Tax Insights & Commentary
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NYC Corporate Tax Update Is a Refreshing Change for Partnerships

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- *KPMG's Aaron Shafer reviews city plans on partnership sourcing*
- *Taxpayers using market-based approach will find change helpful*

The New York City Department of Finance's update on how it may deviate from the state's recently enacted corporate tax regulations is a welcome, if not entirely unexpected, change that will simplify sourcing determinations for corporate taxpayers.

For corporations receiving partnership income, the city has said it generally will apply the same market-based sourcing method as the state.

The state's regulations generally provide that corporate taxpayers should "flow-up" the apportionment factors received from a partnership, and should combine and compute these factors along with their own and those received from other partnerships, using the corporate market-based sourcing rules for the combined activities.

Market-based sourcing determines taxable income based on customer location, rather than where services are performed. Accordingly, a business located in New York state with the same customer profile as an out-of-state business generally would be taxed the same because where the services are performed doesn't determine the tax.

The city indicated earlier this year that its forthcoming regulations would depart from the state's corporate tax regulations by having corporations apportion receipts from partnerships using the unincorporated business tax rules, which generally source receipts based on where services are performed.

This would have undermined one of the fundamental aims of the city's 2015 corporate tax reform—creating a more business-friendly environment for local businesses by not penalizing companies that have more employees and physical operations (that is, those that perform more services) in the state.

If the city had deviated from the state, it could have encouraged businesses to move operations out of the city—under the unincorporated business tax rules, taxable income generally is determined by where the services are performed.

If the Covid-19 era taught us anything about where workers can be productive, it's that the modern workforce—especially financial services—is agile and mobile. If performing fewer services in the city had a tax advantage, many companies could make that move.

The city's announcement also addressed its continuing plan to digress from the state in its approach for a corporate taxpayer's sourcing of fee income from passive investment customers. In general, PICs are entities that pool capital for investment but otherwise aren't engaged in a trade or business.

PICs tend to include, but aren't limited to, hedge funds. New York state regulations say the source of receipts from a PIC are based on the location of its ultimate investors. But if the investors' location information is unknown, all the receipts are sourced to where the contract with the PIC is managed.

A management company based in the state more likely would have a contract with the PIC be managed in the state (and often, that also would mean in the city). If so, then all fees from the PIC potentially could be sourced to the state. This starts to sound like we're back to sourcing based on where services are performed rather than customer location, again deviating from a public policy objective of the 2015 corporate tax reform.

The potential for an all-or-nothing approach by New York state could lead taxpayers to wonder whether the city is purposely trying to drive this type of business out of the state.

The different approach the city indicated in its announcement provides for a bifurcated method that more closely aligns with market-based sourcing: Use investor location detail to the extent available and a fixed 8% rate for the portion of the fee related to investors whose location is unknown.

The state rejected this default 8% method for sourcing services rendered to PICs during its public comment period. The city said it anticipates finalizing its own corporate tax reform regulations by early 2025 and that it will apply these retroactively to years still open from 2015 onward, as the state did.

It took New York state almost a decade to finalize its regulations. During that period, there were numerous issues to work through, some of which remain unresolved. While the city's process will take less time, it could decide certain issues with an approach that varies from the rules adopted by the state.

City-based taxpayers that would benefit from market-based sourcing generally hope for rules that take the market approach. They found the city's announcement about a corporate partner's sourcing of partnership income to be satisfying news.

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