DEPARTMENT OF FINANCE
AUDIT DIVISION

96-1-GCT 1/29/96

STATEMENT OF AUDIT PROCEDURE

NONINTEREST 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 noninterest expenses has been made by a taxpayer. This SAP provides guidance on the direct and indirect attribution of noninterest 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. SAP AP/GCT 2, March 22, 1991 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 noninterest expenses to the respective forms of capital is reasonable, no further examination should be made of the attribution of noninterest 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 noninterest expenses, the desk auditor should consult with the Desk Audit Unit Manager. If the taxpayer reports investment or subsidiary capital or income on the return but has attributed none of its noninterest expenses to those classes of capital or income, or the Desk Audit Manager determines that the taxpayer's direct or indirect attribution of noninterest 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 noninterest expenses to investment or subsidiary income or capital, the auditor may attribute all the noninterest 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 noninterest 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 noninterest 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 noninterest 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 noninterest 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 noninterest 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 auditors's request but the auditor determines that one or more particular noninterest expenses have not been properly

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[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).

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 noninterest 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.

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 noninterest 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 noninterest 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 noninterest 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 sections 11-605(5) and 11-602.8(d) authorize 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 attributed to a class of capital or income in lieu of making a discretionary adjustment, as described above, to all or any part of an expense.

(b) Reimbursed noninterest expenses. (i) Where a taxpayer is reimbursed in whole or in part for noninterest 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) Noninterest 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.