

## New York State Adopts Amendments to Combined Reporting Regulations

January 4, 2013

### Overview

The New York State Department of Taxation and Finance (the “Department”) recently adopted amendments to the combined reporting regulations applicable to general business corporations (including REITs and RICs) subject to the tax (Franchise Tax) imposed by Article 9-A of the New York Tax Law.<sup>1</sup> New York Tax Law generally provides that “related corporations” with “substantial intercorporate transactions” must file a combined report.<sup>2</sup> The Department had issued a technical memorandum, TSB-M-08(2)C (Mar. 3, 2008) that outlined and interpreted the provisions on combined reporting and provided guidance with respect to determining what corporations are required to be included in a combined report. The amendments in large part codify TSB-M-08(2)C, which still remains effective for tax years beginning on or after January 1, 2007 through December 31, 2012. The amended regulations apply to tax years beginning on or after January 1, 2013.

In this External Tax Alert we summarize the amendments and provide an overview regarding how the amendments differ from the guidance contained in TSB-M-08(2)C and, in certain instances, the currently superseded regulations. We also note a few of the Department’s statements in its “Assessment of Public Comment,” which was published in connection with the adoption of the amendments and which addresses written comments submitted regarding the proposed regulations.

### TSB-M-08(2)C and the Amended Regulations Compared

The requirements for filing a combined report set forth in the regulation amendments are in many respects similar to the requirements set forth in TSB-M-08(2)C. However, the amended regulations contain the following notable changes from TSB-M-08(2)C:

- TSB-M-08(2)C does not contain an explicit unitary business requirement for mandatory combined reporting arising from substantial intercorporate receipts or expenditures (although it appears highly unlikely that a taxpayer could be subject to mandatory combined reporting under these tests without being part of a unitary business). Reg. Sec. 6-2.1(a) includes a unitary business requirement (as further described in Reg. Sec. 6-2.3(b)(2)) that is essentially the same as that found in former Regulation Sec. 6-2.2(b).
- Reg. Sec. 6-2.3(b)(2) states that “[i]nterest paid and received on loans between related corporations is considered in determining if there are substantial intercorporate transactions, including interest on loans that constitute subsidiary capital pursuant to section 3-6.3 of this Title and section 208.4 of the Tax Law.” In contrast, under TSB-M-08(2)C, interest paid and received on loans treated as subsidiary capital does *not* qualify as an intercorporate transaction. In addition, Reg. Sec. 6-2.3(b)(2) states that taxes paid or reimbursed will not be considered in determining if there are substantial intercorporate transactions. TSB-M-08(2)C does not address this point.
- Reg. Sec. 6-2.3(b)(1)(v) states that “[i]n determining whether there are substantial intercorporate transactions, the Commissioner will consider and evaluate all activities and transactions of the taxpayer and its related corporations, including but not limited to . . . incurring expenses that benefit, directly or indirectly, one or more related corporations.” This does not appear to be an expansion upon the previously established guidance of TSB-M-

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<sup>1</sup> The amendments, first proposed in the *New York State Register*, Sept. 12, 2012, were adopted and signed by Commissioner Mattox on December 17, 2012. For an earlier Alert dated September 26, 2012, addressing the proposed amendments, go to: [http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us\\_tax\\_multistate\\_NY\\_09-26-12.pdf](http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_multistate_NY_09-26-12.pdf).

<sup>2</sup> N.Y. Tax Law Sec. 211.4.

08(2)C. Language has been added to Reg. Sec. 6-2.3(b)(2) to provide that expenditures for service functions, such as accounting, legal, payroll processing and personnel services, are not considered expenditures benefiting a related corporation or a group of related corporations for purposes of the new expenditure test described directly below. Furthermore, Reg. Sec. 6-2.3(b)(2) states that where a corporation makes expenditures that benefit a related corporation or a group of related corporations and allocates such expenditures to such related corporations, the intercorporate cost allocations are not considered receipts or expenditures.

- TSB-M-08(2)C contains three separate tests for mandatory combined reporting: one based on substantial intercorporate receipts, one based on substantial intercorporate expenditures (including expenditures incurred on behalf of related corporations), and one based on substantial intercorporate asset transfers. The amended regulations also provide for intercorporate receipts, expenditures and intercorporate asset transfer tests for the existence of substantial intercorporate transactions. However, Reg. Sec. 6-2.3(b)(3)(i)(a)(2) and (3) provide for two sets of expenditure testing. Under Reg. Sec. 6-2.3(b)(3)(i)(a)(2), substantial intercorporate transactions exist where 50% or more of a corporation's expenditures includable in its computation of entire net income (including expenditures for inventory, but not for nonrecurring expenditures) are "to" a related corporation or a group of related corporations. Under Reg. Sec. 6-2.3(b)(3)(i)(a)(3), referred to above as the "new expenditure test," substantial intercorporate transactions exist where:

during the taxable year, (i) 50 percent or more of a corporation's expenditures includable in the computation of entire net income (excluding nonrecurring expenditures) directly or indirectly benefit a related corporation or a group of related corporations or (ii) a corporation's expenditures includable in the computation of entire net income (excluding nonrecurring expenditures) directly or indirectly benefiting a related corporation or a group of related corporations are equal to 50 percent or more of the sum of such expenditures and the expenditures (excluding nonrecurring expenditures) of the beneficiary corporation or corporations.

- Reg. Sec. 6-2.3(b)(3)(ii)(a) states that for purposes of meeting the test for substantial intercorporate asset transfers, in general, assets are considered "qualifying assets" only to the extent that they are transferred in exchange for stock or paid-in capital. Transfers of assets other than in exchange for stock or paid-in capital, including transfers of assets through a nonmonetary property dividend, are not considered unless the principal purpose of the transfer is the avoidance or evasion of the franchise tax imposed on the taxpayer or the combined group by New York State. TSB-M-08(2)C provides only that transactions in which assets are exchanged for stock or paid-in capital of the transferee are to be considered, leaving out the possible application of the rule to transfers of assets for other consideration where there was a principal purpose to avoid tax.
- Under TSB-M-08(2)C and Reg. Sec. 6-2.3(b)(3)(ii)(e), a transfer of assets to a related corporation will satisfy the substantial asset transfer test where 20% or more of the transferee's gross income, including any dividends received, in the taxable year of the transfer or in taxable years subsequent to the year the asset or assets were transferred is derived directly from the transferred assets and the corporations are engaged in a unitary business. TSB-M-08(2)C states that gross income from transferred assets that generate income only when used in combination with other assets is *not* derived directly from the assets. An example in TSB-M-08(2)C involves the transfer of a lathe to a related corporation that used it as one of many machines on the production line. Under the TSB, income from the sale of the products produced through the use of the lathe is not considered income directly derived from that lathe and the example provides that this answer holds true even if all of the equipment used to make the product was transferred to the transferee. In contrast, Reg. Sec. 6-2.3(b)(3)(ii)(e) expands the application of the transferred assets rule to include in the test income from the sale of items produced from transferred production

equipment constituting substantially all of the production process, including associated intangibles, such as might occur in the transfer of an operating division.<sup>3</sup>

- Also for purposes of meeting the test for substantial intercorporate asset transfers, Reg. Sec. 6-2.3(b)(3)(ii)(h) states that, if the asset transferred is an interest in another entity, including a partnership, an entity treated as a partnership or a disregarded entity, the interest in the entity is considered the transferred asset and income distributed or deemed distributed to the transferee by such entity is gross income derived directly from the transferred asset. Since New York State generally respects the federal treatment of disregarded entities, the regulation appears to be referring to an asset transfer constituting less than the entire interest in a disregarded entity. As a result of this transfer, the entity would no longer be treated as a disregarded entity for Federal or New York State purposes. In this instance, in subsequent years, the transferee could have income derived from the assets acquired in the transfer.
- New Reg. Sec. 6-2.3(c) sets forth 10 steps that should be used to determine whether a combined report is required and, if so, which corporations are included in that combined report. Those steps generally parallel the steps set forth in TSB-M-08(2)C except in two instances. Regarding step 2, TSB-M-08(2)C states the following:

Identify all of the related corporations that have substantial intercorporate transactions with any taxpayer identified in Step 1. These related corporations and the taxpayers constitute the Step 2 tentative combined group.

The regulation describes step 2 as follows:

Identify all of the related corporations that have substantial intercorporate transactions with a taxpayer identified in Step 1. These related corporations and the taxpayer with which they have substantial intercorporate transactions constitute the Step 2 tentative combined group.

The amended regulation changes the second sentence to “these related corporations and the taxpayer with which they have substantial intercorporate transactions” apparently to eliminate the potentially confusing language in TSB-M-08(2)C that seems to automatically combine all related taxpayers (and those corporations identified as related to those taxpayers in step 2) regardless of whether there were substantial intercorporate transactions among all those related taxpayers.

For step 10, the amended regulation adds New York S corporations and non-New York taxpayer federal S corporations to the list of corporations eliminated from combination.

- Reg. Sec. 6-3.2(b) confirms that it is not necessary that all corporations in the combined group have the same accounting period. This is consistent with TSB-M-08(2)C, but is a change to the existing regulation.

Although not triggering a comparison with TSB-M-08(2)C, it is noteworthy that Reg. Sec. 6-2.2(a)(3) changes the ownership test for combined reporting. Former regulation section 6-2.2(b)(2) based the ownership test on the percentage of voting stock owned by the affiliated corporations. The amended regulation bases the test on the percentage of voting power owned by the affiliated corporations.

### **Statements from the Department’s “Assessment of Public Comment”**

- In its “Assessment of Public Comment,” the Department states that the tests of receipts and expenditures in determining whether substantial intercorporate transactions exist are based on the amounts of receipts and expenditures shown on the taxpayer’s books. If transfer pricing adjustments occur at the federal level, then the intercorporate receipts and/or expenditure tests for the affected years need to be redetermined taking into account such transfer pricing adjustments.

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<sup>3</sup> Reg. Sec. 6-2.3(b)(3)(ii)(e); Reg. Sec. 6-2.3(b)(3)(ii)(k) Ex. 2.

- With respect to the treatment of so-called “stapled corporations” (certain corporations organized outside of the U.S. that file as domestic corporations for federal income tax purposes), the Department states that a corporation organized under the laws of a country other than the U.S. is not required or permitted to make a combined report. Therefore, it would appear that such stapled corporations will be excluded from New York combined return groups (although intercorporate transactions between a stapled corporation and related U.S. corporations can be used in determining whether the related U.S. corporations should be combined).
- The Department also indicates that federal mark-to-market adjustments are not considered as “receipts” or “expenditures” for purposes of testing for the existence of substantial intercorporate transactions.

## Contacts

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