Insights: Publications

4 Key Takeaways | Market Based Sourcing and Discretionary Adjustments

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On April 24th, Kilpatrick tax partner **Jeff Reed** presented during a New York City Bar SALT Committee meeting. Jeff discussed the recent Jefferies Group LLC & Subsidiaries New York Tax Appeals Tribunal decision.

Here are four key takeaways from the presentation.

1. The Parties Agreed that Market-Based Sourcing Applied, but Disagreed on how to Apply the Market-Based Sourcing Rules to the Receipts at Issue

A key issue in the case was how to source receipts from brokerage commissions, margin interest and account maintenance fees. Both the taxpayer and the New York State Department of Taxation and Finance ("NYSDTF") agreed that market-based sourcing rules should apply to source the receipts. The taxpayer argued that the receipts should be sourced to the location of underlying investors, rather than to the location of institutional intermediaries (e.g., registered investment advisors acting on behalf of underlying investors). The NYSDTF argued that the receipts should be sourced to the location of the institutional intermediaries and that looking through the institutional intermediaries to the underlying investors was impermissible.

2. The Tax Appeals Tribunal Affirmed the ALJ's Interpretation of the Statute

An administrative law judge ("ALJ") had previously ruled that the taxpayer must source the receipts to the location of the institutional intermediaries. The Tax Appeals Tribunal affirmed the ALJ on that point, citing to federal regulations stating that broker-dealers are not required to look through intermediaries to underlying beneficial owners. In keeping with the federal regulations, the Tax Appeals Tribunal held that the taxpayer's customer was the institutional intermediaries and under the market-based sourcing rules the receipts must be sourced to the mailing address of the institutional intermediaries, rather than to the mailing address of the underlying investors. In other words, the receipts must be sourced to the location of registered investment advisors acting on behalf of investors rather than to the location of investors.

3. The Tax Appeals Tribunal Reversed the ALJ on Discretionary Authority

Like most states with corporate income tax systems, New York has a provision that requires invocation of discretionary authority, where necessary, to more properly "effect a proper allocation of…income and capital." At the Division of Tax Appeals, the ALJ had determined that the statutory method of allocation based on the mailing address of the institutional intermediaries, which resulted in a 22% NY receipts allocation factor, did not properly reflect the taxpayer's income and capital and that instead apportioning income based on NY's share of the U.S.

population (6.48%) more properly allocated the taxpayer's income and capital to New York. The Tax Appeals Tribunal disagreed, holding that discretionary authority was not warranted on the taxpayer's facts.

4. Uncertain Impact on Other Taxpayers

While the decision is precedential, its impact may be narrow for several reasons. First, the years at issue in the case are under NY's old corporate tax system (pre-2015). Second, the basis for not applying the look-through approach in the case is based on federal regulations for broker-dealers, so other taxpayers not subject to the same regulations could argue that the reasoning of the case does not apply to them. Third, there is little explanation for why discretionary authority was not warranted, meaning it is difficult to argue that it should or should not apply on other facts. What is more certain is that taxpayers in New York and other states will continue to make decisions on whether to apply a look through approach and whether discretionary authority is warranted without many governing principles to rely on.

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