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MULTISTATE INCOME/FRANCHISE TAX

New York Supreme Court Appellate Division holds broker-dealer sourcing rules do not apply to non-broker-dealer disregarded entities

Tax Alert

Overview

On March 10, 2022, the New York Supreme Court, Appellate Division, Third Department ("Appellate Division") issued its opinion in *Matter of BTG Pactual NY Corporation v. New York State Tax Appeals Tribunal et al.* The Appellate Division affirmed a 2020 New York Tax Appeals Tribunal ("Tribunal") decision that the Taxpayer could *not* apply New York's special broker-dealer customer based sourcing rules to receipts derived from Taxpayer's single member limited liability company ("SMLLC"), a non-broker-dealer disregarded entity. The Taxpayer also owned another disregarded entity ("DRE") that was a registered broker-dealer.

This Tax Alert summarizes this New York decision. Unless otherwise noted, quotations included in this Tax Alert are from the Appellate Division decision and all references to New York Tax Law are for laws in effect prior to January 1, 2015.

Appellate Division opinion

Background facts

For the tax years at issue, Taxpayer was a New York corporation and the sole member of SMLLC 1 and SMLLC 2, which were both disregarded entities for federal income tax and New York franchise tax purposes. SMLLC 1 was registered as a broker-dealer with the Securities and Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA"). SMLLC 2 was registered with the SEC as an investment advisor. Neither Taxpayer nor SMLLC 2 were registered as broker-dealers with the SEC or FINRA.

Because SMLLC 1 and SMLLC 2 were DREs for federal income tax and New York franchise tax purposes, Taxpayer included the income, receipts, assets, and activities of SMLLC 1 and SMLLC 2 on its 2012 and 2013 federal income tax and New York franchise tax returns.

For the 2012 and 2013 tax years, the following occurred with respect to Taxpayer's New York corporate franchise tax returns:

- On its original returns, Taxpayer sourced SMLLC 1's receipts using the customer's mailing address location pursuant to N.Y. Tax Law § 210(3)(a)(9), which provides the special sourcing rules for registered broker-dealers. Conversely, Taxpayer sourced SMLLC 2's receipts using its service performance location pursuant to N.Y. Tax Law § 210(3)(a)(2)(b), which provides the general rules for sourcing services.

- Taxpayer subsequently filed amended returns, requesting a refund of approximately $7.5M – nearly all of Taxpayer's New York franchise tax liability for 2012 and 2013. On those returns, Taxpayer modified its receipts factor by applying the special rules for registered broker-dealers, sourcing SMLLC 2's receipts based on customer location.

- Taxpayer's refund claim was based on New York's conformity to the federal entity classification regulations, which provide that if an entity elects to be disregarded, "its activities are treated in the same manner as a…branch or division of the owner." See 26 CFR § 301.7701-2(a). Under this theory, Taxpayer, as well as SMLLC 1 and SMLLC 2, as DREs, were collectively one taxpayer, making each entity eligible to use the special sourcing rules under N.Y. Tax Law § 210 (3)(a)(9).

- Taxpayer's refund claim was denied, and Taxpayer appealed. The matter was heard by a New York Administrative Law Judge ("ALJ") with the Division of Tax Appeals, who also denied the refund claim and determined the following:

    - SMLLC 1's status as a registered broker-dealer could not carry over to the non-broker-dealer receipts earned by SMLLC 2.

    - The fact that SMLLC 2 was treated as a DRE for federal income tax purposes did not dictate whether SMLLC 2's receipts were broker-dealer receipts for purposes of sourcing receipts within and without New York.

    - N.Y. Tax Law § 210(3)(a)(9) unambiguously applies the special sourcing rules only to registered broker-dealers.

- The Tribunal affirmed the ALJ's decision.

New York Appellate Division analysis

The Appellate Division agreed with the Tribunal and the ALJ, ruling that where two SMLLCs are commonly owned by the same single member, the status of one SMLLC as a registered broker-dealer *cannot* carry over to the non-broker-dealer. Thus, SMLLC 2, the non-broker-dealer, cannot use the special sourcing rules of N.Y. Tax Law § 210(3)(a)(9) to source its receipts.

The Appellate Division opinion was based on the following:

- The statutory text for registered broker-dealer sourcing is unambiguous and is limited to registered broker-dealers.

- According to New York's federal conformity doctrine, "courts [should] adopt, whenever reasonable and practical, the [f]ederal construction of substantially similar tax provisions, particularly where the state statute is modeled on [the] federal law." State sourcing provisions are not modeled on any provision of federal tax law and thus, the doctrine is inapplicable.

- Taxpayer "chose to structure [SMLLC 1] and [SMLLC 2] as separate legal entities from itself and from each other and it is bound by the tax consequences of that choice of corporate form."

- New York's adoption of customer-based sourcing in 2015 was significant in construing pre-2015 law. "[T]he Legislature amended the Tax Law in 2015 to extend customer sourcing rules to entities such as [SMLLC 2]. Such amendment lends further support to the Tribunal's position that during the time period at issue here, Tax Law former § 210(3)(a)(9) was intended to apply only to bona fide registered broker-dealers such as [SMLLC 1], and not to investment advisors such as [SMLLC 2]."

It should be noted that the Appellate Division's standard of review of a Tribunal case is limited. If the Tribunal's "determination is rationally based upon and supported by substantial evidence, [it] must be confirmed, even if a different conclusion is reasonable." The Taxpayer generally has 30 days to appeal this decision to the New York Court of Appeals, which is the state's highest court.

Considerations

This decision may be-applicable to (i) New York Corporation Tax under Article 9-A for pre-2015 years, (ii) New York City General Corporation Tax for C corporations for pre-2015 years; (iii) New York City General Corporation Tax for S corporations for all applicable years; and (iv) New York City Unincorporated Business Tax for all applicable years. As a result, non-broker-dealers who have used the special sourcing rules for registered broker-dealers (based on New York's conformity to the federal entity classification rules) should evaluate how this decision may impact them.

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