New York City Department of Finance

UPDATE ON AUDIT ISSUES

Business Income Taxes

Income Allocation

November 25, 2016

I. ISSUES

a. May an entity invoke the receipts allocation provisions of sections 11-508(e-3), 11-654.2(5)(6), or 11-604(3)(a)(10) of the Administrative Code of the City of New York (the "**Code**") if it is not a registered securities or commodities broker or dealer ("**Registered**")?

b. May an entity invoke the registration status of a Registered single-member limited liability company ("**SMLLC**"), which it owns and treats as a "disregarded entity" for federal income tax purposes, in order to apply the allocation provisions of sections 11-508(e-3), 11-654.2(5)(6), or 11-604(3)(a)(10) of the Code (the, "**Broker-Dealer Provisions**") to receipts from activities the SMLLC does not conduct?

II. CITATIONS

Organizations that do business within and without New York City (the "City") must allocate their incomes within and without the City to determine their City business income tax liabilities. Each City business income tax currently applies a three-factor formula, consisting of property, payroll and receipts, to perform that allocation. See, sections 11-508, 11-604(3), 11-642, and 11-654(3) of the Code. This Update on Audit Issues concerns the allocation of receipts within and without the City. For tax years beginning on or after January 1, 2018, receipts will generally be the only factor that determines income allocation under the City business income taxes.

In the case of unincorporated businesses and federal S-corporations, the Code permits a "registered securities or commodities broker or dealer" to use unique customer-based rules for allocating seven enumerated categories of receipts, including: brokerage commissions, margin interest, gross income from principal transactions, certain underwriting revenues, interest on certain loans to affiliated entities, account maintenance fees, and fees for management or advisory services. See, sections 11-508(e-3) and 11-604(3)(a)(10) of the Code. In the case of federal C-corporations, for tax years beginning on or after January 1, 2015, the Code permits a "registered securities broker or dealer" to allocate receipts from securities or commodities broker or dealer activities with the same unique customer-based allocation rules for the same categories of receipts, with the exception of principal transactions, which are excluded.

The Department of Finance ("**DOF**") has observed that some taxpayers have interpreted the terms "registered securities or commodities broker or dealer" and "registered securities broker or dealer" broadly, apparently on the basis of two Finance Letter Rulings under which DOF permitted unregistered limited partnerships to characterize themselves as Registered. DOF reached these determinations on the basis of specific representations from the letter ruling

applicants about the operation of the relevant United States securities laws. See, Finance Letter Rulings #12-4934/UBT (dated August 19, 2013) and #13-4950/UBT (dated March 28, 2014, collectively, the "**Broker-Dealer Rulings**").

In particular, the Broker-Dealer Rulings relied on representations that the taxpayers were entitled to, and did, function as securities or commodities broker or dealers under an exemption from Securities and Exchange Commission registration requirements and pursuant to specific Commodities Future Trading Commission registrations. The facts state: "Taxpayer can act a broker-dealer, perform all functions of a security broker or dealer, hold itself out to customers as a broker or dealer, and be treated as a broker-dealer by all parties with which it interacts." See, FLR #13-4950/UBT (dated March 28, 2014). The facts go on to state that: "[a]s a CPO [Commodities Pool Operator] and CTA [Commodities Trading Advisor], Taxpayer performs the functions of a commodities broker and dealer, acts as a broker and dealer, and is treated as a broker and dealer by all parties with which it acts, as those terms are commonly understood" (collectively, the "**Representations**"). See, Id.

DOF has also been reviewing whether the sole member of a Registered SMLLC may use the SMLLC's registration status as a basis for claiming that the sole member is Registered for purposes of allocating all its receipts. SMLLCs are disregarded entities for City tax purposes if they are disregarded entities for federal tax purposes. See, Fin. Memo 99-1 (October 21, 1999). A published New York State Department of Taxation and Finance Advisory Opinion permits a taxpayer to characterize itself as a broker-dealer for purposes of allocating the receipts that the SMLLC generated. See, New York State Advisory Opinion TSB-A-13(11)C (dated December 20, 2013, the, "**NYS Opinion**").

III. RECOMMENDATIONS

Finance Letter Rulings are not precedential and bind DOF only to the taxpayer and facts, to the extent accurate, set forth in the ruling. Accordingly, taxpayers may not rely on the Broker-Dealer Rulings to take the position that unregistered entities may characterize themselves as Registered under the Broker-Dealer Provisions.

Further, the Broker-Dealer Rulings do not reflect the current analysis of DOF with respect to the application of the Broker-Dealer Provisions because DOF has determined that the Representations in the Broker-Dealer Rulings are not reliable. The letter ruling requests, and Broker Dealer Rulings themselves, did not establish that individual registered representatives, who are associated persons of another company that is Registered, would entitle their unregistered employer to act in the same capacity as a broker or dealer and earn securities or commodities transaction based compensation. The letter ruling requests, and Broker Dealer Rulings themselves, also did not establish that registration as a CPO or CTA would entitle an entity to act in the same capacity as a broker or dealer, as that term is commonly understood.

DOF may consider the application of the Broker-Dealer Provisions, on a case-by-case basis, to entities that establish they are themselves legally acting in the capacity of a broker or dealer with respect to receipts that are specifically enumerated in the Broker-Dealer Provisions; DOF would not, however, permit entities to apply the Broker-Dealer Provisions on the same facts presented in the Broker-Dealer Rulings. For example, DOF may permit an entity that is registered with the Commodity Futures Trading Commission as a Floor Broker or Futures Commission Merchant to

characterize itself as Registered for purposes of the Broker-Dealer Provisions, but DOF would not permit an entity that is a CPO to characterize itself as Registered for the same purpose.

Similarly, no basis exists, under the NYS Opinion or otherwise, for extending the application of the Broker-Dealer provisions to unregistered owners of Registered SMLLCs, apart from receipts the SMLLCs earn. Accordingly, DOF will consider the application of the Broker-Dealer Provisions to receipts generated by an SMLLC that is legally acting in the capacity of a registered securities or commodities broker or dealer, but DOF will not permit entities to attribute the registration or activities of an SMLLC to themselves or their affiliates for purposes of applying the Broker Dealer Provisions to receipts earned by other entities and that the SMLLC did not earn in its capacity as a broker or dealer.