REPORT #602

TAX SECTION

New York State Bar Association

Report On Draft Proposed Regulations
Relating to Investment Capital Under the
New York Corporate Franchise Tax (Article 9-A)

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TAX SECTION
EXECUTIVE COMMITTEE
1989-1990

WILLIAM L. BURKE
Chair
330 Madison Avenue
New York, NY 10017
212/856-4510

TAX REPORT #602

New York State Bar Association

February 10, 1989

FEDERAL EXPRESS

Marilyn Kaltenborn, Esq.
Chief of Tax Regulations
Department of Taxation and Finance
State Campus - Bldg. #9
Albany, New York 12227

Dear Ms. Kaltenborn:

We appreciate the opportunity to comment on the draft franchise tax regulations relating to investment capital.

The enclosed report of the Committee on New York State Tax Matters was written principally by Seymour F. Bernstein and Arthur R. Rosen, with helpful comments from a number of the members of the Committee and other members of the section's Executive Committee.

The report commends the draft regulations as a salutary step forward in modernizing this area of the law. Among the specific changes it endorses is the shift to treating short-term government obligations as cash, even though this invades the favored treatment traditionally given such obligations. The report also recommends several changes in specific provisions in line with the basic objective of the draft regulations and makes recommendations as to effective dates.

In addition, the report notes remaining areas where changes would be desirable but would require statutory revisions.

We will be pleased to contribute further as these regulations move toward promulgation.

Sincerely,

Wm. L. Burke

cc:(w/o encl.) Mr. James W. Wetzler, Commissioner of Finance

Report On Draft Proposed Regulations Relating to Investment Capital Under the New York Corporate Franchise Tax (Article 9-A)

by the Committee on
New York State Tax Matters*

The New York State Department of Taxation and Finance has recently released draft corporate franchise tax regulations relating to investment capital (and investment income). Apparently, the intent of the draft regulations is to revise the current regulations to reflect modern financial instruments and transactions. Inasmuch as the drafters of the regulations are attempting to apply an antiquated law to the contemporary world, they should be commended for the significant progress they have made in modernizing this area.

Background

The New York franchise tax on general business corporations, imposed by Article 9-A of the Tax Law, provides

* This report was written by Seymour F. Bernstein and Arthur R. Rosen. Helpful comments were contributed by James A. Locke, Peter L. Faber, Burt J. Abrams, Willard B. Taylor, Renato Beghe, Sharp Sorenson, William L. Burke, John A. Corry, Sterling L. Weaver, and Ralph O. Winger.

that in computing a corporation's tax, the corporation's capital be trifurcated into investment capital, business capital, and subsidiary capital and that its entire net income be trifurcated into investment income (income generated by investment capital), business income (income generated by business capital), and subsidiary income (income generated by subsidiary capital). The alternative tax on capital is computed by applying the tax rate to the sum of (1) business capital apportioned to the state using the business allocation percentage (based on the proportion of the taxpayer corporation's property, payroll, and receipts in New York) and (2) investment capital apportioned to the state using the investment allocation percentage (based on the proportion of the investment issuer's capital that is allocated to New York). Similarly, the tax on income (which is based on federal taxable income with certain modifications, such as the exclusion of 50% of dividends received from nonsubsi diary corporations) is computed by applying the tax rate to the sum of (1) business income apportioned to the state using the business allocation percentage and (2) investment income apportioned to the state using the investment allocation percentage. Subsidiary capital is subject to a specific tax while income attributable to subsidiary capital is subject to no tax.

Due to the different methods used to allocate business and investment capital and income, the classification of items as business capital or investment capital is extremely important. Since the statute defines business capital as the balance of total capital remaining after subtracting subsidiary and investment capital, the regulations focus on defining the latter two categories of capital.

The current regulation that defines investment capital (20 NYCRR §3-4.2) is very restrictive, generally limiting investment capital to traditional equity and debt instruments issued by corporations and to debt instruments issued by government units. This report describes the expanded definition of investment capital included in the draft proposed regulations, discusses other major changes included therein, and raises other issues which warrant addressing.

Summary

The draft regulations generally are a commendable effort to modernize the badly outdated investment capital provisions. Particularly desirable are the provisions that would treat all short-term debt obligations, including government obligations, as cash. Not only is this consistent with the treatment of such obligations as cash equivalents in modern corporate financial practices, but it should significantly improve efficiency of administration by removing many disputes about the characterization of repurchase agreements that arise under the current regulations.

Although we generally support the draft regulations, we believe several changes should be made in them. It would be very beneficial for the regulations to state as a general rule the basic principles underlying their formulation and the specific inclusions and exclusions from investment capital and investment income. Such a statement of the basic principles could provide very helpful guidance on how to characterize variations in "financial products" that inevitably will develop. Also, given the ability of corporations with substantial investment capital to move financial assets to an affiliate outside New York, the Department of Taxation and Finance should indicate, either in the regulations or by other suitable administrative announcements, that the regulations should be construed to give an expansive definition of investment capital.

Among other, more specific changes, we suggest that the short-term time limit for treating items as cash equivalents should be measured by the period to maturity from acquisition date by the taxpayer, not from the original issue date of the instrument, and that the relevant short-term period should be determined by a survey of actual commercial practice (with the period fixed at 91-days or such greater or lesser time as that review warrants).

We also recommend that the draft regulations be revised to:

(1) include intercompany debt in subsidiary capital (rather than investment capital) whenever the holder of the debt is the parent or affiliate in a greater than 50% ownership group;

(2) include as investment income (rather than exclude) the income, gains and losses from writing unexercised options and from short sales of investment securities (a change that would also help to avoid the undesirable complexity of an integrated transaction rule in the context of the relatively limited role the investment capital and income provisions play for many taxpayers in the franchise tax scheme);

(3) treat investments in short-term money market funds as cash, even though nominally stock investments, and flow through a partnership's or trust's assets to corporate partners and beneficiaries; and

(4) use the tracing and apportionment rules in TSB-M-88(5)C in computing reductions for liabilities.

Finally, we note that there may be a challenge to the Department's authority to adopt some of the changes in the draft regulations and that in any event, such changes would alter long-standing rules that affect assets and liabilities of varying degrees of illiquidity. We therefore recommend that the draft regulations should be implemented prospectively either with a further phase-in period for existing investment capital at the taxpayer's election or with a deferred effective date in all cases. Thought should also be given to whether tax policy and revenue considerations warrant granting the taxpayer the option to apply some or all of the changes retroactively.

It must also be noted that many of the major problems relating to investment capital can only be solved through statutory changes. For example, in addition to the question discussed below about the statutory definition of "cash on hand

or on deposit," if investment capital were defined as any intangible asset that is a capital asset for federal income tax purposes (except for intangibles defined by IRC section 936(h)), conformity with federal Schedule D would be possible. Alternatively, the limitation of investment capital to instruments issued by corporations and governments could be eliminated, so instruments issued by certain trusts and partnerships could qualify as investment capital.

Expanded Scope of Investment Capital

The draft regulations eliminate current general restrictions and specific exclusions and further extend the scope of investment capital to include a number of particular items. The expanded definition also highlights certain statutory restrictions that are not properly changed by regulations but should be the subject of revisions by legislative action.

1. Elimination of general restrictions. The draft regulations would delete current language restricting investment capital to securities that are customarily sold in the open market or on a recognized exchange issued for the purpose of financing corporate enterprises, and to debt instruments of the type commonly dealt in upon securities exchanges or markets or commonly dealt with as a medium for investment. Thus, it appears that many securities or instruments not dealt in on public exchanges or markets would qualify for investment capital purposes.

2. Elimination of current exclusions. The draft regulations also would delete existing provisions that now specifically exclude from investment capital such items as real property bonds and mortgages, chattel bonds and mortgages, contracts of sale, purchase money obligations, bills of lading, bills of exchange, bankers' acceptances and other commercial instruments. Accordingly, these and similar instruments issued by corporate entities apparently would be eligible to qualify for investment capital treatment if the other criteria, as discussed below, are also met.

3. Additional specific investment capital items.

The following particular items would be added to the definition of investment capital to the extent not excluded as subsidiary capital or treated as a cash equivalent under the 91-day rule:

a. Options on stock, government obligations and qualified corporate debt instruments (except options that are part of a hedging transactions entered into in a taxpayer's trade or business);

b. Stock rights and warrants;

c. "Qualified corporate debt instruments," broadly defined to encompass all corporate debt instruments except for the following specific items:

- taxpayer's own securities,
- securities acquired for services rendered or for property (other than investment capital) sold or transferred,
- securities acquired as part of a lending company business,
- debt instruments issued by any member of a taxpayer's affiliated group (80% voting stock).

d. Repurchase agreements (with the allocation, percentage potentially depending upon whether the agreement is further characterized as a loan or as a purchase and resale of the securities).

4. Comment on the Regulation Changes. We believe the provisions expanding the definition generally are an excellent effort to modernize the statute within the limits permitted by the statutory language and should be adopted.

We question, however, the exclusion from "qualified corporate debt instruments" of securities acquired for services rendered or for property (other than investment capital) sold or transferred. Although the security derives from business activity, so may cash invested in a short term financial instrument. The purpose served by this provision is not clear since a taxpayer receiving such instruments could exchange them for comparable instruments which would qualify as investment capital. Conversely, a taxpayer desiring business capital could structure transactions so that it is compensated with an investment instrument that it would otherwise purchase itself.

We also question the rules in the draft regulations for determining when a repurchase agreement is to be treated as a loan or as a purchase in those cases where the agreement is not treated as cash under the 91-day rule.[*]

Under the draft regulations, the classification as a purchase rather than a loan generally would result

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[*] The further loan/purchase classification is necessary as the first step in determining the investment allocation percentage, which is based on the underlying issuers' allocation percentages. If deemed a loan, the issuer would be the obligor; if deemed a purchase, the issuers of the underlying securities would be the issuers for purposes of computing the investment allocation percentage.

if the lender/purchaser has alienability rights and market value risks (if these criteria are ambiguous, other listed factors would be considered). Rather than developing specific criteria for determining the correct classification of repurchase agreements, federal authority should be followed.[**]

5. Exclusions from investment capital. Securities issued by individuals, noncorporate entities (such as certain trusts, partnerships, FNMA, GNMA), DISCS, and REMICs, would continue not to qualify as investment capital, following the statutory restriction. Securities held for sale to customers would also continue not to constitute investment capital. We endorse the exclusion of securities held as inventory but we believe that the modernization of the investment capital accomplished by the draft regulations only highlights the need for these statutory limitations being revisited by the legislation in the context of modern financial practices.

** For example, the draft regulations (§3-4.2(f)(1)) states that the purchaser/lender will be deemed to be the owner of the underlying securities if, among other factors, the purchaser/lender has the opportunity for profit and the risk of loss. Comparable federal authority considers opportunity for profit without the risk of loss as sufficient. The reason for this state divergence is not evident.

Other Major Changes and Considerations

1. Cash classification expansion. Under the statute, short term debt instruments included in the category of "cash on hand or cash on deposit" may be treated (along with all other cash items) as either investment capital or business capital, generally at the taxpayer's election (unless the taxpayer's investment allocation percentage is zero, in which case all "cash" is deemed business capital). Further, investment capital instruments classified as cash do not enter into the computation of the investment allocation percentage.

All types of debt instruments payable on demand or within 91 days, measured by the instrument's date of issuance, would be treated as cash under the draft regulations. Corporate debt and government debt would also be included. The critical elements concerning this new short-term cash equivalency test include the following:

a. The 91-day short-term maturity period would be measured from the issuance date and not by the taxpayer's holding period;

b. The renewal of an instrument would be considered a new debt;

c. 91-day government securities would be totally removed from the investment allocation percentage computation, and, for practical purposes, would lose the favorable classification now given all government securities;

d. Most loan-type repurchase arrangements (under the 91-day rule) would constitute cash;

e. Apparently, the current treatment of all certificates of deposit, including those with terms of greater than 91 days, would be altered so that some investments formerly considered cash would lose that advantage.

It appears that the intent of the revisions is to match the regulations' treatment of cash to current business practice, and we generally support that effort. Consideration should be given, therefore, to measuring the 91-day period (or whatever other time might be selected) from date of acquisition by the taxpayer to the date of maturity since this is consistent with the manner in which such debt instruments are commonly classified, traded, and used in the market. It is not uncommon for purchasers of Treasury securities, for example, to have no knowledge of the securities' issue dates. In any event, the character of the instrument should be determined at its acquisition date; no change should occur through the passage of time while the instrument is held by a single holder.

Also, we believe the apparent rationale of the proposed changes supports setting the "short-term" period by reference to a survey of prevailing business practices, whether that shows that 91 days or some other period is a suitable dividing line.

It should also be noted that there may be some question relating to whether these changes, including the expansion of the categories of instruments included as cash and the exclusion of long-term certificates of deposit, are consistent with the statutory (Tax Law §208.7) term of "cash on hand and on deposit." We believe that legislative approval of the proposed revisions would be desirable to eliminate any such issue.

2. Intercompany debt. The proposed draft regulations would automatically deny investment capital treatment to intercompany debt between members of an affiliated group where there is an 80% or more voting stock ownership. This automatic removal from the investment capital category would not apply to a corporate group where the debtor member is owned by the group at a level of less than 80% of the voting stock. Also, with the possible exception of cases of corporations filing as a combined group, intercompany debt of an 80% affiliated group may constitute subsidiary capital when the debt is directly between a parent and a subsidiary. However, such debt within an 80% group incurred between brother-sister corporations or parent and second-tier subs-diaries would not qualify for subsidiary capital treatment. Instead, such debt would be classified business capital.

We recommend that all intercompany debt within an affiliated group should be entitled to be treated as subsidiary capital. We believe that this would be permissable under the current statute.

Also, the use of the 80% affiliated group for this purpose appears inappropriate. To be consistent with the statutory scheme, the same test that is used in connection with subsidiary capital (more than 50% ownership) should be employed.

Moreover, the term "80% voting stock" is ambiguous when a company has several classes of voting stock with different voting rights. Consideration should be given to following the federal rules which incorporate a "voting power" test.

3. Options and financial futures. Under the draft regulations, purchased option contracts on corporate stock or bonds would qualify for investment capital treatment, and gain or loss from the sale of such contracts would be included in investment income. However, premiums from writing unexercised options and income from short sales would not be included in investment income. Further, financial futures contracts would be excluded from investment (and the income, gain or loss correspondingly excluded from investment income) because the understanding of the drafters of the draft regulations is that a financial futures contract is not an asset and therefore not capital.

We believe that premiums on unexercised options and income, gain or loss from short sales and financial futures all should be included in investment income, and that the regulations incorectly view an asset with a zero (or net zero) investment basis as not constituting "investment capital" so that the corresponding income is not "investment income".

Gain realized on a short sale represents a gain on the sale of borrowed stock that is ultimately determined and realized upon the "closing" of the transaction (purchase and return of the borrowed stock). The borrowing of stock should not preclude the fact that a gain has been realized on the sale of stock (whether borrowed or not borrowed); the borrowed stock constitutes an asset of the seller, albeit one offset with a corresponding liability for the obligation to deliver the stock to the buyer. Such gain should be classified as investment income. The premium received for an unexercised call similarly should be treated as realized from the asset on which the call is written.

Financial futures do constitute an asset (even if at times the asset has a book value and basis of zero), particularly if there is a downpayment or premium paid or the contract's value (as of a balance sheet date) reflects a market value profit; the "mark-to-market" margin could be deemed to constitute the "investment". For these reasons, financial futures contracts, being similar to stock and bond options, should be included within the stock option category as investment capital. Further, if the underlying items are cash, the futures contract should also be cash (using the look-through concept)

4. Short term government obligations. The reclassification of 91-day government (federal, New York, other state and municipal) obligations as cash results in a loss of a substantial benefit heretofore associated with these obligations. This benefit derived from the decision of Forbes, Inc. v. Department of Finance, 66 NY2d 253 (1986), where all government obligations -- federal, state and local -- were included in investment capital with a zero issuer's allocation percentage for investment allocation percentage purposes. The effect was to reduce both the percentage of the holder's investment capital and income that was taxable and also the percentage of the securities issued by the holder that were in turn treated as taxable investment capital in the hands of corporations holding its securities. The reclassification of all 91-day obligations, including those issued by governments, into cash dilutes the effect of the court's decision in Forbes since cash does not enter the computation of the investment allocation percentage, while government debt obligations are added to the denominator but not the numerator of the New York investment allocation percentage.

Whether to provide favored treatment to securities issued by a governmental entity involves political decisions of comity on which we make no comment. It is clear, however, that one objective of the changes in the draft regulations is to eliminate the problem of whether short-term repurchase agreements should be treated as loans or purchase agreement (with the concomitant effect on who is the issuer of the instrument involved). That cannot be accomplished without removing the issue as to what is included in the denominator of the holder’s allocation computation as well as what goes in the numerator.

Since a great portion of repurchase transactions involve government securities and because we support the effort to mute the classification problems relating to repurchase agreements, we support the proposed change, at least for short-term government obligations.

5. Money market mutual funds. Absent a special provision, an investment in a money market mutual fund would be classified as a stock investment, not as a debt investment; thus, it could not be treated as cash (although dividends paid by thrift institutions presumably will be considered as cash). However, investment in such mutual funds are valued and redeemed on the basis of principal plus a daily interest accrual and the fund's assets are typically invested wholly or primarily in cash and other short-term "cash equivalents". Such investments are also frequently viewed as equivalent to (and a substitute for) deposits in bank accounts. We therefore believe that it is analytically sound and administratively sensible to treat such investments as cash for investment capital purposes.

6. Partnership and Trust investments. The draft regulations state that investments in partnerships do not constitute investment capital. This provision should be amended to clarify that the classification of a trust's or partnership's assets and capital flow through to corporate owners and partners. To remain consistent with basic flow-through principles, this appears to be the only way in which such assets (directly owned by partnerships and other non-corporate "entities”) can be treated.

7. Reduction for liabilities. The draft regulations incorporate the 1987 Tax Law amendments that gave the Commissioner discretionary authority to require the deduction of all liabilities attributable to each category of capital in the computation of the value of capital. As expected (and apparently intended), that discretion would be exercised through these regulations by universally requiring the deductions. (A similar amendment would be made to the investment income regulation.) The tracing and apportionment rules in TSB-M-88(5)C should eventually be incorporated into the regulations.

8. Indentification of issuer. The regulations relating to computations of the investment allocation percentage would be expanded to clarify that in determining the issuer's or obligor's allocation percentage, the issuer of a note is the maker or obligor (not the guarantor); the issuer of a banker's acceptance is the accepting bank (not the endorser); the issuer of a trade acceptance is the party accepting the draft; the issuer of an option is the issuer or obligor of the underlying instrument (except in the case of an index option, where the Department may use a sampling of the constituent issuers and obligors); and the issuer of stock rights and warrants is the issuer or obligor of the underlying instrument. We support each of these determinations as properly reflecting the principal focus of the investor in making its investment decision.

9. Subpart F income. The draft regulations do not address the situation where a corporation includes deemed dividends from foreign affiliates because of IRC §958 constructive ownership rules but, because the dividends were generated by minority-owned controlled foreign corporations rather than by direct (first-tier) subsidiaries of the corporation, subsidiary income treatment is denied. In such cases, the deemed dividends, even if not paid directly by the first tier subsidiaries, are still attributable to the stock ownership in the first tier subsidiaries (and are ultimately accounted for as if distributed up the chain when actual distribution occurs). We believe that timing should not result in a change from subsidiary to investment classification and that the concept of constructive ownership should apply for both purposes so as to rectify the asymetrical situation that now exists. A similar rule should apply for investment capital in the case of 10% owned controlled foreign corporations.

10. Effective Date. The draft regulations would make significant changes in the classification of assets as between business and investment capital.

Some of the changes would reverse or modify statutory interpretations of such long-standing and uniform application that it could be argued that the Department of Taxation and Finance may lack the legal authority to make the changes without further legislative action. We support a short delay in the implementation of the regulations to permit the Legislature to alter the changes if it wishes.

Separate from any question of validity, we believe that the changes proposed are sufficiently extensive that they should be applied only prospectively. In addition, existing investment positions may not be alterable quickly without significant economic detriment. We therefore recommend that consideration also be given to postponing the effective date for a reasonable "sunset" period for existing investments unless the taxpayer elects to apply the new regulations to all of its investments from the effective date. Since many of the changes would appear to reduce the number of audit disputes and increase administrative efficiency for the Department and taxpayers alike, we also urge review of whether tax policy and revenue considerations permit some or all of the proposed changes to be applied retroactively. Retroactive application at the election of the taxpayer may be particularly pertinent to consider in the case of repurchase agreements and other instruments about which the current regulations are silent.