.

Second, the Department's proposed allocation approach would create conflicting business corporation tax and UBT exemptions. The business corporation tax provides exemptions for income from investment capital,[40] dividends from unitary corporations,[41] and Subpart F income,[42] among others. By contrast, the UBT provides exemptions, as non-business income, for income from certain trading or investment activities[43] or certain real property activities,[44] among others. The Department's proposed allocation approach would seemingly allow UBT exemptions in computing the separately allocable partnership income of corporate partners, despite those UBT exemptions being unallowable for business corporation tax purposes. Otherwise, income exempt for UBT purposes would nonetheless be sourced at the corporate partner-level using the place of performance sourcing rules applicable for UBT purposes, an equally, if not more, unusual and incongruous result.

Likewise, the Department's proposed allocation approach would seemingly deprive corporate partners of unique business corporation tax exemptions, as well as the opportunity to elect the fixed percentage method with respect to receipts and net gains from qualified financial instruments under which, rather than applying customer-based sourcing rules, corporations are electively permitted to include in the numerator of their receipts fraction "eight percent of all net income (not less than zero) from qualified financial instruments…"[45]

The Department's proposed allocation approach's inequities among similarly situated corporate taxpayers, as described in detail above, and the resulting inconsistency, complexity, and confusion, are no less inexplicable in the context of either partnership losses or certain exemptions. Accordingly, we

[39] N.Y.C. ADMIN. CODE § 11-654.1(3).

[40] N.Y.C. ADMIN. CODE §§ 11-652(7), -654(1)(e)(1).

[41] N.Y.C. ADMIN. CODE § 11-652(5-a)(c).

[42] N.Y.C. ADMIN. CODE § 11-652(5-a)(b).

[43] N.Y.C. ADMIN. CODE §§ 11-502(c)(2), -506(c)(9).

[44] N.Y.C. ADMIN. CODE §§ 11-502(d), -506(c)(8).

[45] N.Y.C. ADMIN. CODE § 11-654.2(5)(a)(1).

respectfully urge the Department to reconsider such a departure from the allocation approach used by the State, which departure, we believe, lacks statutory grounding. The New York City Law Department must ultimately "review the proposed rule to determine whether it is within the authority delegated by law to the [Department]."[46] As described in detail above, the Department's proposed allocation approach is inconsistent with clear and unambiguous statutory provisions, and in such cases, the statutes must prevail. We also strongly believe that a proposed rule that falls squarely within the Department's statutory authority would assuredly yield a more productive and constructive notice-and-comment period and administrative record from which the Department can finalize workable rules.

2. **Even if the Department possessed the requisite statutory authority, the Department should avoid promulgating such a regulation on public policy grounds.**

    a. **The Department's proposed allocation approach disincentivizes City-based fund managers from locating or expanding operations in the City.**

With the passage of the 2015-2016 New York City corporate tax reform, the Legislature intended for significant parity between the State and City corporate tax frameworks.[47] The Legislature acknowledged that "[b]usinesses and the City face an additional layer of complexity and administrative burden if the City and New York State use different tax structures to determine corporate taxable income."[48] The Legislature, therefore, sought to avoid the undesirable complexities and administrative burdens of divergence between the State's and City's corporate tax frameworks:

> This reform proposal would address these issues by modernizing the City's tax law so that it more accurately reflects the realities of the business environment, creating clarity and certainty in the most commonly disputed areas of law, and conforming closely to the corporate tax amendments enacted last year by New York State. In particular, general business corporations…would be subject to the same corporate tax, and all taxpayers would source their business receipts to the location of their customers.[49]

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[46] N.Y.C. ADMIN. CODE § 45-1043(c).

[47] *See* 2015-16 NEW YORK STATE EXEC. BUDGET, REVENUE ARTICLE VII LEGISLATION, MEMORANDUM IN SUPPORT 46 (2015) ("Purpose: The bill would modernize the system of taxation for general business corporations…that do business in New York City by adopting many of the recent statutory changes to the State's corporate tax that go into effect for tax years beginning on or after January 1, 2015."), https://www.budget.ny.gov/pubs/archive/fy1516archive/eBudget1516/fy1516artVIIbills/REVENUE_ArticleVII_MS.pdf.

[48] *Id.* at 47.

[49] *Id.*

As it had successfully done the year prior in the State's corporate tax reform,[50] the Legislature specifically intended to avoid "creat[ing] disincentives to increasing a corporation's activities in the City" and explained that,

> [t]he City's corporate tax framework…has not been updated to reflect the shift to a service-based economy. Companies that generate significant receipts from services currently incur greater tax liability if they increase their activity in the City, for example, by adding office space or basing more employees in the City.[51]

Accordingly, corporations subject to business corporation tax source receipts from services not specifically enumerated in statute to "the location of the customer,"[52] as is the case with respect to the State,[53] determined by a hierarchy, the first method of which is where the benefit is received.[54]

The Department's "propos[al] to continue to use the UBT provisions as the primary method for the taxation and allocation of items of partnership income flowing to corporate partners"[55] runs the very risks that the Legislature sought to avoid—first, unnecessary disparities in tax outcomes for State and City corporate taxpayers; second, disincentives to corporations locating or expanding operations in the City, including increased exposure to City tax; and third, opportunities for aggressive tax planning.

First, the Department readily admits that its proposed allocation approach would drive disparities in tax outcomes for State and City corporate taxpayers. The legislative history does not reflect that the Department conceived of, much less explained to the New York State Governor, Legislature, or Department of Taxation and Finance, the possibility of a radical departure between the State and City corporate tax frameworks. To the contrary, the Legislature saw the potential competitive and cooperative

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[50] *Compare id. with* 2014-15 NEW YORK STATE EXEC. BUDGET, REVENUE ARTICLE VII LEGISLATION, MEMORANDUM IN SUPPORT 5 (2014) ("New York [State]'s current sourcing rules fail to acknowledge the shift to a service-based economy. Companies that generate significant receipts from services can incur greater tax liability if they increase their activity in New York. This reform proposal would source a business's receipts to the location of its customers…This removes a previous disincentive to locating in New York."), https://www.budget.ny.gov/pubs/archive/fy1415archive/eBudget1415/fy1415artVIIbills/REVENUE_ArticleVII_MS.pdf.

[51] *Id.*

[52] N.Y.C. ADMIN. CODE § 11-654.2(10)(a).

[53] *Compare id. with* N.Y. TAX LAW § 210-A(10)(a).

[54] N.Y.C. ADMIN. CODE § 11-654.2(10)(b).

[55] N.Y.C. DEP'T OF FIN., BUSINESS CORPORATION TAX REGULATIONS, ALLOCATION OF FLOW-THROUGH INCOME FROM PARTNERSHIPS 2 (2024), https://www.nyc.gov/assets/finance/downloads/pdf/24pdf/bct-regs-write-up.pdf.

benefits of closely conforming the State's and City's corporate tax frameworks and explicitly intended parity between the two.[56]

Second, the Department's proposed allocation approach would be fundamentally at odds with the Legislature's intention that "*all* [corporate] taxpayers would source their business receipts to the location of their customers."[57] Instead, under the Department's proposed allocation approach, only *some* corporate taxpayers (which are not corporate partners) would be subject to customer-based sourcing rules, while others (to the extent they are corporate partners) would be subject to place of performance sourcing rules, the effect of which rules are reminiscent of pre-reform, general corporation tax sourcing results. Such results would constitute a failure of a foundational principle of New York City corporate tax reform that the "receipts sourcing methodology allocates [a] corporation's taxable income among those jurisdictions where its customers are located, and eliminates factors that would increase [a] corporation's tax liability if it increased its activity in the City."[58]

Third, as described in detail throughout, the Department's proposed allocation approach compels dramatically different results depending on whether certain types of receipts, income, gain, loss and deduction are generated by an unincorporated business or corporation (on a standalone basis, as a corporate partner or otherwise). Such varied outcomes are likely to lead to economic and behavioral distortions based exclusively on organizational form and without regard to any substantive or operational differences. The resulting opportunities for aggressive tax planning (by, for example, inserting or removing an unincorporated business from an organizational structure) are untenable to an equitable corporate tax framework and anathema to the Legislature's reform purpose. Indeed, the Legislature specifically intended to cure the "outdated, unduly complex" City corporate tax framework of its "vulnerab[ility] to aggressive tax avoidance techniques" and "tax[ation] [of] similarly-situated taxpayers differently…"[59]

b. The Department's proposed allocation approach undermines the "regulations regarding the special allocation of income from passive investment customers" and raises horizontal equity concerns.

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[56] 2015-16 NEW YORK STATE EXEC. BUDGET, REVENUE ARTICLE VII LEGISLATION, MEMORANDUM IN SUPPORT 47 (2015) ("The greater certainty created by the bill, combined with the elimination of impediments for businesses wishing to expand their activity in the City, will make the City's corporate tax system more competitive. Closely conforming to the New York State corporate tax structure will also make it easier for taxpayers to comply with the City's corporate tax, and will facilitate joint City-State tax audits."), https://www.budget.ny.gov/pubs/archive/fy1516archive/eBudget1516/fy1516artVIIbills/REVENUE_ArticleVII_MS.pdf.

[57] *Id.* (emphasis added).

[58] *Id.*

[59] *Id.* at 46.

We commend "[t]he Department['s] propos[al] to adopt New York State's regulations regarding the special allocation of income from passive investment customers" and its consideration of "departing from the state's fallback allocation approach."[60] In furtherance of the Department's objectives, we append to this letter our recommendations to the State with respect to its passive investment customer rules which, we believe, are equally appropriate for the Department's passive investment customer rules and, therefore, encourage the Department to adopt those recommendations.[61]

We are deeply concerned, however, that the Department's proposed allocation approach undermines its passive investment customer rules by making their application dependent on the taxpayer's formal organizational structure. Under the Department's proposed allocation approach, fund managers which structure their management companies as partnerships with corporate partners for regulatory or other non-tax reasons would be subject to the place of performance sourcing rules applicable for UBT purposes because the fund management activities (and the receipts therefrom) are generated by an unincorporated business. At the same time, fund managers which structure their management companies as standalone corporations would be subject to the customer-based sourcing rules applicable for business corporation tax purposes. The latter, standalone corporate management companies, would be able to avail themselves of the passive investment customer rules, whereas the former, corporate partners, would not.

The Department's proposed allocation approach, therefore, would undermine the express purpose of industry- and activity-tailored customer-based sourcing rules—to reflect more accurately the economics of specific service provider-customer arrangements. In the fund management industry, similarly situated corporate taxpayers would apply diametrically opposed sourcing rules based merely on the existence of an underlying partnership and without regard to any substantive or operational differences. Such an outcome is violative of a fundamental principle of fairness in tax policy that tax burdens should be distributed in a manner that is horizontally equitable, or put simply: like-taxpayers should be taxed alike. The principle of horizontal equity guards most explicitly against arbitrary discrimination, as would be the effect of the Department's proposed allocation approach.

Accordingly, we respectfully urge the Department to reconsider such a departure from the allocation approach used by the State, which departure, we believe, would frustrate, rather than advance, the goals of the 2015-2016 New York City corporate tax reform. The New York City Law Department must ultimately determine "whether [the] proposed rule: (i) is drafted so as to accomplish the purpose of the

[60] N.Y.C. DEP'T OF FIN., BUSINESS CORPORATION TAX REGULATIONS, ALLOCATION OF INCOME FROM PASSIVE INVESTMENT CUSTOMERS 2 (2024), https://www.nyc.gov/assets/finance/downloads/pdf/24pdf/bct-regs-write-up.pdf.

[61] Letter from Managed Funds Association to Kathleen D. Chase, Office of Counsel, New York State Dep't of Taxation and Fin. (Oct. 10, 2023) (appended).

authorizing provisions of law; (ii) is not in conflict with other applicable rules; [and] (iii)…is narrowly drawn to achieve its stated purpose…"[62]

The Department's justification for its proposed allocation approach and its departure from the State's approach is inapposite for these purposes. As described in detail above, Section 11-654(4-a) does not in fact provide the Department regulatory latitude over and above clear and unambiguous statutes to the contrary. Nor does the fact that "New York City currently taxes partnerships at the entity level pursuant to the [UBT]," whereas "[i]n contrast, New York State does not have a UBT and treats partnerships consistently with federal income tax as flow-through entities," offer any relevant support.[63] Indeed, even under the pre-reform, general corporation tax, the Department would have (and in fact has) insisted that items of income or gain from a partnership be included in the receipts factor of a corporate partner, without separately allocating such income or gain under the statutory and regulatory rules of the UBT.[64] Beyond the Department insisting on such an approach, courts have required it.[65]

We strongly believe, therefore, that the Department's proposed allocation approach neither accomplishes the purposes of either Section 11-654(4-a) or Section 11-654.2 (and more importantly, frustrates the purpose of the latter) nor is narrowly drawn so as not to frustrate the industry-wide scope of its passive investment customer rules. Moreover, for the reasons discussed above, we strongly believe that the Department's proposed allocation approach is thoroughly in conflict with other applicable business corporation tax rules.

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[62] N.Y.C. ADMIN. CODE § 45-1043(d).

[63] N.Y.C. DEP'T OF FIN., BUSINESS CORPORATION TAX REGULATIONS, ALLOCATION OF INCOME FROM PASSIVE INVESTMENT CUSTOMERS 2 (2024), https://www.nyc.gov/assets/finance/downloads/pdf/24pdf/bct-regs-write-up.pdf.

[64] *See In re Goldman Sachs Petershill Fund Offshore Holdings (Del.) Corp.*, TAT (H) 16-9 (GC) (N.Y.C. Tax App. Trib., A.L.J. Div., Dec. 6, 2018), *aff'd*, TAT (E) 16-9 (GC) (N.Y.C. Tax App. Trib., March 12, 2021), *aff'd*, 204 A.D.3d 469 (N.Y. App. Div. 2022).

[65] *See In re Nat'l Bulk Carriers, Inc. & Affiliates*, TAT (H) 04-33 (GC) (N.Y.C. Tax App. Trib., A.L.J. Div., May 3, 2006), *aff'd*, TAT (E) 04-33 (GC) (N.Y.C. Tax App. Trib., Nov. 30, 2007), *aff'd*, 61 A.D.3d 522 (N.Y. App. Div. 2009), *lv. denied* 12 N.Y.3d 716, 2009 WL 1852004 (N.Y. 2009).

*   *   *

We appreciate the opportunity to submit our comments on the Department's forthcoming business corporation tax regulations, and we would be pleased to meet with the Department to discuss our comments. If the Department has any questions or comments, please do not hesitate to call Joseph Schwartz, Vice President and Senior Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Global Regulatory Affairs
Managed Funds Association

cc: *NYC Department of Finance*
Preston Niblack, Commissioner
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Stanislav Timerman, Agency Attorney

NYC Office of the Mayor
Sheena Wright, First Deputy Mayor of New York City

NYC Mayor's Office of Management and Budget
Jacques Jiha, Budget Director

Appendix

Letter from Managed Funds Association to Kathleen D. Chase, Office of Counsel, New York State Dep't of Taxation and Fin. (Oct. 10, 2023)

Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels | London

October 10, 2023

Via Electronic Submission: tax.regulations@tax.ny.gov

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

Re: Text of Proposed Rule related to Part 4; Proposed Updates to the Article 9-A Business Corporation Franchise Tax Regulations

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to provide feedback to the New York Department of Taxation and Finance (the "**Department**") on the text of proposed rules under Part 4 of the Article 9-A Business Corporation Franchise Tax Regulations,[2] regarding apportionment, including, in particular, rules relating to "passive investment customers".[3] MFA represents the global alternative asset management industry, of which over 900 New York State-based investment managers, in total, manage over $3.3 trillion in gross assets.[4] Institutional investors—like pensions, university endowments, and nonprofits—rely on MFA members to meet financial obligations, diversify their investment portfolios, and manage risk.

For regulatory, tax, and other reasons, our members may structure their management companies as business entities classified for federal and state income tax purposes as corporations or partnerships with corporate partners. The proposed Regulations will ultimately dictate how those members (and the Department) measure taxable in-state investment management activities. We are supportive of the Department's continued effort to marry the New York State Legislature's (the "**Legislature**") intent to apply customer-based, or market, sourcing rules with administrable regulations which reflect the economics of specific service provider-customer arrangements and, in doing so, submit for public feedback multiple iterations of such regulations.

We commend the Department for its receptivity to the overwhelming view of respondents that receipts for administration, distribution, and management services provided to a passive investment customer (collectively, "**investment management receipts**") should be sourced to the investors[5] in the

[1] Managed Funds Association ("**MFA**"), based in Washington, D.C., New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 170 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly $2.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

[2] Unless otherwise indicated, all "Section" and "Regulation" or "Reg." references are to the Consolidated Laws of New York, Chapter 60 (Tax), Article 9-A (Franchise Tax on Business Corporations), as amended, and the Official Compilation of Codes, Rules & Regulations of the State of New York promulgated thereunder.

[3] N.Y. Dep't of Taxation & Fin., Corporate Tax Reform draft regulations (last updated July 26, 2023), https://www.tax.ny.gov/bus/ct/corp_tax_reform_draft_regs.htm.

[4] *Number of Hedge Fund and Fund-of-Funds Firms by State or US Territory*, HEDGE FUND ALERT (June 28, 2023).

[5] We refer to "investors" and "beneficial owners", as contemplated by *Proposed* Regulation section 4-4.4(c)(2)(i), collectively and generically as "investors".

passive investment customer.[6] We continue to believe that this view is consistent with the 2014-2015 corporate tax reform legislation and the Legislature's decision to expand the use of market sourcing of receipts to a full range of service industries.[7] We also believe, in turn, that such rules eliminate a clear disincentive to investment managers locating or expanding operations in New York State, relative to other jurisdictions that have adopted or proposed to adopt similar rules.

Accordingly, we encourage the Department to proceed to formally adopt the proposed Regulations with the following recommended modifications to further enhance the accuracy and administrability of the rules relating to the sourcing of investment management receipts:

(a) A ***direct tracing method of apportionment*** should apply to investment management receipts, rather than the "average value of the interests" method.

(b) Clarify that investment management receipts attributable to ***investors the locations of which <u>can</u> be identified*** should be sourced to them, notwithstanding whether the remaining share of investment management receipts can be similarly traced.

(c) The ***reasonable approximation methods*** of *Proposed* Regulation sections 4-4.5 and 4-4.6, including the ***sourced receipts method***, should apply to investment management receipts that are attributable to investors the locations of which cannot be identified, rather than the location where the contract for such services is managed by the passive investment customer.

(d) The definition of "management services" should specifically include services performed under an ***investment sub-advisory agreement***.

(e) Clarify that investment management receipts include receipts for services that do not fit squarely within the definitions of "administration services", "distribution services", and "management services" but are ***ancillary or closely related to such services***.

(f) Clarify that the principles of the rules relating to the sourcing of investment management receipts also apply where the investment management receipts are received by a ***registered broker or dealer*** under Section 210-A(5)(b)(5).

<u>MFA Recommendations</u>

A. A ***direct tracing method of apportionment*** *should apply to investment management receipts, rather than the "average value of the interests" method.*

We recommend that the Department modify *Proposed* Regulation section 4-4.4(c)(2)(iii) to provide that a direct tracing method of apportionment, akin to New Jersey's "asset management services" allocation rule,[8] applies to investment management receipts, rather than the currently proposed "average value of the interests" method. New York State embarked on industry- and activity-based market sourcing rules to reflect more accurately the economics of specific service provider-customer arrangements. However, the accuracy (and, therefore, the value) of the "average value of the interests"

[6] N.Y. Dep't of Taxation & Fin., Regulatory Impact Statement (July 25, 2023), https://www.tax.ny.gov/pdf/rulemaking/jul2523/corpreform/sapa/ris.pdf.

[7] Letter from Managed Funds Association to N.Y. Dep't of Taxation & Fin. (Aug. 26, 2022) ("**August 2022 letter**"), https://www.managedfunds.org/wp-content/uploads/2022/09/MFA-New-York-Corporate-Sourcing-Regulations-Comments.pdf.

[8] *See* N.J. ADMIN. CODE § 18:7-8.10A(a)(8).

method is severely constrained for several reasons rooted in standard commercial practices and economic realities.

First, the "average value of the interests" method presumes that investment management receipts (or "fees and expenses") are borne by investors in a passive investment customer (or "fund") on a pro rata basis. Frequently, however, investment managers charge fees and allocate expenses on a non-pro rata basis. This may occur, for example, when an investment manager forms bespoke structures for large or strategic investors, such as separate accounts, funds-of-one, and co-investment vehicles, that invest in other funds managed by the investment manager. Another example where different fee arrangements may apply is when an investment manager broadly offers multiple fund share classes, each with different terms related to, most notably, fees and expenses, but also liquidity, transparency, etc.

In such cases, investors in a passive investment customer may bear fees and expenses disproportionately to the "value of the interests" they hold in the passive investment customer. As a result, the "average value of the interests" method may inappropriately source a greater proportion of investment management receipts to the location of a large (by interest) investor even though that investor economically bears a smaller proportion of fees and expenses. In addition to its inaccuracy, this uneconomic result upsets the principle of tax neutrality, *i.e.*, that pooling capital in a fund should not distort the tax consequences (to investors or the investment manager) that would follow from investors' capital being managed separately.

Second, the "value of the interests" is often difficult to determine. In the partnership context, a large and increasing number of Internal Revenue Code provisions, the regulations thereunder, and administrative guidance refer to the ownership percentages of a partner's interest in a partnership. In some places, the reference specifies a partner's interest in partnership profits or capital, and in others, the reference is not defined. Although the goal of these references is often simple—to describe a partner's economic interest in or control relationship to a partnership—the order of complexity of making such a determination when the reference is left undefined is compounded by the fact that passive investment customers are rarely "straight-up" partnerships in which the partners share in profits, loss, and capital in the same ratios. As a result, the "average value of the interests" method is likely to drive significant diversity in practice, with equally significant costs to administration and enforcement.

Third, and more fundamentally, open-end funds and funds with more liberal redemption terms risk even more severe distortion under the "average value of the interests" method as investors enter and exit the fund frequently and throughout the year. The "average value of the interests" method, which essentially takes a snapshot of investors' economic interests at the beginning of the taxable year and at the end of the taxable year, is prone to understate investment management receipts sourced to the location of investors that made contributions or received redemptions throughout the year and overstate those receipts sourced to the location of non-redeeming, non-contributing investors.

Accordingly, we urge the Department to modify *Proposed* Regulation section 4-4.4(c)(2)(iii) to provide that investment management receipts will be included in the numerator of the business apportionment factor to the extent attributable to an investor the location of which is determined to be New York State under *Proposed* Regulation section 4-4.4(c)(2)(ii). This direct tracing method of apportionment is not only more accurate but also more administrable than the "average value of the interests" method. Investment managers already prepare detailed fee and expense disclosures and are readily able to provide investors with statements of fees and expenses allocated to them. This market-standard practice may easily serve the purpose of sourcing investment management receipts.

B. *Investment management receipts attributable to **investors the locations of which <u>can</u> be identified** should be sourced to them, notwithstanding whether the remaining share of investment management receipts can be similarly traced.*

We recommend that the Department clarify in its adoption of final regulations or other administrative guidance that the rules in *Proposed* Regulation section 4-4.4(c)(2) do not depend on the investment manager's ability to identify the locations of *all* investors in a passive investment customer. In other words, to the extent that the investment manager is able to identify *some* investors in a passive investment customer in accordance with *Proposed* Regulation section 4-4.4(c)(2)(ii), investment management receipts attributable to investors the locations of which can be identified should be sourced in accordance with the primary rule, however formulated, in *Proposed* Regulation section 4-4.4(c)(2)(iii). The remaining share of investment management receipts attributable to investors the locations of which cannot be identified should be subject to the rules applicable to the investment manager if it cannot determine the location of investors.

For administrability reasons, nearly every jurisdiction in which market sourcing applies to service revenue has adopted a hierarchical approach with successive substitute rules that are applicable where the information required by the previous rule was unknown or otherwise indeterminable. The nature and order of these substitute rules rest on a policy judgment that each rule before the next is a more accurate characterization of the location at which the benefit of such services is received. Again, New York State embarked on industry- and activity-based market sourcing rules to reflect more accurately the economics of specific service provider-customer arrangements. Accordingly, we request that the Department clarify that investment managers should not entirely abandon a more accurate, or higher tier, sourcing rule merely because of the inability to identify some investors in a passive investment customer; only investment management receipts attributable to those residual investors the locations of which cannot be identified should be subject to a "back-up," or lower tier, sourcing rule.

C. *The **reasonable approximation methods** of Proposed Regulation sections 4-4.5 and 4-4.6, including the **sourced receipts method**, should apply to investment management receipts that are attributable to investors the locations of which cannot be identified, rather than the location where the contract for such services is managed by the passive investment customer.*

We recommend that the Department modify *Proposed* Regulation section 4-4.4(c)(3) to provide that, if the investment manager cannot determine the locations of some investors under *Proposed* Regulation section 4-4.4(c)(2)(ii), it may source such receipts in accordance with the reasonable approximation methods of *Proposed* Regulation sections 4-4.5 and 4-4.6, including where applicable, in the same proportion as its sourced receipts (the "**sourced receipts method**"), as described in *Proposed* Regulation section 4-4.5(c)(3). The reasonable approximation methods set forth in *Proposed* Regulation sections 4-4.5 and 4-4.6 should serve as a substitute for the currently proposed "back-up" rule which requires the benefit of management, distribution, and administration services provided to a passive investment customer to be presumed to be received at the location where the contract for such services is managed by the passive investment customer.

Notably, this currently proposed "back-up" rule was formerly the primary sourcing rule in *Draft* Regulation section 4-4.4(c)(2) (2022) that suffered from the tendency to produce cost-of-performance sourcing results contrary to the text of the authorizing statute and its legislative intent. Indeed, separate and apart from the concerns expressed in our August 2022 letter, the rationale for the recent determination of the Division of Tax Appeals in *Matter of Jefferies Group LLC & Subsidiaries*[9] casts doubt on whether such a rule would ever be appropriate under either the authorizing statute[10] or Commerce and Due Process Clause principles.[11] At best, such a rule seems universally vulnerable to alternative apportionment as described in Section 210-A(11) under which an investment manager could

[9] *Matter of Jefferies Group LLC & Subsidiaries*, Administrative Law Judge DTA, Nos. 829218 & 829219 (Aug. 31, 2023).

[10] *Id.* at 72-82.

[11] *Id.* at 99-102 (citing *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931)).

easily carry its burden by showing that the rule, in effect, sources all investment management receipts to New York State.

Relatedly, the sourcing hierarchy in Section 210-A(10)(b) and *Proposed* Regulation section 4-4.2(b) goes to great lengths to avoid cost-of-performance sourcing results—first, allowing reasonable approximation based on customer information under *Proposed* Regulation section 4-4.5, including the sourced receipts method, or general information under *Proposed* Regulation section 4-4.6, and then, the delivery destination method under *Proposed* Regulation section 4-4.7, and then, the preceding taxable year method under *Proposed* Regulation section 4-4.9, and in the final instance, the current taxable year method under *Proposed* Regulation section 4-4.10. At no point does the proposed general framework for market sourcing concede to simply sourcing receipts to New York State, without more. Moreover, the Department is promulgating the rules relating to the sourcing of investment management receipts under the authority of Section 210-A(10) under which any such rules are necessarily, and without further discretion, subject to the hierarchy of methods in Section 210-A(10)(b). Therefore, the Department should permit the use of the reasonable approximation methods of *Proposed* Regulation sections 4-4.5 and 4-4.6, consistent with the methods prescribed in Section 210-A(10)(b)(3) and (4).

Further, the special rules in *Proposed* Regulation section 4-4.3 provide that the reasonable approximation methods under *Proposed* Regulation section 4-4.5 and 4-4.6 apply to determine where the benefit of certain services is received. Similarly, these reasonable approximation methods should apply to determine where the benefit is received under *Proposed* Regulation section 4-4.4, including in the case of a passive investment customer. Moreover, we are not aware of any other jurisdiction, which has adopted or proposed to adopt similar rules, that would not permit reasonable approximation prior to defaulting to an in-state presumption.[12] Accordingly, we urge the Department to align the rules relating to the sourcing of investment management receipts with this general framework and permit the use of the sourced receipts method as a "back-up" rule, rather than the location where the contract for such services is managed by the passive investment customer.

D. *The definition of "management services" should specifically include services performed under an **investment sub-advisory agreement**.*

We recommend that the Department modify the definition of "management services" to specifically include services performed under an investment sub-advisory agreement. The definition of "management services", as currently proposed, contemplates the rendering of investment management or advisory services to, and pursuant to a contract with, a passive investment customer. However, some investment managers operate in a structure under which the investment manager delegates one or more duties, which would otherwise be described by the definition of "management services", to one or more sub-advisers (which are often affiliates of the investment manager), with the investment manager obligated to monitor and oversee the actions of the sub-adviser(s). Generally, sub-advisers contract with and are compensated by the "primary" investment manager. The definition of "management services", therefore, seemingly excludes such services performed under an investment sub-advisory agreement because the language "rendering…to a passive investment customer" or "on behalf of a passive investment customer" does not clearly encompass the performance of such services indirectly and, more explicitly, because the limiting clause, "but only where such activity or activities are performed pursuant

[12] *See*, *e.g.*, *Draft* CAL. CODE REGS. tit. 18, § 25136-2(c)(2)(B) (2021) ("If the taxpayer does not know the average value of interest in the assets held by the asset's investors or beneficial owners domiciled in this state, the receipts shall be assigned to this state to the extent the average value of interest in the assets held by the asset's investors or beneficial owners domiciled in this state is reasonably estimated to be in this state."); N.J. ADMIN. CODE § 18:7-8.10A(a)(8)(ii)(1) ("In the event the domiciles of the beneficiaries are not or cannot be obtained, a reasonably proxy may be used to allocate receipts to new Jersey that reflects the trade or business practice and economic realities underlying the generation of receipts from the asset management services.").

to a contract with the passive investment customer," excludes services performed under a market-standard investment sub-advisory agreement.

There is no policy reason to exclude services performed under an investment sub-advisory agreement from the definition of "management services", especially where the sub-adviser is an affiliate of the investment manager and where the arrangement is dictated by regulatory or other legal considerations (for example, because the passive investment customer is organized in a different jurisdiction from where the investment management or advisory services are being performed). The duties performed by sub-advisers are precisely those described in *Proposed* Regulation section 4-4.4(c)(4)(iv)—"the rendering of investment advice…, making determinations as to when sales and purchases of securities are to be made…, or the selling of securities…, and related activities."

Nor is there an administrability reason to exclude such services. Often, as noted, sub-advisers are affiliated with the primary investment manager which should obviate any concern that a sub-adviser would be unable to diligence the location at which the benefit of such service is received in accordance with the primary sourcing rule. Even with respect to unaffiliated sub-advisers, we do not foresee any concerns with the primary investment manager disclosing the necessary information for the sub-adviser to properly source such receipts in accordance with the primary sourcing rule. Indeed, as part of the confidentiality provisions of a market-standard investment sub-advisory agreement, each party to the agreement is generally permitted to disclose, without limitation of any kind, the tax treatment and tax structure of the passive investment customer and any of its transactions, and all materials (including opinions or tax analyses) relating to such tax treatment and tax structure. Accordingly, we urge the Department to modify the definition of "management services" by either (i) including language contemplating the performance of such services "directly or indirectly" and deleting the limiting clause beginning with "but only if…", or (ii) making separate provision for services performed under an investment sub-advisory agreement in the definition of "management services".

E. *Clarify that investment management receipts include receipts for services that do not fit squarely within the definitions of "administration services", "distribution services", and "management services" but are* ***ancillary or closely related to such services****.*

We recommend that the Department clarify in final regulations that when investment management receipts are comprised of both receipts from services specifically described by the definitions of "administration services", "distribution services", and "management services", and receipts from services ancillary or closely related to the same, but not so neatly defined, the receipts should not be divided into separate components for purposes of the application of the rules in Part 4 but rather should be considered one receipt, regardless of whether the components are separately stated in any fee or expense disclosure.[13] The definition of "management services" in *Proposed* Regulation section 4-4.4(c)(iv) includes "related activities", but the definitions of "administration services" and "distribution services" in *Proposed* Regulation sections 4-4.4(c)(i) and (iii) are not as flexibly drafted. We recommend that the catch-all "related activities" concept be added to the definitions of "administration services" and "distribution services".

The types of fees and expenses chargeable to investors that may be contemplated by a passive investment customer's organizational and offering documents are varied and may include, in addition to investment management receipts as strictly defined in the proposed Regulations, fees and expenses from origination and distribution[14] services, deal sourcing activities related to unsuccessful investments

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[13] We note that an analogous issue is presented in the context of a sale that is comprised of both a digital product and a digital service, as to which *Proposed* Regulation section 4-1.3(a) applies a "lump sum payments" concept to treat the payments as one receipt rather than disaggregating the separate components.

[14] We use "distribution services" in this context to refer to the distribution of securities in connection with a portfolio investment, rather than the distribution services or investor account servicing in connection with the passive investment customer contemplated by *Proposed* Regulation section 4-4.4(c)(4)(iii).

(or "broken deal expenses"), or services performed pursuant to a contract other than directly with a passive investment customer. Moreover, fees and expenses associated with examinations, investigations, or other regulatory or compliance matters may not be considered "legal" services for purposes of the definition of "administration services" because the services do not involve the practice of law strictly understood. Investment managers may also utilize a pass-through expense model under which the passive investment customer pays for most of the investment manager's expenses, but the investment manager does not charge a management, advisory, or similar fee.

In any case, certain fees and expenses may not fit squarely within the categories of investment management receipts but are either aggregated with or so closely related to the same that considering such fees and expenses as one receipt (or, at a minimum, receipts of a similar kind) is both the most administrable, and likely the most accurate, characterization of the location at which the benefit of such service is received. The definition of "management services" appears to recognize the breadth of services for which an investment manager may charge a management, advisory, or similar fee, through the inclusion of the catch-all "related activities" concept. However, the meaning of this catch-all "related activities" concept may be construed as limited by the kind or class of activities that immediately precede the catch-all language and, therefore, exclude certain ancillary services. The definitions of "administration services" and "distribution services" do not include similar catch-all language. Accordingly, we request that the Department both add the catch-all "related activities" concept to the definitions of "administration services" and "distribution services" and clarify in final regulations that rules relating to the sourcing of investment management receipts apply to receipts from aggregated, ancillary, or closely related services.

F. *Clarify that the principles of the rules relating to the sourcing of investment management receipts also apply where the investment management receipts are received by a* ***registered broker or dealer*** *under Section 210-A(5)(b)(5).*

We recommend that the Department clarify in final regulations that a service provider sources investment management receipts from a passive investment customer in accordance with the principles of *Proposed* Regulation section 4-4.4(c), regardless of whether the service provider is a registered broker or dealer.

Although most investment managers are not registered as brokers or dealers, some are registered due to regulatory requirements or other considerations. For example, a registered securities broker-dealer may be involved in the marketing or selling of interests in a passive investment customer which is a "distribution service" described in *Proposed* Regulation section 4-4.4(c)(iii). As described above, as set forth in our August 2022 letter, and as recognized by the proposed Regulations, the true customers of these types of services are generally the investors in a passive investment customer, rather than the passive investment customer itself. There is no policy reason why the rules relating to the sourcing of investment management receipts should not apply merely because the recipient is a registered broker or dealer. Regardless of whether the investment management receipts from the passive investment customer are received by a registered broker or dealer, customer-based sourcing principles mandate that the receipts be sourced to the location of the investors in the passive investment customer, for the reasons set forth in our August 2022 letter.

Well before the 2014-2015 corporate tax reform legislation that expanded customer-based sourcing to a full range of service industries, the Legislature recognized that it was important to provide customer-based sourcing for registered brokers and dealers in order to preserve New York State's preeminent position in the securities industry.[15] Thus, Section 210-A(5), originally enacted in 2000 as

[15] *See*, *e.g.*, 2002-03 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support 10 (2002) ("The customer sourcing provisions for registered brokers and dealers enacted by Chapter 63 of the Laws of 2000 were intended to alleviate the tax burden placed on the securities industry under existing tax statutes and act as an incentive for the

former-Section 210(3)(a)(9), provides customer-based sourcing for a wide range of receipts of a registered securities broker or dealer. Specifically, Section 210-A(5)(b)(5) provides that, "[r]eceipts constituting fees for management or advisory services . . . shall be deemed to be generated within the state if the mailing address of the customer who is responsible for paying such fees is within the state."

Accordingly, we request that the Department clarify in final regulations that, for purposes of Section 210-A(5)(b)(5), in the case of investment management receipts from a passive investment customer, the "mailing address of the customer who is responsible for paying such fees" shall be deemed to be the mailing address of the investors in such passive investment customer as determined under *Proposed* Regulation section 4-4.4(c)(2).

* * *

We appreciate the opportunity to provide our feedback to the Department on the text of proposed rules under Part 4 of the Article 9-A Business Corporation Franchise Tax Regulations, and we would be pleased to meet with the Department to discuss our feedback. If the Department has questions or comments, please do not hesitate to contact Joseph Schwartz, Director and Counsel, Regulatory Affairs, or the undersigned at (202) 730-2600.

Respectfully submitted,

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Mark Massaroni, Deputy Commissioner of Tax Policy Analysis

financial services industry to retain its strong presence in New York."), https://www.budget.ny.gov/pubs/archive/fy0203archive/fy0203articleVIIbills/revenue_memo.html.