SUBSTANCE OF THE PROPOSED RULE

DEPARTMENT OF TAXATION AND FINANCE

This proposal amends the Business Corporation Franchise Tax Regulations, as published in Subchapter A of Chapter 1 of Title 20 NYCRR, relating to the taxation of corporate partners.

Section 1 amends the definition of a partnership contained in section 1-2.6 of the regulations to include limited liability companies that have elected to be treated as partnerships under Federal regulations.

Sections 2, 3 and 4 amend sections 3-1.2, 3-2.1 and 3-3.1 of the regulations, respectively, to cross reference taxpayers to Subpart 3-13 for rules relating to corporate partners.

Section 5 amends section 3-3.2(a)(1) of the regulations relating to the definition of investment capital to delete cross references to former sections 3-6.3(e) and (f) relating to mergers and acquisitions which have been repealed. In addition, it sets forth the rule, with respect to a taxpayer that is a partner in a partnership using the aggregate method or that is a foreign corporate limited partner which has made an election with respect to such partnership pursuant to section 3-13.5 of this proposal, that the election to treat cash as business or investment capital is made at the partner level and that the partner takes into account its proportionate part of partnership items constituting cash.

Section 6 amends section 3-3.2(a)(2)(vii) of the regulations relating to the definition of investment capital to provide, with respect to a taxpayer that is a partner in a partnership using the aggregate method or that is a foreign corporate limited partner that has made an election with respect to such partnership pursuant to section 3-13.5 of the proposal, that in determining whether a stock, bond or other security is held for sale to customers in the regular course of business that, with respect to items held by such partnership, we look at the item itself to see if it is held as inventory by the partnership for sale to its customers in the regular course of its business.

Section 7 amends section 3-3.2(d)(2)(ii) of the regulations relating to the definition of investment capital to provide, with respect to a taxpayer that is a partner in a partnership using the aggregate method or that is a foreign corporate limited partner that has made an election with respect to such partnership pursuant to section 3-13.5 of the proposal, that the determination of whether a taxpayer is principally engaged in the lending of funds is made at the partner level and that the partner takes into account its distributive share of gross receipts from the partnership in making such determination.

Section 8 conforms section 3-3.3(d) of the regulations relating to the definition of business capital to the amendment made by section 5.

Section 9 amends section 3-4.1 of the regulations to cross reference taxpayers that are partners in partnerships to Subpart 3-13 for rules relating to corporate partners.

Section 10 amends section 3-5.1(b)(1) of the regulations relating to the computation of the tax measured by the fixed dollar minimum to capture the general executive officer concept at the partnership level.

Sections 11 amends the definition of the term subsidiary contained in section 3-6.2 of the regulation to provide that stock of a corporation owned through a partnership is not directly owned by the taxpayer and therefore does not meet the definition of a subsidiary. It also provides an example illustrating the rule.

Section 12 amends the definition of subsidiary capital contained in section 3-6.3 of the regulations to provide that where a taxpayer owns directly more than 50 percent of the stock of a corporation that any stock of such corporation owned by a partnership in which the taxpayer is a partner qualifies as subsidiary capital. Conversely, it provides that where a taxpayer does not directly own more than 50 percent of the stock of a corporation, any stock of such corporation owned by a partnership in which the taxpayer is a partner does not qualify as subsidiary capital but may qualify as investment capital. It also provides examples illustrating the rules.

Sections 13 and 14 amend sections 3-11.1 and 3-12.1 of the regulations, respectively, to cross reference taxpayers to Subpart 3-13 for rules relating to corporate partners.

Section 15 amends the index of Subpart 3-13, Corporate Partners, to facilitate the amendments thereto.

Section 16 renumbers section 3-13.1 to 3-13.5, repeals sections 3-13.2 and 3-13.3 and adds new sections 3-13.1, 3-13.2, 3-13.3 and 3-13.4.

(a) Section 3-13.1 provides that except for a foreign corporate limited partner that has made an election with respect to a partnership pursuant to section 3-13.5 of the proposal, that a taxpayer that is a partner in a partnership shall compute its tax under either the aggregate or entity method and provides a general description of each method.

(b) Section 3-13.2 sets forth the determination of the applicable method (aggregate or entity) of computing the tax under Article 9-A of the Tax Law. It provides that a taxpayer must use the aggregate method in computing its tax if it has access to the necessary information and provides criteria where the taxpayer is presumed to have access to such information. In addition, it provides that the taxpayer may overcome the presumptions and be allowed to use the entity method if it can establish and certifies that the information is not obtainable. It further provides how the determination is made with respect to lower tier partnerships. It also provides definitions of terms contained within the presumptions.

(c) Section 3-13.3 sets forth the computation of tax under the aggregate method. It provides that a taxpayer shall take into account its distributive share of partnership items of receipts, income, gain, loss and deduction and its proportionate part of each partnership asset and liability and activity in computing its tax bases under Article 9-A of the Tax Law. It retains the existing source and character rules in current section 3-13.2. In addition, it provides that a taxpayer's proportionate part of assets and liabilities and activities shall be determined in accordance with the taxpayer's capital interest in the partnership unless it does not properly reflect the taxpayer's share of partnership items constituting business and investment income. In such cases, the

taxpayer's proportionate part is determined using the percentage resulting from the manner in which the partners divide the partnership profits or losses. It also provides that an allocation (commonly referred to as a special allocation) of an item, amount or activity, even if recognized for federal income tax purposes, will not be recognized if it has as a principal purpose the avoidance or evasion of New York State tax and sets forth criteria for determining whether a principal purpose is the avoidance or evasion of tax. Lastly it provides specific rules relating to the computation of each tax base under Article 9-A of the Tax Law.

(d) Section 3-13.4 sets forth the computation of tax under the entity method. It provides that, in computing each tax base under Article 9-A of the Tax Law, a corporate partner is treated as owning an interest in the partnership entity and that the interest is an intangible asset which is business capital. It also provides specific rules relating to the computation of each tax base under Article 9-A.

Sections 17 and 18 make technical and clarifying amendments to section 3-13.5, as renumbered by section 16 of the proposal, relating to foreign corporate limited partners. In addition, section 17 amends subdivision (a) of section 3-13.5 to provide that if the taxpayer does not have the information necessary to compute its tax as prescribed in such section, it may treat its distributive share of partnership items as business income and its interest in the partnership as business capital. It further provides how such amounts shall be allocated.

Section 19 adds a new section 3-13.6 which retains the rules in current section 3-13.3 relating to tiered partnerships and makes technical and clarifying amendments thereto.

Section 20 adds a new section 3-13.7 that provides for the treatment of a gain or loss resulting from the sale of a partnership interest.

Section 21 amends section 4-1.1 of the regulations to cross reference taxpayers to Subpart 3-13 for rules relating to corporate partners and section 4-6.5 for allocation rules relating to corporate partners.

Section 22 amends section 4-2.2 of the regulations to set forth the determination of the principally engaged test with respect to taxpayers engaged in the conduct of aviation or in the conduct of a railroad or trucking business. In addition, it provides how such determination is made in the case of a taxpayer that is a partner in a partnership using the aggregate method or that is a foreign corporate limited partner that has made an election with respect to such partnership pursuant to section 3-13.5 of the proposal.

Section 23 makes technical and clarifying amendments to paragraphs (1) and (2) of subdivision (a) of section 4-6.5 relating to the allocation rules for a taxpayer that is a partner in a partnership using the aggregate method. In addition, it sets forth rules that provide for inter-entity eliminations and exclusions in the property and receipts factors in computing the business allocation percentage and alternative business allocation percentage.

Section 24 renumbers paragraphs (3) and (4) of subdivision (a) of section 4-6.5 to (4) and (6), respectively, and adds new paragraphs (3) and (5). New paragraph (3) provides examples illustrating the inter-entity eliminations and exclusions discussed in section 23. No amendments are made to renumbered paragraph (4). New paragraph (5) sets forth the allocation rules for a taxpayer using the aggregate method that is principally engaged in the conduct of aviation or in the conduct of a railroad or trucking business.

Section 25 makes technical and clarifying amendments to paragraph (6) of subdivision (a) of section 4-6.5, as renumbered by section 24, relating to the computation of the investment allocation percentage.

Section 26 reletters subdivisions (b), (c) and (d) of section 4-6.5 to (c), (d) and (e), respectively, repeals subdivision (e) and adds a new subdivision (b). New subdivision (b) sets forth the allocation rules for a taxpayer using the entity method. It provides that a taxpayer using the entity method shall allocate its distributive share of partnership items of income, gain, loss and deduction included in its business income and alternative business income by its business allocation percentage computed pursuant to section 4-2.2 of the regulations. Such percentage is computed without regard to its distributive share of any partnership items of income, gain, loss

and deduction and its proportionate part of the partnership's assets, liabilities and activities. In addition, it provides that if using such percentage does not properly reflect the taxpayer's business activity in New York State, the taxpayer shall use any other method that the Commissioner determines results in a proper reflection of the taxpayer's business activity in New York State.

Section 27 makes technical and clarifying amendments to subdivision (c) of section 4-6.5, as relettered by section 26, relating to the computation of the business allocation percentage for taxpayers that are foreign corporate limited partners.

Section 28 renumbers paragraph (4) of subdivision (c) of section 4-6.5, as relettered by section 26 of this proposal, to paragraph (5) and adds a new paragraph (4). New paragraph (4) sets forth the allocation rules for taxpayers that are foreign corporate limited partners that are principally engaged in the conduct of aviation or in the conduct of a railroad or trucking business. No amendments are made to paragraph (5) relateing to the computation of the investment allocation percentage for a foreign corporate limited partner.

Section 29 provides that the amendments shall apply to taxable years beginning on or after January 1, 2007.