Tax Report #917

New York State Bar Association

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NYSBA

January 20, 1998

Honorable Michael H. Urbach
Commissioner of Taxation and Finance
New York State Department of
Taxation and Finance
W.A. Harriman Campus
Albany, NY 12227

Dear Commissioner Urbach:

I am pleased to enclose a report recommending the adoption of a New York State and City franchise tax exemption for certain non-U.S. ("offshore") investment companies.

The Taxpayer Relief Act of 1997, adopted by Congress last year, contains a provision that is designed to simplify and reduce the cost of the administration of corporate offshore investment vehicles. Effective January 1, 1998, corporate offshore investment vehicles with U.S. investment managers can maintain their exemption from U.S. federal income tax for their securities trading profits even if their trading activities and their "principal office" and related administrative functions are conducted in the United States. Federal law had previously required that the "principal office" be located, and related administrative function be carried on, offshore. Congress anticipated that this simplification measure would result in increased employment and business revenues in the United States, resulting in increased tax revenues.

However, the benefits of the 1997 Act will not be fully available to corporate investment vehicles conducting investment and administrative activities in New York unless New York grants a parallel franchise tax exemption, because otherwise these non-U.S. corporations could become subject to franchise tax upon moving their "principal office" and related administrative functions to New York. As a result, such corporations will not locate these operations in New York. They will either continue to maintain their administrative offices offshore or they will move their operations to states such as Connecticut where they will not be subject to tax. As these offshore investment entities do not now pay New York tax, we believe there will be no significant New York revenue loss from granting this exemption.

We recognize that our recommendation will benefit our clients, but it will, we believe, also benefit New York and strengthen its preeminence as a financial center.

We would be pleased to discuss our recommendation with you. Please call either the undersigned at (212) 859-8260 or Mr. Yaron Z. Reich, the principal author of the report, at (212) 225-2540.

Copies of this report, together with a similar accompanying letter, have been sent to those on the attached list.

Very truly yours,

Richard O. Loengard, Jr.
Chair

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Draft of January 6, 1998

New York State Bar Association Tax Section

REPORT RECOMMENDING THE ADOPTION OF A NEW YORK STATE AND CITY FRANCHISE TAX EXEMPTION FOR CORPORATE OFFSHORE INVESTMENT VEHICLES*

I. INTRODUCTION.

The purpose of this report is to recommend that, in view of certain changes in federal law enacted in the Taxpayer Relief Act of 1997 (the "1997 Act"), New York State should adopt legislation exempting from the State franchise tax and the City general corporation tax (collectively, the "franchise tax") those non-U.S. corporations whose sole connection to New York is the investing or trading in stocks, securities or commodities for their own account at the direction of an investment manager located in New York and the performance of functions (including administrative functions, general management, sales of the corporation's own stock and maintenance of an office) related to such investment activity, and whose gains from trading in stocks, securities and commodities are exempt from federal income tax pursuant to the securities and commodities trading safe harbors of section 864(b)(2) of the Internal Revenue Code of 1986, as amended (the "Code"). A similar exemption should be adopted for the purposes of the State and City tax on banking corporations (the "bank franchise tax").

The adoption of such legislation should not have a material adverse impact on tax revenues because we understand that currently the State and City do not collect any material

* This report was prepared by Yaron Z. Reich on behalf of an *ad hoc* committee including Dale Collinson, Peter L. Faber, Maria Jones, Carolyn Joy Lee and Richard O. Loengard, Jr. Helpful comments were provided by Samuel J. Dimon, Pinchas Mendelson, Richard L. Reinhold and Arthur R. Rosen. Michael J. Sutton assisted in the preparation of this report.

amount of franchise tax from offshore investment vehicles. Indeed, as Congress recently concluded in enacting the relevant provision of the 1997 Act, that provision is expected to result in increased employment and business revenues in the United States. Similarly, the enactment of an exemption from the franchise tax would likely result in the conduct of many of the administrative functions of these investment vehicles in New York, and such increased economic activity presumably would result in an increase in tax revenues. In addition, the proposal would increase the conformity of New York tax law to the federal system, with resultant simplification, and would eliminate a tax impediment to the conduct of investment-related activity in New York that can already be conducted without difficulty in other states.

The 1997 Act provision that prompts our recommendation relaxed the conditions that offshore investment vehicles must satisfy in order to qualify for the federal tax exemption for securities trading under Code section 864(b)(2). Previously, in order to qualify for that exemption, a non-U.S. corporation whose principal activity was trading in stocks or securities for its own account and that used a U.S. investment manager was required to maintain its principal business office outside the United States, from which all or substantially all of certain (ten) enumerated administrative functions were conducted (the so-called "ten commandments" or "principal office rule"). The 1997 Act repealed the principal office rule, so that for taxable years beginning after December 31, 1997, an offshore investment vehicle can qualify for the safe harbor exemption under Code section 864(b)(2) even if it maintains no office outside the United States and conducts all its administrative functions, as well as investment management activities, from an office located in the United States.

Congress enacted this change because "the principal office rule operates simply to shift certain administrative functions with respect to securities trading – and the associated jobs –

offshore," and Congress wished to "facilitate the foreign investment in U.S. markets that the safe harbor was designed to promote."[1] However, the cost benefits of the 1997 Act will not be available to corporate investment vehicles having New York-based investment managers unless New York grants a parallel franchise tax exemption, because otherwise these non-U.S. corporations could become subject to franchise tax upon moving their "principal office" and related administrative functions to New York. As a result, such corporations will not locate these operations in New York. They will either continue to maintain their administrative office offshore or they will move these operations to states such as Connecticut where they will not be subject to tax.

Part II of this report describes the federal rule and the various organizational structures of offshore investment vehicles. Part III describes the relevant New York State and City tax rules. Part IV sets forth the details of our recommendation.

II. OFFSHORE INVESTMENT VEHICLES.

A. Federal Law.

Federal income tax law has a long-established policy of encouraging foreign investment in U.S. capital markets. As early as 1936, the tax law provided that engaging in business in the United States "does not include the effecting of transactions in the United States in stocks, securities, or commodities through a resident broker, commission agent or custodian."[2]

1 H.R. Rep. No. 105-220, Ways and Means Committee Report on the Revenue Reconciliation Bill of 1997, 105th Cong. 1st Sess., 298.

2 Revenue Act of 1936, § 211, 49 Stat. 1648, 1715.

The beneficial treatment accorded to such investors was expanded and clarified in Code section 864(b)(2), which was enacted as part of the Foreign Investors Tax Act of 1966.

Under Code section 864(b)(2)(A)(ii), a non-U.S. person will not be treated as being engaged in a trade or business within the United States during a taxable year (and therefore will be exempt from U.S. federal income taxation on a net income basis) as a result of effecting transactions in the United States in stocks or securities for the taxpayer's own account, irrespective of whether such transactions are effected by the taxpayer or its employees or agents in the United States pursuant to discretionary authority to make decisions in effecting the transactions and irrespective of the volume of the transactions.[3] However, this safe harbor exemption is not available to a dealer in stocks and securities. Additionally, for taxable years beginning before January 1, 1998, this safe harbor exemption required that a non-U.S. corporation whose principal activity is trading in stocks and securities for its own account maintain a principal office outside the United States at which its management is located and at which it conducts all or a substantial portion of certain (ten) enumerated administrative functions.[4]

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3 Under the case law, a person is not treated as engaged in the conduct of a trade or business if it is merely "investing" in stocks and securities, but is treated as engaged in the conduct of a trade or business if it is "trading" in stocks and securities. See, e.g., Higgins v. Commissioner, 312 U.S. 212 (1941); Moller v. United States, 721 F.2d 810 (Fed. Cir. 1983). The distinction between "investing" and "trading" is a factual one, and takes into account the volume, frequency of trading and investment strategy of the taxpayer. Id. Section 864(b)(2)(A)(ii) obviates the need to distinguish between investing and trading in the context of non-U.S. persons by providing protection to trading activities, and thereby promotes foreign investment in the U.S. capital markets.

4 The ten enumerated functions are (i) communicating with its shareholders; (ii) communicating with the general public; (iii) soliciting sales of its own stock; (iv) accepting subscriptions of new stockholders; (v) maintaining its principal corporate records and books of account; (vi) auditing its books of account; (vii) disbursing payments of dividends, legal fees, accounting fees, and officers' and directors' salaries; (viii) publishing (continued...)

The regulations extend the safe harbor exemption and (for taxable years beginning before January 1, 1998) the principal office rule to partnerships as well.[5]

As previously noted, the 1997 Act repeals the principal office rule for taxable years beginning after December 31, 1997.

Code section 864(b)(2)(B) establishes parallel safe harbor exemptions for trading in commodities where the commodities are of a kind customarily dealt in on an organized commodity exchange and the transaction is of a kind customarily consummated at such place. However, unlike the securities trading safe harbor, the commodities trading safe harbor never included a principal office rule.

Because of the Federal laws dealing with passive foreign investment companies ("PFICs"), controlled foreign corporations ("CFCs") and foreign personal holding companies

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or furnishing the offering and redemption price of the shares of stock issued by it; (ix) conducting meetings of its shareholders and board of directors; and (x) making redemptions of its own stock. Treas. Reg. § 1.864-2(c)(2)(iii).

The principal office rule did not apply to a corporation that is, or but for section 542(c)(7), 542(c)(10), or 543(b)(1)(C) would be, a personal holding company.

5 Treas. Reg. § 1.864-2(c)(2)(ii).

In addition to the safe harbor for trading for the taxpayer's own account contained in Code section 864(b)(2)(A)(ii), subparagraph (i) of section 864(b)(2)(A) contains a safe harbor exemption for trading in stocks or securities through a resident broker, commission agent, custodian, or other independent agent if the taxpayer does not have an office or other fixed place of business in the United States through which or by the direction of which the transactions in stocks or securities are effected. This exemption, which is available to dealers as well, is intended to facilitate the execution of transactions through U.S. brokers that do not exercise discretionary authority on behalf of the taxpayer.

("FPHCS"),[6] taxable U.S. investors generally do not find it attractive to invest in these offshore entities.

B. Organizational Structures of Offshore Investment Vehicles.

Encouraged by these favorable tax rules, countless vehicles have been organized to enable foreign investors to invest in stocks, securities and commodities under the investment discretion of U.S. investment managers. Paralleling the wide variety of investment vehicles that are available to U.S. investors – which, for example, range from publicly offered mutual funds to partnerships, and include venture capital funds, leveraged buyout funds, arbitrage funds, hedge funds, fixed income funds, equity funds that target different geographic, industry or other market sectors or that have specific investment strategies, etc. – the offshore investment vehicles reflect a similar diversity of investment strategies and investor profiles. Indeed, it is not uncommon for U.S. investment managers to organize and manage offshore investment vehicles for foreign investors that parallel in their investments the vehicles that such managers have organized and manage for U.S. investors. Sometimes the offshore investment vehicles are publicly traded or are open-ended funds with numerous investors, while at other times they are privately held by a small group or even a single investor.

Due to the financial preeminence of New York, many of these offshore investment vehicles have New York investment managers and/or sponsors.

Frequently, the offshore investment vehicle is organized as a limited partnership (or as a limited liability company ("LLC") that is treated as a partnership for U.S. income tax purposes). Typically, the investors hold the limited partnership interests (or non-management

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6 See Code sections 1291-1298, 951-964 and 551-558, respectively.

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LLC interests), the U.S. investment manager is the investment general partner, and (in order to satisfy the pre-1997 Act principal office rule) a special purpose vehicle, organized in a foreign jurisdiction and owned by the sponsor (but typically managed by a professional service company), is the administrative general partner.

Often, however, the investment vehicle is organized as a corporation under the laws of a foreign jurisdiction (for example, the Cayman Islands). The investors hold the participating equity of the corporation.[7] The corporation enters into an investment management agreement with a U.S. investment manager , who is granted discretionary authority over investment decisions.[8] In order to satisfy the pre-1997 Act principal office rule, the corporation also enters into an administrative management agreement with a professional service company in the foreign jurisdiction for the maintenance of an office, the furnishing of directors and officers and the conduct of the functions enumerated in the regulations.

Depending upon the circumstances, the offshore investment vehicle may also enter into custodial arrangements with U.S. custodians for the custody of its investments. The custodian or the U.S. investment manager (or an affiliate) maintains daily records of the vehicle's investments, although under the principal office rule the permanent books and records of the vehicle are maintained at its office outside the United States.

More complicated variations of the foregoing structures also exist. For example, under a two-tier structure, a corporate offshore investment vehicle may invest in a partnership or

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7 Sometimes the sponsor will own voting shares that do not participate in profit.

8 As a federal income tax matter, the U.S. investment manager can also be an employee of the corporation. Occasionally, therefore, where the U.S. investment manager is located in a state that follows the federal exemption for securities trading, he may be employed (continued...)

LLC. The partnership (or LLC) might have other (U.S. and/or non-U.S.) investment vehicles as partners (or members), in a "master-feeder" or "hub and spoke" configuration. However, the basic elements of the offshore investment vehicle are set up in compliance with the safe harbor exemption under Code section 864(b)(2).

The securities and commodities trading safe harbors under sections 864(b)(2)(A)(ii) and 864(b)(2)(B)(ii) are also relied upon by non-U.S. corporations that are engaged in active businesses either inside or outside the United States (other than as securities or commodities dealers) and that grant discretionary authority to persons located in the United States to invest and trade in stocks, securities and commodities on their behalf.[9]

As a result of the 1997 Act's repeal of the principal office rule, it is anticipated that offshore investment vehicles that are organized after 1997 will wish to simplify their organizational structure and reduce operating costs by eliminating the non-U.S. office and conducting the administrative functions enumerated in the regulations from the office of the investment manager or custodian (or an affiliate) located in the United States. It is also anticipated that many existing offshore investment vehicles will similarly wish to simplify their organizational structure and reduce operating costs.

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directly by the investment vehicle.

9 The gains from trading in stocks, securities and commodities that are derived by non-U.S. corporations that are otherwise engaged in an unrelated U.S. trade or business would not be "effectively connected" to that U.S. trade or business, and therefore would be exempt from federal income tax. See Treas. Reg. section 1.864-4(c)(3).

III. RELEVANT NEW YORK STATE AND CITY TAX RULES.

New York State and City impose a corporate franchise tax on foreign corporations doing business, employing capital, owning or leasing property, or maintaining an office in the State.[10] The New York State regulations contain the following example:

> A foreign corporation operates or is organized for the purposes of buying and selling securities. It does not maintain a physical office anywhere, other than a statutory office in the state of its incorporation. Regular and continuous purchases of securities are directed by its officers or agents located in New York State. The corporation is subject to tax.[11]

Tax advisors to corporate offshore investment vehicles that have New York-based investment managers are concerned that if those corporations fail to maintain their "principal office" outside the United States in conformity with the pre-1997 Act securities trading safe harbor but, instead, have their administrative functions conducted in New York by the investment manager, custodian or other service provider, the New York tax authorities will contend that the corporations are subject to State and City franchise tax. While typically the amount of tax collected will be negligible because the New York investment allocation percentage usually will be extremely small, concern has been expressed about the time and expense in preparing and filing returns, as well as the adverse impact that any tax would have on the willingness of foreign investors to engage New York-based investment managers, particularly if neighboring states offer more favorable treatment.

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10 N.Y. State Tax Law § 209.1; N.Y. City Administrative Code § 11.603.1

11 N.Y. State Business Corporation Franchise Tax Regulations, section 1-3.2(f). New York City has an identical example in N.Y. City General Corporation Tax Regulations § 142.83[1].

The problem of potential taxation exists *only* in the case of investment vehicles that are organized as corporations and do not qualify as mutual funds.[12] Investment vehicles that are organized as limited partnerships or as LLCs that are characterized as partnerships for tax purposes – whether for non-U.S. or U.S. investors – are exempt from New York State and City franchise and income taxation,[13] as are their limited partners (unless they are N.Y. resident individuals or are otherwise subject to the corporate franchise tax).[14] In this regard, a special exemption is provided for corporate limited partners of "portfolio investment partnerships."[15]

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12 Mutual funds organized as regulated investment companies (and their non-N.Y. shareholders) generally do not pay New York State or City franchise or income taxes. N.Y. State Tax Law § 209.7; N.Y. City Administrative Code § 11-603.8 (the New York State and City tax regime for regulated investment companies parallels the federal income tax regime, with taxable income being reduced by a dividends paid deduction and no tax on the capital base).

13 Partnerships and LLCs that are treated as partnerships for federal income tax purposes are fiscally transparent for New York State franchise and income tax purposes. New York City exempts from the unincorporated business tax partnerships that are engaged in the purchase and sale of property, including stocks, securities and commodities, for their own account (other than dealers holding property for sale to customers). N.Y. City Administrative Code § 11-502(c). Investors that own an interest in a partnership that is "primarily engaged" in activities qualifying for the self-trading exemption also will not be subject to the unincorporated business tax on gains from such partnership. Id.

14 See N.Y. State Personal Income Tax Law §§631(a)(1) and (d); N.Y. Personal Income Tax Regulations §137; TSB-A-92(2) I (June 4, 1992) (nonresident partners of a partnership trading for its own account are not subject to New York Personal Income Tax on payments from the partnership).

15 See N.Y. State Business Corporation Franchise Tax Regulations § 1-3.2(a)(6)(i); N.Y. City General Corporation Tax Regulations § 142.82(5); TSB-A-96(ii) C (April 1, 1996) (applying portfolio investment partnership rule to an LLC). A "portfolio investment partnership" is defined as a limited partnership that meets the gross income requirement of Code section 851(b)(2) (*i.e.*, at least 90% of its income is derived from dividends, interest, certain gains, etc., or other income with respect to its business of investing in stocks, securities, or currencies), as expanded for State but not City purposes to cover commodities trading activities, but that is not a securities or commodities dealer. N.Y. State Business Corporation Franchise Tax Regulations § 1-3.2(a)(6)(iii)(d); N.Y. City
(continued...)

Thus, offshore investment vehicles that are organized as partnerships or LLCs and that have New York based investment managers will be able to benefit from the 1997 Act by moving their "principal office" and administrative functions to New York without jeopardizing their New York tax position or the tax position of their corporate limited partners.[16] By contrast, absent some change in New York law in response to the 1997 Act, offshore investment vehicles that are organized as corporations and that conduct investment activities in New York directly do not have the same protections.

Corporate offshore investment vehicles that are subsidiaries of non-U.S. banks and that therefore are potentially subject to the bank franchise tax are exempt from New York tax on any income that qualifies for the federal securities and commodities trading safe harbors, as well as from the alternative tax on taxable assets, because those provisions exclude from the tax base any income that is not effectively connected with the conduct of a U.S. trade or business (and related assets).[17] However, absent some change in New York law in response to the 1997 Act,

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General Corporation Tax Regulations § 142.82(5).

16 As indicated below, however, the New York State and City rules dealing with investment partnerships are themselves imperfect, in particular because they are inconsistent with each other and with the federal rules for offshore investment vehicles.

17 N.Y. State Tax Law §§1453(a)(3) and 1455(b)(1)(v)(A); N.Y. City Administrative Code §§11-641(a)(3) and 11-643.5(b)(2). While probably not intended, it may be that any such corporation that earns dividend or interest income from U.S. sources is subject to the City alternative minimum tax based on the part of its capital stock (or assets) that bears the same relation to the portion of its "gross income" (as defined in the Code) that is attributable to business carried on within the City, since Code section 882(b)(1) includes in gross income any U.S. source income that is not effectively connected with the conduct of a U.S. trade or business.

those entitles may be required to file returns and pay the minimum tax ($250 for the State and $125 for the City) if they move their "principal office" and administrative functions to New York.

IV. RECOMMENDATION.

Particularly in light of the fact that New York clearly has adopted a policy of attracting investment vehicles to New York by according favorable tax treatment to them, we believe it appropriate to clarify the treatment of *corporate* offshore investment vehicles conducting business in a manner permitted under the 1997 Act by exempting such vehicles from the State and City franchise tax on business corporations and the bank franchise tax.

To accomplish this goal, we recommend the adoption of a provision exempting from the New York State and City franchise tax and bank franchise tax any non-U.S. corporation that would not be subject to such franchise tax but for the conduct of activities relating to investing or trading in stocks, securities and commodities described in Code section 864(b)(2) (including, without limitation, the exercise of discretionary authority within New York, the conduct of administrative, management or other incidental functions, sales of the corporation's own stock, or the maintenance of an office within New York in respect of the foregoing), *provided* that such non-U.S. corporation is not engaged in a trade or business within the United States in respect of such activities.[18]

As noted above, the adoption of such legislation should not have a material adverse impact on tax revenues because we understand that currently the State and City do not collect any material amount of franchise tax from these vehicles. Indeed, as Congress recently

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[18] Thus, the exception would not be available to securities or commodities dealers. If a non-U.S. corporation were otherwise doing business in New York, it would not be eligible for the franchise tax exemption, but the income from its securities and commodities trading (continued...)

concluded in repealing the principal office rule, this legislation may result in increased employment and business revenues the United States. Since much of the increased activity is likely to take place in New York, the enactment of a franchise tax exemption presumably will result in an increase in New York tax revenues.

As an alternative to legislation, consideration might be given to the implementation of this recommendation through regulations. It would seem that there is adequate regulatory authority for the New York tax authorities to provide in regulations that the conduct of investment and trading activities relating to stocks, securities and commodities and related administrative and management functions through an agent located in New York does not constitute doing business, employing capital, owning or leasing property or maintaining an office in New York. For the avoidance of doubt, however, legislation would be preferable.

We believe it important that the State and City provision closely track the Code provision, so as to ensure conformity in treatment for federal, State and City purposes of non-U.S. corporations engaged in such investment activity. Thus, consistent with the federal rule, the exemption should apply to a non-U.S. corporation in respect of its securities and commodities trading activities regardless of whether such activities constitute its principal activity, so long as the corporation is not engaged in a U.S. trade or business in respect of such activities.[19]

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activities generally would be subject to the investment allocation formula.

19 In this regard, we note that each of the various State and City provisions relating to portfolio investment partnerships and, for City unincorporated business tax purposes, certain investment partnerships, define permissible activities inconsistently with each other and with the federal rule that applies to offshore investment vehicles. While the proper scope of these provisions is beyond the scope of this report, it would be desirable if the applicable State and City provisions were revised to achieve greater conformity.

In crafting such legislation, the question arises as to whether a franchise tax exemption should be accorded only to non-U.S. corporations that qualify for the securities and commodities safe harbors under Code section 864(b)(2) or should be extended to New York- and other U.S.- incorporated corporate investment vehicles. Because U.S. corporate investment vehicles that do not qualify as regulated investment companies under Code section 851 are subject to federal income taxation and may also be subject to the personal holding company tax[20] and the accumulated earnings tax,[21] such corporations frequently would be subsidiaries of larger corporate groups. Thus the issue can be framed in terms of whether it is appropriate to exempt from New York franchise tax the securities and commodities investment company subsidiaries of U.S. corporate groups (such as industrial companies, securities firms and banks).[22]

While the line-drawing exercise that is inherent in the legislative process necessarily raises the question of fairness, on balance we believe that the exemption should be limited at this time to non-U.S. corporations that qualify for the federal tax exemption, for several reasons. The immediate problem arises from the 1997 Act's repeal of the principal office rule applicable to offshore investment companies. Providing an exemption for these companies clearly is consistent with federal as well as State and City policies, will preserve the current expectations of these companies and their foreign investors while enabling them to take advantage of the cost benefits intended by the 1997 Act, and will not have a material adverse impact on State and City

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20 See Code sections 541 - 547.

21 See Code sections 531 - 537.

22 In the context of investment subsidiaries of banks, the implications of the State and City bank franchise tax would also need to be considered.

revenues. It is less certain that the same can be said with respect to corporate investment subsidiaries of U.S. companies.

Assuming the legislation excludes U.S. corporate investment vehicles from the scope of the exemption, it might be questioned whether it is appropriate also to exclude non-U.S. corporations that are subsidiaries of U.S. corporations in order to prevent U.S. corporations from conducting securities and commodities investment activities through non-U.S. subsidiaries that are managed in New York. This may not be necessary since the federal CFC rules may well be a sufficient barrier to such activity, although New York might reasonably conclude that it should have its own carveout from the exemption for subsidiaries of U.S. corporations.[23] However, any such exclusion should be drafted carefully so as not to deny an exemption to non-U.S. corporate investment vehicles merely because they have U.S. investors. As indicated above, taxable U.S. investors generally do not find it attractive to invest in these offshore entities, as a result of the PFIC, CFC and FPHC rules, although from time to time they will do so,[24] as may tax-exempt U.S. investors.[25] We do not believe that these situations should be viewed as problematic as a New

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23 If so, for this purpose, "subsidiary" might be defined more broadly than in section 208.3 of the Tax Law to include a corporation more than 50 percent of the value or voting power of the shares of which is owned, directly or indirectly, by a single U.S. corporation.

24 For example, taxable U.S. investors might acquire the preferred stock of a corporate offshore investment vehicle that has been organized to provide financing to affiliates or to invest in a designated pool of securities. Such investors typically would make a "qualified electing fund" ("QEF") election under section 1295 of the Code to report on a current basis their share of the earnings of the corporation and thereby to mitigate the adverse consequences of investing in a PFIC. Earnings that are reported as a result of a QEF election would also be taken into account for New York tax purposes by a shareholder that is a N.Y. resident or that is subject to the franchise tax (unless the corporate investment vehicle is a subsidiary).

25 Tax-exempt U.S. investors generally are not subject to the PFIC, CFC, or FPHC rules with respect to an investment in a corporate offshore investment vehicle. In addition, their (continued...)

York tax matter, and that New York should not have a more restrictive rule in this regard than federal tax law.

Finally we believe it is critical that any proposed legislation include identical amendments to the New York State Tax Law and the New York City Administrative code. Since much of the investment activity we have described takes place in New York City, without an exemption from both State and City taxes, the purpose of the exemption, to encourage the location of these investment vehicles in New York, will not be accomplished. In addition, it is eseential that the amendments to the State and City statutes be identical in order to eliminate doubt and achieve conformity. This goal would best be achieved by a bill that simultaneously amends all the relevant sections in both the State and City laws.

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investment income from such vehicles generally will not be unrelated business taxable income ("UBTI") under section 512 of the Code.