New York State Department of Taxation and Finance
Office of Counsel
Advisory Opinion Unit

TSB-A-13(11)C
Corporation Tax
December 20, 2013

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C110112D

The Department of Taxation and Finance received a Petition for Advisory Opinion from [redacted]. Petitioner asks whether certain of its transactions, referred to as "matched principal transactions," are principal transactions that can be sourced using the production credit method of allocation found in Tax Law § 210.3(a)(9)(A)(iii). Petitioner also asks if it can use the production credit sourcing method of allocation in Tax Law § 210.3(a)(9)(A)(iii) for both voice-brokered transactions and electronically traded transactions.

We conclude that Petitioner, either directly through its ownership interest in various single member limited liability companies (SMLLCs) that were registered broker-dealers prior to January 2005, or through its partnership interest in a partnership that in turn owned SMLLCs that were registered broker-dealers after December 31, 2004, is viewed as a principal in the transactions for purposes of Tax Law § 210.3(a)(9)(A)(iii), and that matched principal transactions in which Petitioner incurs a risk of loss based on the differences in the sales prices of the two component trades of a matched transaction qualify as principal transactions for purposes of Tax Law § 210.3(a)(9)(A)(iii). Gross income derived directly from the profit or loss from the difference in the trade prices of the two sides of a matched principal transaction may be sourced by the production credit method described in that Tax Law section. Further, any income that represents in whole or in part revenue from brokerage services may not be sourced based on production credits. If Petitioner uses the production credit sourcing method to allocate gross income from matched principal transactions, it will have the burden on audit to prove that its production credit sourcing method is designed at least in material part to attribute gross income from matched principal transaction to the offices, branches or employees responsible for generating that income.

Facts

The Petitioner, [redacted] ("X") is a wholly-owned indirect U.S. subsidiary of [redacted] ("Y"), a publically traded company on the London Stock Exchange. X is headquartered and principally operating in New Jersey. From April 1, 2004 through December 31, 2004, X owned multiple single member limited liability companies (SMLLCs) that were disregarded entities and thus were treated as divisions of the Petitioner for corporate tax purposes. After December 31, 2004, X owned 88.8% of a partnership called [redacted] ("Z") This partnership, in turn, owned the SMLLCs that were formerly owned directly by X. When owned by the partnership, the SMLLCs continued to be treated for tax purposes as disregarded entities. Several of the SMLLCs are registered broker-dealers with the Securities and Exchange Commission. One of these SMLLCs, [redacted] ("A") which was formerly known as [redacted]

[redacted], is the entity through which X conducts its electronic inter-dealer trading system. A is a registered broker-dealer with the Securities and Exchange Commission, and is headquartered in New Jersey, with additional sales and support personnel located in Illinois.

One of the specialist intermediary brokering services X offers to professionals in the wholesale financial markets is facilitating "matched principal transactions." In these types of transactions, X anonymously matches up buyers and sellers of securities. X purchases securities from the seller, and then immediately resells them to the buyer. A or one of the other SMLLCs wholly owned by Z always acts as principal, executing the buy and sell transactions in its own name. The SMLLC takes legal title to the securities, and the risk of loss on them, before either submission of the transaction to the relevant clearing institution or self-clearing the transaction for settlement. The SMLLC's income is derived from the spread between the price it pays the seller for the security and the price at which it sells the security to a buyer. Sometimes, A acts as a "name-passing/introducing" broker for its clients, in which case it does not become, either directly or indirectly, "a principal to any Transaction," according to its Electronic Broking Master Participant Trading Agreement ("Master Agreement"). Alternatively, it can act as a "matched/riskless principal broker."

X's matched principal transactions are done through both voice brokering and electronic trading. For voice brokering, a broker prepares a trade ticket for each transaction containing all relevant information, which X's internal accounting system uses to match production credits with the specific trading desk and/or individual broker involved in the transaction.

When electronic trades occur, A similarly uses its internal accounting system to measure the amount of revenue and production credits that should be awarded to each of its particular trading desks. Although A's customers execute their trades using the electronic system, A has sales staff on each trading desk assigned to each customer. Each trading desk is devoted to a particular type of security, and trading desk personnel are in regular contact with their customers to provide investment advice and information.

If both customers are members of a clearing institution, such as the Fixed Income Clearing Corporation ("FICC"), matched principal transactions are fully cleared through the institution. However, if a non-FICC member is involved, the transaction must be "self-cleared" by X through its clearing institution, The Bank of New York. However, X bears the economic risk associated with completing a transaction if the trade fails on either the buyer or seller side of the transaction and must be cleared outside of the clearing house. X is required to provide a certain amount of margin money to FICC per day depending on how many transactions it has submitted with a non-FICC member involved.

X has a substantial amount of unmatched trades in any given day for which it has not yet found a buyer or seller. X claims its unmatched trades often exceed $100 million and subject it to market fluctuation risk.

X operates in New Jersey, New York, Kentucky, California, Georgia and Massachusetts. Petitioner contends that X has the capability, using its internal accounting systems, to accurately identify and source revenues from principal transactions based on production credits being awarded to officers or employees for services provided.

Analysis

In order to use the production credit method of allocation for income from principal transactions, Petitioner must be a "registered securities or commodities broker or dealer." Tax Law § 210.3(a)(9)(A). A registered securities or commodities broker or dealer is a broker or dealer who is registered by the Securities and Exchange Commission or the Commodities Futures Trading Commission. *See* TSB-M-00(5)C, 12/27/00. Under the facts presented, Petitioner itself is not registered with either of those commissions. However, several of the SMLLCs that are either owned directly or owned indirectly through a partnership are registered with the Securities and Exchange Commission.

A SMLLC that is treated as an entity disregarded from its single member for federal tax purposes will be disregarded for State tax purposes as well. *See* 26 (CFR § 301.7701-3(b)(1)(ii); NYS Tax Publication 16. Thus, when Petitioner is the single member of the SMLLC, the SMLLC is treated as a part of the Petitioner. When the partnership is the single member of the SMLLC, the SMLLC is treated as a part of the partnership.

The Department has concluded that certification under the Empire Zones Program of a SMLLC that is a disregarded entity treated for tax purposes as a division of its single member is treated as the certification of the single member *See* TSB-A-12(6)C, 10/15/12. This type of conclusion should be extended to the registration of broker-dealers with the Securities and Exchange Commission. Thus, if a SMLLC that is treated for tax purposes as a disregarded entity is a registered broker-dealer, its single member should be treated for purposes of the allocation rules under Tax Law § 210.3(a)(9) as a registered broker-dealer.

Section 3-13.1 of the Corporate Franchise Tax Regulations states that "a taxpayer that is a partner in a partnership shall compute its tax with respect to its interest in such partnership under the aggregate method or entity method, whichever applies" according to the rules in § 3-13.2 of the regulations. 20 NYCRR 3-13.1(a). Taxpayers with more than a 5% interest in a partnership are required to use the aggregate method unless they are unable to access the information necessary to compute their tax using this method. 20 NYCRR 3-13.2. When using the aggregate method, "a corporate partner is viewed as having an undivided interest in the partnership's assets, liabilities and items of receipts, income, gain, loss and deduction. Under the aggregate method, the partner is treated as participating in the partnership's transactions and activities." 20 NYCRR 3-13.a (b). An Article 9-A taxpayer who uses the aggregate method to calculate its tax with respect to its interest in a partnership must use "its distributive share of the partnership's receipts … within and without New York State … in computing its business allocation percentage." 20 NYCRR 4-6.5(a)(1). To do so, the taxpayer must calculate its receipts factor by adding its own business receipts within New York State to its distributive share of the partnership's receipts. A taxpayer that is a corporate partner in a partnership which is a registered broker-dealer would utilize the allocation rules for registered security brokers and dealers provided for under Tax Law § 210.3(a)(9) for its distributive share of the receipts from the partnership. Section 4-4.7(c). [1]

In sum, Petitioner will be deemed to be a registered broker-dealer and may use the production credit method to source gross income from principal transactions when the gross income is passed to it directly as the single member of the SMLLCs in question or indirectly from the SMLLCs owned by the partnership in which Petitioner is a partner.

Tax Law § 210.3 (a)(9)(A)(iii) provides that, for a registered securities or commodities broker:

> Gross income, including any accrued interest or dividends, from principal transactions for the purchase or sale of stocks, bonds, foreign exchange and other securities or commodities (including futures and forward contracts, options and other types of securities or commodities derivatives contracts) shall be deemed to arise from services performed within the state either (I) to the extent that production credits are awarded to branches, offices or employees of the taxpayer within the state as a result of such principal transactions or (II) if the taxpayer so elects, to the extent that the gross proceeds from such principal transactions (determined without deduction for any cost incurred by the taxpayer to acquire the securities or commodities) are generated from sales of securities or commodities to customers within the state based upon the mailing addresses of such customers in the records of the taxpayer. . . . For purposes of this subparagraph, the term "production credits" means credits granted pursuant to the internal accounting system used by the taxpayer to measure the amount of revenue that should be awarded to a particular branch or office or employee of the taxpayer which is based, at least in part, on the branch's, the office's, or the employee's particular activities. . .

TSB-M-02(5)(C) defines "principal transaction" as "one where the registered broker or dealer is acting as principal for its own account, rather than agent for the customer." Thus, gross income from a matched principal transaction includes only the income derived from the spread between the price the registered broker-dealer pays the seller for the security and the price at which it sells the security to a buyer. If the price the registered broker-dealer pays the seller for the security equals the price at which it sells the security to a buyer, the principal transaction itself does not generate any gross income. Any income received by the registered broker-dealer in that scenario would not be "gross income from principal transactions" sourced according to production credits, but rather akin to a commission derived from the execution of securities purchase or sales orders for the accounts of customers, and should be sourced to the customers'

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[1] Although the regulations cited here were adopted in 2006 (20 NYCRR § § 3-13.1, 3-13.2, 4-6.5) and 2007 (20 NYCRR § 4-4.7), it is reasonable to apply the interpretations described in those regulations to the Petitioner since those regulations represented in large measure codification of existing Department policy and statutory interpretation. *See* NYS Register, 8/23/06 pp 20-23, 10/24/07, pp 39-43.

mailing addresses as provided in § 210.3(a)(9)(A)(i). If income can be attributed both to the spread between the price the registered broker-dealer pays the seller for the security and the price at which it sells the security to a buyer as part of a matched principal transaction and to other sources, the income may not be sourced based on production credits.

If Petitioner uses the production credit method to source income distributed to it from the SMLLC registered broker-dealer for purposes of § 210.3(a)(9)(A)(iii), it will bear the burden on audit to establish that that income so sourced qualifies as gross income from principal transactions and that the production credit method used is bona fide and designed at least in material part to attribute gross income from matched principal transaction to the offices, branches or employees responsible for generating that income.

DATED: December 20, 2013

/S/
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NOTE: An Advisory Opinion is issued at the request of a person or entity. It is limited to the facts set forth therein and is binding on the Department only with respect to the person or entity to whom it is issued and only if the person or entity fully and accurately describes all relevant facts. An Advisory Opinion is based on the law, regulations, and Department policies in effect as of the date the Opinion is issued or for the specific time period at issue in the Opinion. The information provided in this document does not cover every situation and is not intended to replace the law or change its meaning.