F I N A N C E
NEW ● YORK
THE CITY OF NEW YORK
DEPARTMENT OF FINANCE

DEPARTMENT OF FINANCE

AUDIT DIVISION

GCT-2008-04
4/09/08

STATEMENT OF AUDIT PROCEDURE

NON-INTEREST EXPENSE ATTRIBUTION

I. BACKGROUND

For taxable years beginning after December 31, 1987, the Commissioner of Finance has exercised the Commissioner's discretion to require certain amounts deducted for federal income tax or New York City General Corporation Tax ("GCT") purposes that are directly or indirectly attributable to subsidiary capital or to income, gains or losses from subsidiary capital as a carrying charge or otherwise, to be added back to federal taxable income for purposes of computing entire net income. In addition, the Commissioner has exercised the Commissioner's discretion to require investment income to be reduced by deductions directly or indirectly attributable to investment capital or to income, gains or losses from investment capital. Finally, for taxable years beginning after June 30, 1994, the Commissioner has exercised the Commissioner's discretion to require investment income of a taxpayer subject to the Unincorporated Business Tax ("UBT") to be reduced by deductions directly or indirectly attributable to investment income or capital.

Consistent with New York City's longstanding tradition as a center of corporate headquarters, under the GCT and UBT, investment income generally is allocated to the City at a lower percentage than business income, and, for GCT purposes, income, gains and losses from subsidiary capital are excluded from entire net income. There is, however, a tax on subsidiary capital, but it is imposed at a very low rate. The purpose of expense attribution is to avoid a double tax benefit resulting from giving favorable tax treatment to income from investment and subsidiary capital while simultaneously allowing a deduction against business income for expenses related to investment or subsidiary capital. In accordance with New York City's corporate headquarters tradition, the expense attribution rules are to be construed so as not to alter a system designed and intended to enable New York to attract and retain corporate activity by attracting capital and offering a unique and certain set of structures for the favorable treatment of many activities, such as the holding of subsidiaries and investments.

II. SCOPE

GCT and UBT returns affected by the attribution requirements described above are subject to both desk and field audits. This Statement of Audit Procedure ("SAP") is intended to give desk and field auditors guidance on how to review a return to determine whether an appropriate attribution of non-interest expenses has been made by a taxpayer. This SAP provides guidance on the direct and indirect attribution of non-interest deductions among the various classes of capital and income. This SAP is effective for tax years beginning on or after January 1, 1995, and supersedes SAP 93-1-GCT (3/1/93) for those years. This SAP does not address the issue of attribution of interest expenses or the issue of attribution of liabilities in computing the tax on business and investment capital and the separate tax on subsidiary capital. Policy Bulletin 2-84 issued on April 2,1984 will continue to be in effect with regard to the attribution of interest expenses.

III. AUDIT PROCEDURES

A. Desk Audit

As part of the review of GCT and UBT returns, desk auditors should determine whether an attribution of expenses to the appropriate classes of capital or income has been made. If the GCT return reports investment or subsidiary capital or income, or a UBT return reports investment income and, in either case, it appears that the taxpayer's direct and indirect attribution of non-interest expenses to the respective forms of capital is reasonable, no further examination should be made of the attribution of non-interest expenses as part of a desk audit. If the desk auditor is in doubt as to whether the taxpayer has made a reasonable attribution of non-interest expenses, the desk auditor should consult with the Desk Auditor Unit Manager. If the taxpayer reports investment or subsidiary capital or income on the return but has attributed none of its non-interest expenses to those classes of capital or income, or the Desk Audit Manager determines that the taxpayer's direct or indirect attribution of non-interest expenses to investment or subsidiary capital or income is unreasonable, the following steps will be taken.

(1) The desk auditor will inform the taxpayer by letter that the issue of attribution of expenses is being examined. That letter will give the taxpayer a reasonable time to either submit corrected schedules to make an appropriate attribution or to provide a detailed explanation as to why the position taken on its original return with regard to attribution was appropriate. The auditor will provide a reasonable additional amount of time to comply if requested by the taxpayer or its authorized representative.

(2) If the taxpayer neither submits corrected schedules nor provides a reasonable explanation for the position taken on its original return within the time allowed and the taxpayer has not attributed any non-interest expenses to investment or subsidiary income or capital, the auditor may attribute all the non-interest expenses shown on the return, other than those expenses listed at IV.A(3) (b) (i) (A) below that are readily identifiable from the return or from information provided by the taxpayer, to the various types of capital or income using the appropriate method of indirect attribution described below.[1]

(3) If, on the basis of the information provided on the return or in response to inquiries directed to the taxpayer described above, the Desk Audit Unit Manager determines that the taxpayer has not made a reasonable attribution of non-interest expenses to investment or subsidiary capital or income, the desk auditor may apply the appropriate method of indirect attribution to attribute to subsidiary, investment or business income or capital any non-interest expenses that, in his or her discretion, exercised in accordance with the standards set forth below, cannot readily be directly attributed based on the information provided.

B. Field Audit

Once a return has been selected for field audit, the taxpayer's attribution of non-interest expenses can be examined as part of the audit. The field audit unit may examine this issue even if it has been examined as part of a desk audit. If the attribution of non-interest expenses is to be examined, an information document request will be sent to the taxpayer concerning this issue, giving the taxpayer a reasonable period of time to provide documentary support for the propriety of the direct and indirect attribution of non-interest expenses in its original return, or to submit corrected schedules making an appropriate attribution.

If the taxpayer provides acceptable documentation supporting the propriety of the direct and indirect attribution shown on the return or submits corrected schedules with acceptable supporting documentation, the auditor, subject to further review, will close his or her examination of this issue based upon the information or schedules submitted.

If the taxpayer makes a reasonable effort to respond to the auditor's request but the auditor determines that one or more particular non-interest expenses have not been properly attributed, the field auditor should make a reasonable effort to directly attribute the expenses if they are easily identifiable and the attribution is supported by acceptable documentation in accordance with the standards set forth below. If a non-interest expense cannot easily be directly attributed, the expense may be attributed by the appropriate method of indirect attribution as described below.

If the taxpayer does not make a reasonable effort to support its original return or submit corrected schedules, the auditor may apply the appropriate method of indirect attribution to attribute to subsidiary, investment or business income or capital any expenses that, in his or her discretion, exercised in accordance with the standards set forth below, cannot readily be directly attributed based on the information provided.

[1] The appropriate method will be the combined asset and income method unless the taxpayer has properly elected the alternative asset method as described below at IV.A(3) (c).

C. Prior State Audit

This SAP is the product of a coordinated effort by the New York City Department of Finance and the New York State Department of Taxation and Finance. Pursuant to that effort, the Department of Finance has agreed that if the taxpayer has previously been the subject of a field audit by the New York State Department of Taxation and Finance on the issue of non-interest expense attribution for a tax period with respect to which a City audit is being conducted and the State audit has been concluded by the issuance of a no-change letter, a notice and demand or a notice of deficiency prior to the commencement of the City audit, City desk and field auditors will not propose non-interest expense attribution adjustments that are inconsistent with the audit findings of the Department of Taxation and Finance except to the extent necessitated by differences between applicable State and City law unless the taxpayer waives such conformity during the course of the City audit. Any such waiver shall be irrevocable for the tax period under audit. It should be noted in this regard that such State and City conformity rules will apply only if the taxpayer makes the same elections for both State and City purposes under section IV(3) (b) (i) (A) (relating to direct attribution to business capital), section IV (3) (b) subparagraphs (v) and (vi) (relating to the 95 percent safe harbors), and section IV (3) (c) (iii) (relating to the use of the asset percentage in indirect attribution). In the case of simultaneous audits, the State and City have agreed to consult with each other on this issue. Auditors should ask taxpayers if they are being audited by the State on this issue.

IV. ATTRIBUTION STANDARDS

Desk and field auditors are required to apply the standards set forth below in determining whether a taxpayer has properly attributed non-interest expenses under the above procedures.

A. Deductions must be properly deducted by taxpayer.

(1) The deductions subject to attribution are limited to those deductions properly allowed to the taxpayer for GCT or UBT purposes adjusted as provided in (a).

(a) Expenses subject to discretionary adjustment. Administrative Code section 11-605(5) and 11-602.8(d) authorized the Commissioner of Finance to make certain adjustments to items of income, deduction or capital where necessary to properly and accurately reflect income of a taxpayer in the City. Similarly, the Commissioner of Finance may determine that the taxpayer has improperly reported its federal taxable income and that gross income, deductions, credits or allowances should be redistributed, apportioned or allocated between the taxpayer and another entity owned or controlled directly or indirectly by the same interests under Internal Revenue Code section 482. In any case where the Commissioner of Finance has exercised his or her discretion described above by adjusting a deduction for all or part of any expense, that deduction is subject to attribution after any such adjustment.

However, an expense may not be a discretionary adjustment, as described above, to all or any part of an expense.

(b) Reimbursed non-interest expenses. (i) Where a taxpayer is reimbursed in whole or in part for non-interest expenses incurred on behalf of another person or entity, the amount of reimbursement must be treated as business income, and deductions for expenses for which, and to the extent, such reimbursement is received must be directly attributed to business income and capital.

(ii) Non-interest expenses will be treated as reimbursed provided that on or before the due date, excluding extensions, for its return for the taxable year, reimbursement is made pursuant to a written agreement between the parties, or the taxpayer receives payment of an amount equal to the amount of the expense incurred either as a direct cash payment or through offsets to other accounts receivable or payable and the payment or adjustment is identified as a reimbursement on the books and records of the taxpayer and the payor. Absent a written agreement or timely reimbursement, the nature of the transaction as one involving reimbursed expenses must be proven by the taxpayer. Amounts incurred by a taxpayer for expenses charged back to another person or entity for which no reimbursement is received cannot be considered reimbursed for these purposes.

(c) Non-interest expenses charged to another person or entity. Non-interest expenses incurred by a taxpayer for the benefit of, or on behalf of, an affiliated corporation or other affiliated entity that are either charged back to that corporation or other entity or offset on the books and records of the taxpayer, other than through a reimbursement arrangement described above or through a management fee described below, are not subject to attribution provided a deduction for such expenses is not claimed by the taxpayer.

(d) Management fees. Compensation received through a management or similar fee arrangement between the taxpayer and a corporation or other entity, whether or not affiliated with the taxpayer, must be treated as business income, and deductions for non-interest expenses compensated for by such management or similar fee must be directly attributed to business income and capital. Non-interest expenses can be treated as compensated for through a management or similar fee provided the fee is paid pursuant to a written agreement. Absent a written agreement, the nature of the transaction as one involving compensation through a management or similar fee must be proven by the taxpayer, for example, by submission of contemporaneous corporate minutes or memoranda.

(2) Federal base modifications. In determining those deductions subject to attribution, adjustments required by the Administrative Code must be taken into account. In addition, expenses required to be capitalized and for which no deduction is allowed for City purposes are not subject to attribution under these provisions.

(3) Attribution of non-interest deductions.

(a) The following rules must be applied in determining whether a taxpayer has properly attributed non-interest deductions directly and indirectly among classes of capital and the income, gains and losses therefrom. Deductions not directly attributed to one or more classes of capital or income under these rules must be included in the residual group of deductions that will be indirectly attributed as provided in paragraph (c).

(b) Direct attribution of non-interest deductions. Where possible, the taxpayer must directly attribute to the appropriate class of capital or income those non-interest deductions for expenses that proximately, and not incidentally, benefit that class of capital or income. The determination of which classes of capital or income are proximately benefited must be made on the basis of all of the facts and circumstances, including but not limited to the nature of the income that proximately relates to the expenses that are the basis for the deduction. Taxpayers should maintain books and records sufficient to support the direct attribution of expenses among the classes of capital and income.

Except as provided in subparagraph (i) (A), below, if a deduction is for an expense that proximately benefits more than one class of capital or the income therefrom, the deduction must be apportioned among those classes of capital or income that are benefited.

(i) Direct attribution of non-interest deductions to business capital or income.

(A) At the election of the taxpayer, each of the following non-interest deductions will be irrebuttably presumed to be directly attributable to business income or capital.[2] In response to any letter sent to the taxpayer as provided under the procedures set forth above, the taxpayer need only substantiate the nature and amount of each item on this list with respect to which such an election is made; the taxpayer is not required to separately establish the basis for direct attribution of those items for which such an election is made to business income or capital:

(a) cost of goods sold;

(b) bad debts other than items properly classified as subsidiary or investment capital;

(c) property, excise and sales and use taxes;

[2] This does not preclude as a separate issue a discretionary adjustment as described in section IV.A (1) (a) above, to any expense on this list. Such adjustments could relate, for example, to the amount of the expense or the identity of the taxpayer to which the deduction is allowable.

(d) real estate rents, depreciation and repairs;

(e) utilities including telecommunications costs;

(f) amortization of real property leasehold costs and improvements;

(g) depletion;

(h) advertising;

(i) non-interest expenses for which reimbursement is received in the form of a management fee treated on the report as business income'

(j) research and development;

(k) marketing expenses;

(l) property and casualty and product liability insurance and uninsured deductible casualty and product liability losses;

(m) compensation packages of the chief executive officer, chief financial officer and chief operating officer (identified by reference to duties and not to titles);

(n) directors' fees, expenses and indemnity insurance;

(o) charitable contributions;

(p) stationery, printing, postage and other similar distribution costs;

(q) non-interest costs and expenses relating to communication and interaction with the taxpayer's shareholders and investors;

(r) non-interest costs and expenses relating to routine reporting requirements of the Securities and Exchange Commission or other federal, state or local regulatory entities, routine financial statements and tax filings;

(s) travel and entertainment expenses;

(t) non-interest costs and expenses incurred in connection with an uncompleted acquisition;

(u) non-interest costs and expenses of developing company or group-wide administrative procedures; and

(v) internal auditing costs and expenses.

(B) Taxpayers shall directly attribute to business capital or income those non-interest deductions for expenses that proximately and not incidentally benefit business capital or income. The following is a non-exclusive list of examples of non-interest deductions that, except as provided in subparagraph (i) (A) above, under appropriate facts and circumstances may be directly attributed to business capital or income. In response to any letter sent to the taxpayer as provided under the procedures set forth above, the taxpayer must substantiate the direct attribution of these deductions to business capital or income as well as the amount of the deduction:

(a) deductible costs of shipping goods to customers;

(b) compensation and other benefits of officers and employees engaged in manufacturing, sales, services, or other activities directly producing business capital or income (for situations where such activities are not exclusive, see examples in section IV.B below); and

(c) deductible legal expenses incurred in conducting the taxpayer's business, such as costs incurred to acquire or protect a copyright or patent owned by the taxpayer and used in the taxpayer's business or legal expenses incurred in negotiating contracts or resolving labor disputes with employees engaged directly in manufacturing, sales, services, or other activities directly producing business capital or income.

(d) Reimbursed non-interest expenses as provided in section IV.A (1) (b) above.

(ii) <u>Direct attribution of non-interest deductions to subsidiary capital or income, gains or losses therefrom.</u> Taxpayers shall directly attribute to subsidiary capital or income those non-interest deductions for expenses that proximately and not incidentally benefit subsidiary capital or income. The following is a non-exclusive list of examples of non-interest deductions that, except as provided in subparagraph (i) (A), above, should be directly attributed to subsidiary capital or income from subsidiary capital:

(A) compensation and other benefits of officers and employees engaged in the acquisition, management or disposition of subsidiary capital or income therefrom (for situations where such activities are not exclusive, see examples in section IV.B below);

(B) legal and accounting expense deductions relating to the management of subsidiary capital or income therefrom;

(C) computer expense deductions relating to the management of subsidiary capital or income therefrom:

(D) other deductible fees and expenses incurred in connection with the completed purchase of subsidiary capital, or the sale, whether or not completed, of subsidiary capital;

(E) other deductible expenses incurred by the taxpayer for its own benefit in its role as a holder of subsidiary capital, including but not limited to;

(a) deductible expenses incurred in reviewing information prepared by the subsidiary where such review is undertaken by the taxpayer in its role as a holder of subsidiary capital;

(b) deductible expenses incurred in connection with the general supervision of a subsidiary by the taxpayer's employees (stewardship expenses). These expenses do not include expenses relating to the day-to-day operation of the subsidiary;

(c) deductible expenses incurred by the taxpayer to preserve its investment in subsidiary capital; and

(d) deductible expenses incurred in meeting reporting requirements or other legal obligations imposed on the taxpayer in its role as a holder of subsidiary capital.

(iii) Direct attribution of non-interest deductions to investment capital or income. Taxpayers shall directly attribute to investment capital or income those non-interest deductions for expenses that proximately and not incidentally benefit investment capital or income. The following is a non-exclusive list of examples of non-interest deductions that, except as provided in subparagraph (1)(A), above, should be directly attributed to investment capital or income.

(A) safe deposit box rentals for safekeeping of certificates or other documents relating to investment capital;

(B) financial news subscriptions utilized exclusively by employees engaged primarily in the acquisition, management or disposition of investment capital or the income therefrom;

(C) compensation and other benefits of officers and employees engaged in the acquisition, management or disposition of investment capital or the income therefrom (for situations where such activities are not exclusive, see examples in section IV.B below);

(D) the deductible cost of insurance and fidelity bonds covering investment capital;

(E) deductible custodian fees, investment advisory fees and legal and accounting costs and fees relating to the management of investment capital or the income therefrom;

(F) deductible computer expenses relating to the, management of investment capital or the income therefrom;

(G) deductible fees and expenses incurred in connection with the completed purchase of investment capital, or the sale, whether or not completed, of investment capital; and

(H) other deductible expenses incurred by the taxpayer for its own benefit in its role as a holder of investment capital, including but not limited to;

(a) deductible expenses incurred in reviewing information prepared by the corporation, where such review is undertaken by the taxpayer in its role as a holder of investment capital;

(b) deductible expenses incurred in connection with the general supervision of the corporation by the taxpayer's employees. These expenses do not include expenses relating to the day-to-day operation of the corporation;

(c) deductible expenses incurred by the taxpayer to preserve its investment capital; and

(d) deductible expenses incurred in meeting reporting requirements or other legal obligations imposed on the taxpayer in its role as a holder of investment capital.

(iv) <u>Direct attribution to more than one class of capital.</u> A specific non-interest deduction may represent an expense that proximately and not incidentally benefits more than one class of capital or income. In that case, the taxpayer should directly attribute a portion of that deduction to each class of capital or income proximately benefited by that expense using a method that is reasonable for that particular expense. Such a method can be based on one or more factors appropriate given the nature of the deduction. Such factors may include but are not limited to time, space, payroll, and numbers of personnel. See examples below. Deductions listed in subparagraph (i) (A) of this paragraph are, where the taxpayer so elects, irrebuttably presumed to be directly attributable entirely to business capital.

(v) <u>Operating Division Safe Harbor.</u> (A) If a taxpayer can substantiate that at least 95 percent of the non-interest expenses of an operating division are directly attributable to a particular class of capital or income, 100 percent of the non-interest expenses of that operating division may be directly attributed to that class of capital or income at the election of the taxpayer. Non-interest expenses subject to this rule include expenses listed in subparagraph (i) (A) of this paragraph and all other non-interest expenses of that operating division. A taxpayer electing to u se these rules for operating divisions may not also elect to use the entity-wide safe harbor provided in subparagraph (vi) below.

(B) For purposes of this subparagraph, the term “operating division” shall mean a subunit of the taxpayer that meets the following criteria:

(a) the activities of the submit constitute a trade or business; and

(b) a separate set of books and records is maintained with respect to the subunit.

(C.) Trade or Business. The determination as to whether activities constitutes a trade or business is dependent on all of the facts and circumstances. Generally a trade or business is a specific set of activities that constitutes or would constitute an economic enterprise carried on for profit if carried on by a separate entity. To constitute a trade or business, a group of activities must ordinarily include every operation that forms a part of, or a step in, an income producing or profit making process including the collection of income and the payment of expenses. It is not necessary that the activities carried out by an operating division constitute a different trade or business from those carried out by other divisions of the taxpayer. A vertical, functional or geographic division of the same trade or business may be a trade or business for this purpose provided that the activities otherwise qualify as a trade or business under this subparagraph (v) (C). However, activities that are merely ancillary to a trade or business do not constitute a trade or business. For example, administrative activities, including, but not limited to, legal, accounting or financial services, where such services are not offered to the public on a regular and continuous basis by the taxpayer, will generally be considered ancillary and will not constitute a trade or business for this purpose.

(D) Separate Books and Records. To have a separate set of books and records a subunit must maintain at a minimum, a separate set of ledger accounts (i.e. cash receipt, cash disbursements, accounts receivable, and accounts payable) and a general journal or similar book of original entry.

(vi) Entity-Wide Safe Harbor. If a taxpayer can substantiate that at least 95 percent of the non-interest expenses of the taxpayer are directly attributable to a particular class of capital or income, the taxpayer may elect to directly attribute 100 percent of the non-interest expenses of the taxpayer to that class. A taxpayer electing to use this safe harbor may not elect also to apply the operating division safe harbor in subparagraph (v) above; the operating division safe harbor in subparagraph (v) above cannot be applied to enable a taxpayer to qualify for this safe harbor.

(vii) Combined Reports. Each member of a group of corporations filing a combined report may separately opt to apply the operating division safe harbor in subparagraph (v) or the entity-wide safe harbor in subparagraph (vi) above. Alternatively, for purposes of the entity-wide safe harbor in subparagraph (vi) above, all of the corporations filing a combined report may opt to be treated as a single taxpayer.

(c) Indirect attribution of residual non-interest deductions.

(i) Non-interest deductions that cannot be directly attributed as provided in section IV.A (3) (b) above ("residual non-interest deductions") must be attributed to business, subsidiary and investment capital using either the combined asset and income method set out in subparagraph (ii) below, or if an election is made as provided for therein, the alternative asset method set out in (iii) below. The amount of residual non-interest deductions is determined by subtracting the amount of non-interest deductions attributed directly under section IV.A (3) (b) above from the total amount of attributable non-interest deductions.

(ii) Combined asset and income method.

(A) An amount of residual non-interest deductions determined by multiplying residual non-interest deductions by the subsidiary capital combined percentage (defined in (v) below), must be indirectly attributed to subsidiary capital, and the income therefrom.

(B) An amount of residual non-interest deductions determined by multiplying residual non-interest deductions by the investment capital; combined percentage (defined in (v) below), must be indirectly attributed to investment capital and income.

(C) The excess of the amount of residual non-interest deductions over the amount of residual non-interest deductions indirectly attributed pursuant to (A) and (B) above must be indirectly attributed to business capital and income.

(iii) Alternative Asset Method.

(A) Method of Attribution

(a) The taxpayer must indirectly attribute to subsidiary capital and income an amount of residual non-interest deductions determined by multiplying residual non-interest deductions by the asset factor (defined in (iv) below) for subsidiary capital.

(b) The taxpayer must indirectly attribute to investment capital and income an amount of residual non-interest deductions determined by multiplying residual non-interest deductions by the asset factor (defined in (iv) below) for investment capital.

(c) The taxpayer must indirectly attribute to business capital and income the excess of the amount of residual non-interest deductions over the amount of residual non-interest deductions indirectly attributed pursuant to (a) and (b) above.

(B) Election. In order to use the alternative asset method to attribute its residual non-interest deductions, the taxpayer must elect to do so for both subsidiary and investment capital and the income therefrom on a return or amended return for the applicable tax year. A separate election must be made for each year. This election is irrevocable for each year with respect to which the election is made unless the filing status of the taxpayer as combined or separate is changed as a result of an audit or where a change in the composition of a combined group is made on audit. The taxpayer may not elect the alternative asset method for any year in which the value of the taxpayer's total assets is not greater than zero. The taxpayer may elect the alternative asset method on an amended return provided that at the time it is filed, no audit has been commenced with respect to the year covered by the return. In the absence of a timely election the taxpayer must use the combined asset and income method specified in subparagraph (ii) above.

(iii) <u>Computation of Asset and Income Factors.</u>

(A) Asset Factor . The asset factor with respect to subsidiary capital is determined by dividing the average value of the taxpayer's subsidiary capital, without reduction for liabilities attributable to subsidiary capital, by the total average value of all the taxpayer's assets without reduction for liabilities. The asset factor with respect to investment capital is determined by dividing the average value of the taxpayer's assets constituting investment capital, without reduction for liabilities attributable to investment capital, by the total average value of all the taxpayer's assets without reduction for liabilities. If the value of a taxpayer's assets constituting investment or subsidiary capital is not greater than zero and the total assets is greater than zero, the respective asset factor for that class is zero. For these purposes, real property and marketable securities must be valued at fair market value and the value of personal property other than marketable securities must be the value thereof shown on the books and records of the taxpayer in accordance with generally accepted accounting principles consistent with Administrative Code section 11-604.2.

(B) Income factor. The income factor for subsidiary capital is determined by dividing the taxpayer's gross income from subsidiary capital by its total gross income. The income factor for investment capital is determined by dividing the taxpayer's gross income from investment capital by its total gross income. If a taxpayer's gross income from investment or subsidiary capital is equal to zero and total income is greater than zero, the respective factor for that class is zero.

(a) For these purposes total gross income means gross income as defined in Internal Revenue Code section 61, increased by (a) those items described in such section 61 that are included in the computation of entire net income by reason of Administrative Code section 11-602.8(c), and (b) interest on State and local bonds excluded from gross income under Internal Revenue Code section 103. Gross income is not reduced by any deduction for capital losses or by any other deductions.

(b) Gross income from subsidiary capital is that portion of total gross income consisting of dividends, interest, and gains (but not losses) from subsidiary capital.

(c) Gross income from investment capital is that portion of total gross income consisting of dividends, interest , and gains (but not losses) from investment capital as well as items described in 19RCNY section 11-69(b), definition of Investment Income, (i) (B) through (E).

(iv) <u>Computation of subsidiary and investment capital combined percentages.</u>

(A) The subsidiary capital combined percentage is computed by adding together two times the taxpayer's income factor for subsidiary capital and the taxpayer's asset factor for subsidiary capital and dividing the total by three. (The income and asset factors are defined in (iv) above.)

(B) The investment capital combined percentage is computed by adding together two times the taxpayer's income factor for investment capital and the taxpayer's asset factor for investment capital and dividing the total by three.

(C) In determining the subsidiary capital and investment capital combined percentages, if total gross income is zero, the subsidiary and investment capital combined percentages are equal to their respective asset factors. If total assets are not greater than zero, the subsidiary and investment capital combined percentages are equal to their respective income factors.

B. Examples

The following examples illustrate the direct and indirect attribution of non-interest deductions to subsidiary, investment and business capital.

Example 1: Each member of taxpayer's accounting staff spend 40% of his or her time analyzing whether the taxpayer should restructure its subsidiaries. Each member of the accounting staff spends 20% of his or her time analyzing the taxpayer's investment portfolio. The accounting staff does not spend any other time on issues relating to subsidiary or investment capital or income. The taxpayer attributes 40% of the accounting staff's salaries and related employee benefit expenses and payroll taxes to subsidiary capital and 20% to investment capital. This method is acceptable.

Example 2: The facts are the same as in example 1. In addition, the accounting staff occupies 10% of a building rented by the taxpayer. The other 90% is used for the taxpayer's service business. All rental expense may, at the election of the taxpayer, be directly attributed to business capital pursuant to paragraph A(3) (b) (i) (A) (d). None of the rental expense would then be attributed to subsidiary or investment capital or income.

Example 3: The facts are the same as in example 1. The taxpayer has a total of 100 employees. Ten employees are in the accounting department. Each member of the accounting staff spends 40% of his or her time analyzing whether the taxpayer should restructure its subsidiaries and each member of the accounting staff spends 20$ of his or her time analyzing the taxpayer's investment portfolio. Ten employees are in the personnel department. They are responsible for managing the hiring, salaries, pension and medical benefits of all employees. Of the remaining 80 employees, five spend 20% of their time on activities related to investment capital and 40% of their time on activities related to subsidiary capital. The other 75 employees spend no time on activities relating to subsidiary or investment capital. The 15 employees engaged in activities relating to investment and subsidiary capital (ten from the accounting staff and five others) represent 25% of the total payroll of the taxpayer other than the payroll of the personnel department.

The taxpayer attributes 5% (25% X 20%) of the salaries and related employee benefit expenses and payroll taxes of the personnel department employees to investment capital and 10% (25% X 40%) to subsidiary capital. This method, based on time and payroll, is reasonable under the circumstances and is acceptable.

Example 4: The CEO of a corporation does not maintain detailed time records. However, she does maintain a diary that shows that she spends approximately 20% of her time in planning the corporation's strategy for investment in subsidiaries and 80% of her time in planning the corporation's strategy for developing, manufacturing and marketing its products. The taxpayer may elect to attribute the CEO's compensation package to business capital pursuant to paragraph A(3) (b) (i) (A) (m). None of the CEO's compensation package would then be attributed to subsidiary (or investment) capital.

Example 5: <u>Income and Assets.</u> Corp. X has $10,000 of business income, $4,000 of business assets, $300 of income from subsidiary capital, $1,000 of subsidiary assets, $500 of investment income and $2,000 of investment assets. (Assets here are calculated without reduction for liabilities.)

Expenses. Corp. X has $6,000 in non-interest expenses, of which $3,500 is directly attributable to business capital and properly substantiated, including items on the list of expenses, which Corp X elects to attribute to business capital under paragraph A (3) (b) (i) (A) above.

Separate Operating Division. Corp. X has a manufacturing division that qualifies as an operating division. $1,000 of the $6,000 of non-interest expenses are attributable to that division and are not included in the $3,500. Of that $1,000, $400 is wages and salaries, $100 is for equipment rental and depreciation, and $500 consists of items on the list in paragraph A (3) (b) (1) (A) above that Corp. X elects to directly attribute to business capital. Corp. X can substantiate that at least $950 of the $1,000 is directly attributable to business capital. Therefore, Corp. X may elect to attribute all $1,000 of the expenses of that division directly to business capital and does so elect.

The total of directly attributable expenses is $4,500. ($1,000 from the division and $3,500 from the corporation as a whole.)

Subsidiary and Investment Capital Combined Percentages

Subsidiary:	[$300/$10,800	(income) +	$300/$10,800
	(income) +	$1,000/$7,000	(assets)] /3 = 6.61%
Investment:	[%500/$10,800	(income) +	$500/$10,800
	(income) +	$2,000/$7,000	(assets)]/3= 12.61%

Indirect residual non-interest deductions of $1,500 ($6,000 less the $4,500 directly attributed to business) are attributed, 6.61% ($99.15) to subsidiary capital and 12.61% ($189.15) to investment capital. The remainder, $1,211.70 ($1500 – [$99.15 + $189.15]) is attributed to business capital.

The total direct and indirect non-interest expense attribution is $5,711.70 to business, $99.15 to subsidiary and $189.15 to investment capital.

Example 6: Income and Assets. Corp. X has $10,000 of business income, $4,000 of business assets, $300 of income from subsidiary capital, $1,000 of subsidiary assets, $500 of investment income and $2,000 of investment assets. (Assets here are calculated without reduction for liabilities.)

Expenses. Corp. X, a broker dealer, has $5,000 in non-interest expenses, of which $2,000 is substantiated as compensation of account representatives, $1,000 is substantiated as for computer equipment and software and wire services used exclusively to manage customer accounts and execute customer transactions, $1,000 consists of items on the list in paragraph (A (3) (b) (i) (A) above the Corp. X elects to directly attribute to business capital and $500 is substantiated as directly attributable to investment capital.

The total of directly attributable expenses is $4,500. ($4,000 to business capital and $500 to investment capital)

Subsidiary and Investment Capital Combined Percentages.

Subsidiary:	[$300/$10,800	+	$300/$10,800	+
	$1,000/$7,000]/3	=	6.61%	
Investment:	[$500/$10,800	+	$500/$10,800	+
	$2,000/$7,000	=	12.61%	

Indirect residual non-interest expenses of $500 are attributed 6.61% ($33.05) to subsidiary capital and 12.61% ($63.05) to investment capital. The remainder, $403.90, ($500 – [$33.05+63.05)] is attributed to business capital.

The total direct and indirect non-interest expense attribution is $4,403.90 to business, $33.05 to subsidiary and $563.05 to investment capital.