New York City Tax Appeals Tribunal

In the Matter of CREDIT INDUSTRIEL ET COMMERCIAL Petitioner.	DECISION TAT (E) 02-19(BT)

Credit Industriel et Commercial ("Petitioner") filed an Exception to a portion of the Determination of the Chief Administrative Law Judge dated April 13, 2005 (the "CALJ Determination"). The Chief Administrative Law Judge ("CALJ") sustained the Notice of Determination issued by the New York City Department of Finance (the "Department") asserting deficiencies of New York City Banking Corporation Tax (the "Bank Tax") under Part 4, Subchapter 3, Chapter 6 of Title 11 of the Administrative Code of the City of New York (the "Code") for the calendar years 1992, 1993 and 1994. Petitioner's Exception is only with respect to the CALJ's finding that Petitioner was not entitled to exclude from the numerator of Petitioner's deposits factor for its tax year 1994 (the "Tax Year"), all of the deposits recorded on the books of the international banking facility ("IBF") established by Petitioner's branch in the City of New York (the "City Branch"). Petitioner appeared by Maria T. Jones, Esq., of Kramer Levin Naftalis & Frankel LLP and the Commissioner of Finance of the City of New York (the "Commissioner" or "Respondent") appeared by Robert J. Firestone, Esq., Senior Counsel, New York City Law Department. Both parties filed briefs and oral argument was held before the Tribunal.

During the Tax Year, Petitioner, formerly known as Compagnie Financiere De CIC et De L'Union Europeene, was engaged in a banking business in New York State (the "State") and in the City of New York (the "City") as a State-chartered branch of a foreign bank.[1] The City Branch established its IBF in the State (the "CIC IBF") prior to 1992. The City Branch established the CIC IBF, in part, to receive increased access to foreign deposits as a result of an exemption from the reserve requirements, 12 C.F.R. section 204 ("Reg D"), and the interest rate ceilings, 12 C.F.R. section 217 ("Reg Q"), imposed by the Board of Governors of the Federal Reserve System (the "FRB").

An IBF is a separate set of asset and liability accounts segregated on the books and records of the banking entity that established the IBF. For the Tax Year, the CIC IBF maintained separate books and records that accurately reflected the gross income, gain, losses, deductions, assets, liabilities and other activities of the CIC IBF. The CIC IBF's asset and liability accounts contained only IBF time deposits and extensions of credit.

For the Tax Year, Petitioner filed a Federal Income Tax Return, Form 1120F, and a City Tax Return for Banking Corporations, Form NYC-1. Petitioner properly elected to use the formula allocation modification, described below, with respect to the CIC IBF in determining Petitioner's Bank Tax liability for the Tax Year.

The Department issued a Notice of Determination, dated March 29, 2002, that, in part, asserted a Bank Tax deficiency for the Tax Year of $225,484.77 with interest calculated to April 15, 2002 of $184,048.29. Of the $225,484.77 in additional Bank Tax, $218,234 resulted from the Department's assertion that certain deposits from foreign persons recorded in the accounts of the CIC IBF were not properly attributable to the production of eligible

[1]The CALJ's Findings of Fact relating to the issue before this Tribunal, although paraphrased and amplified in part, have generally been adopted for purposes of this Decision. We have omitted those Findings of Fact relating to issues as to which Petitioner did not take Exception.

gross income of the CIC IBF. As a result, the Department increased the numerator of Petitioner's deposits factor in its allocation percentage by $1,265,695,410.

For the Tax Year, Petitioner calculated its interest expense deduction under Treasury Regulation section 1.882-5.

During the Tax Year, the CIC IBF accepted deposits only from "foreign persons" ("Foreign Persons") as defined in Code sections 11-641(f)(8) and 11-642(b)(2)(B). Funds raised by the CIC IBF through those deposits were initially "put with" the City Branch. The parties stipulated that Petitioner either used those funds to repay foreign depositors or made a business decision to use those funds for any other business or investment purpose including making loans to foreign persons.

During the Tax Year, the CIC IBF's only extensions of credit that paid interest were made to Foreign Persons and all of the income reflected in the books and records of the CIC IBF during the Tax Year was eligible gross income of the CIC IBF.

If at the close of a business day, the amount by which the CIC IBF's time deposits, as defined in Reg D, from Foreign Persons exceeded the amount of the CIC IBF's extensions of credit, as defined in Reg D, to Foreign Persons, FRB rules[2] required the CIC IBF to report that difference as "due from" the City Branch, *i.e.*, as an "IBF extension of credit" under Reg D. That difference averaged $1,265,695,410 during the Tax Year (the "Excess Funds"). These same amounts were reported by the City Branch as "due to" the CIC IBF. The amounts reported as "due from" the City Branch were reported as assets on the separate

[2]FRRS 2-309.48.

accounts of the CIC IBF.[3] The CIC IBF received no interest from the City Branch on the Excess Funds.[4]

The City Branch invested the Excess Funds in liquid United States government obligations that had limited credit risk and could readily be converted to cash, or used as collateral to obtain cash. All of the income generated by the City Branch as a result of those investments was included in Petitioner's entire net income ("ENI") and in the numerator of Petitioner's receipts factor for purposes of calculating its ENI and alternative ENI allocation percentages. The parties stipulated that because the Excess Funds were invested by the City Branch in liquid United States government obligations, those funds were more accessible to Petitioner to make IBF loans, repay foreign depositors or for any other business purpose of the City Branch than if those funds had been loaned to or placed with unrelated foreign persons subject to specified maturity dates.[5]

For the Tax Year, Petitioner calculated its ENI and alternative ENI allocation percentages by including all deposits of the CIC IBF in the denominator, but not the numerator, of the deposits factor. Thus, Petitioner reported $816,817,293 as deposits maintained in branches in the City other than in the CIC IBF, and reported $2,190,605,951 as deposits maintained in branches everywhere, including the CIC IBF.

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[3]We are amplifying the CALJ's Finding of Fact to note that the amount due from the City Branch was shown as an asset on the CIC IBF books as stipulated by the parties. Joint Stipulation of Facts and Exhibits ("Stipulation") ¶44.

[4]Federal Reserve Regulations in effect during 1994 permitted an IBF to "put" its funds with a U.S. or non-U.S. office of the entity establishing the IBF, in an office of a U.S. or alien bank located outside the United States, or in another IBF. Although IBFs may only accept deposits payable after at least one day, for FRB purposes, an IBF is free to "put" funds with its establishing entity, another IBF or another non-U.S. banking office in any type of account that can be owned by a corporation. Federal banking laws in effect for the Tax Year prohibited a bank from directly or indirectly paying interest on demand deposit accounts. Reg. Q.

[5]Stipulation ¶54.

On audit for the Tax Year, the Department increased the amount reported by Petitioner as deposits maintained in branches in the City, other than in the CIC IBF, by the amount of the Excess Funds, increasing the numerator of the deposits factor from $816,817,293 to $2,082,512,703.

The CALJ concluded that Petitioner was not entitled to reduce its deposits factor by the amount of deposits representing the Excess Funds (the "Excess Funds Deposits") because rather than use those funds to make loans to Foreign Persons, which would have generated eligible gross income, those funds were advanced to the City Branch on an interest-free basis and were used by the City Branch to invest in United States government obligations generating City income. In its Exception, Petitioner does not dispute any of the CALJ's Findings of Fact but does assert that the CALJ erred in characterizing the Excess Funds Deposits as advances to the City Branch.[6]

In its Exception, Petitioner argues that it was entitled to exclude from the numerator of its deposits factor all of the CIC IBF deposits because the CIC IBF earned only eligible gross income and had deposits only from Foreign Persons during the Tax Year. Petitioner argues that all of the deposits of the CIC IBF were properly attributable to the production of eligible gross income because the CIC IBF had no other income to which the deposits could be attributable. Petitioner contends that this result is required by the statute, the legislative intent of the legislation enacting the relevant IBF provisions and the Department's Rules governing the Bank Tax (the "Bank Tax Rules").[7] Petitioner also contends that the Commissioner did not have broad discretion to interpret the applicable statutory provision.

[6]*See*, CALJ Determination at 16 & 17. As this characterization is not pivotal to our analysis of the case at bar, we find no need to address Petitioner's objection.

[7]19 RCNY Ch. 3.

Respondent contends that the CALJ Determination should be affirmed as it is supported by the statute, the Bank Tax Rules and the legislative history and, therefore, the deficiency for the Tax Year should be sustained.

For the following reasons, we affirm the CALJ's Determination and sustain the deficiency for the Tax Year.

For tax years beginning on and after January 1, 1985, the Bank Tax is imposed on every banking corporation for the privilege of doing business in the City. The tax is based either on a percentage of the banking corporation's ENI allocable to the City or on one of three alternative bases, whichever produces the highest amount of tax. Code §§11-639 and 11-643.5.

For a banking corporation organized in a country other than the United States, ENI is limited to the amount effectively connected with a trade or business conducted in the United States as determined under section 882 of the Internal Revenue Code, with certain modifications. Code §11-641(a)(3).

The ENI or other tax base (other than the fixed minimum tax), of banking corporations carrying on business within and outside the City is allocated to the City using an allocation percentage based upon the percentages of the taxpayer's payroll, receipts and deposits in the City. Code §11-642(a). For purposes of allocating ENI, the payroll factor is weighted at 80% while the receipts and deposits factors are each weighted at 200%. Code §11-642(a).

The Code provides for special treatment under the Bank Tax for IBFs established in the State. A banking corporation establishing an IBF in the State has the option of either deducting from its ENI the "adjusted eligible net income" of the IBF (Code section 11-

641(f)) (the "Income Modification") or electing to include in ENI the income or loss of the IBF but to treat certain payroll, receipts and deposits "properly attributable to the production of eligible gross income" as derived from outside the City for purposes of calculating the allocation factors. Code §11-642(b)(2). This second option is referred to herein as the "Formula Modification."

"Eligible gross income" is defined in Code section 11-641(f)(2) as gross income derived by an IBF from (i) "making, arranging for, placing or servicing loans to foreign persons" with certain limitations not relevant here; (ii) making or placing deposits with foreign persons that are banks or foreign branches of banks or IBFs; and (iii) certain foreign exchange or hedging transactions.[8] All of the gross income of the CIC IBF during the Tax Year was eligible gross income.

For the Tax Year, Petitioner properly elected to use the Formula Modification. In calculating its deposits factor under the Formula Modification, Petitioner excluded all of the deposits of the CIC IBF from the numerator of the fraction on the basis that all of those deposits were "properly attributable to the production of eligible gross income."

The eligible gross income of the CIC IBF for the Tax Year as reported by the Petitioner was $3,756,473. The only extensions of credit by the CIC IBF that paid interest, *i.e.*, that were income-producing, were made to Foreign Persons. The average amount of such extensions of credit during the Tax Year was $108,093,248.[9] At the same time, the

[8]For purposes of the Formula Modification, the definition of "eligible gross income" is modified to exclude foreign branches of the bank establishing the IBF from the term "Foreign Persons." Code §11-642(b)(2)(B).

[9]This is the amount remaining after subtracting from Petitioner's total deposits reported for the Tax Year ($2,190,605,951) the amount reported as City deposits ($816,817,293) and the amount of Excess Funds ($1,265,695,410). The CALJ described this amount as the amount of Petitioner's reported deposits that "could have been used" by the CIC IBF to make loans to Foreign Persons. CALJ Determination, at 17, fn. 11. Petitioner takes exception to this characterization arguing that the CIC IBF could have used all of its funds derived from deposits from Foreign Persons to make such loans. We find it unnecessary to address Petitioner's disagreement with the CALJ's

average amount of deposits from Foreign Persons was $1,373,788,658.[10] The parties have stipulated that $1,265,695,410, (the Excess Funds), were "put with" the City Branch. The parties have further stipulated that the City Branch used the Excess Funds to purchase United States government obligations the income from which was included in Petitioner's ENI for the Tax Year and treated as receipts derived from the City for purposes of the receipts factor of the allocation percentages. No portion of the income from those obligations was reported as income of the CIC IBF. Had it been so reported, that income would not have been eligible gross income.

Petitioner argues that the Excess Funds were "put with" the City Branch and used to purchase liquid government securities so as to ensure that the CIC IBF had "ready access" to those funds to repay depositors or to make loans to Foreign Persons, which would have produced eligible gross income. For this reason, Petitioner asserts that the Excess Funds Deposits were properly attributable to the production of eligible gross income. We do not find this argument persuasive. While it is reasonable for a bank to retain some liquid assets against withdrawals by depositors (and banks are required by FRB rules to maintain reserves), Petitioner has not provided any evidence that business prudence would require an IBF to maintain liquid assets equal to 92% of its deposits. Moreover, as Petitioner has stipulated, one of the principal purposes of establishing the CIC IBF was to avoid having to meet FRB reserve requirements with respect to its deposits from foreign persons.

The CALJ concluded that the Commissioner has broad discretion to determine when an IBF's deposits are "properly attributable" to the production of eligible gross income.

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characterization. Regardless of what the CIC IBF might have done with its funds, the facts as stipulated by the parties and as found by the CALJ indicate that the average amount of extensions of credit to Foreign Persons during the Tax Year equaled this amount.

[10]This amount is the excess of the total amount of deposits reported by Petitioner ($2,190,605,951) over the amount reported as City deposits ($816,817,293).

Petitioner takes exception to the CALJ's conclusion. Petitioner asserts that where an IBF has no ineligible gross income, the statute requires all deposits of the IBF to be excluded from the numerator of the deposits factor under the Formula Modification as "properly attributable to the production of eligible gross income" because there is no other income in the IBF to which its deposits could be attributed. Petitioner asserts that no interpretation of the statutory language by the Commissioner or this Tribunal is required. We disagree.

Chapter 6 of Title 11 of the Code contains numerous provisions under which the Commissioner may determine whether a particular result is "proper" or whether one item is "attributable" to another.[11] Most of those provisions expressly provide that the Commissioner has discretion to apply them in an appropriate manner. "Where the same word or group of words is used in different parts of the same statute there is a presumption that the Legislature intended to convey the same conception each time...." McKinney's Statutes §236. Although Code section 11-642(b)(2) contains no specific reference to the Commissioner's authority or discretion, we believe that to be consistent with the similarly worded provisions of Chapter 6 of Title 11 of the Code, the legislature's use of the phrase "properly attributable" in the Formula Modification should be understood to authorize the Commissioner to adopt rules for determining whether deposits are "properly attributable to the production of eligible gross income." Subsection 1 of Code section 11-687 provides:

> The commissioner of finance shall administer and enforce the tax imposed by the named subchapters [including the Bank Tax] and the commissioner is authorized to make such rules and regulations ... as the commissioner may deem necessary to

[11] *See, e.g.,* Code §11-642(a)(6), discussed *infra* p. 24, Code §11-646(f) relating to the circumstances under which a combined return is required or permitted, Code §11-646(c) permitting an extension of time to file a return if the taxpayer pays an amount of properly estimated tax, Code §11-642(a)(2)(E) and (i) governing the sourcing of various receipts within and without the City for Bank Tax purposes and Code §11-602.5 and 8(b)(6) relating to expenses attributable to investment or subsidiary capital or income therefrom.

> enforce the provisions of this subchapter and of the named subchapters; ….

Consequently, we agree with the CALJ that the Commissioner had discretion to interpret the statutory language and believe a review of the Department's rules in this area is appropriate.

Section 3-04(a)(3)(ii)(C) of the Bank Tax Rules provides that if a taxpayer elects the Formula Modification, the deposits factor of the allocation percentage is adjusted by:

> (C) including in the denominator but excluding from the numerator of the deposits factor, deposits *the expenses of which are attributable, as provided in §3-03(c)* of these regulations, to the production of eligible gross income. (Emphasis added.)

Section 3-03(c) of the Bank Tax Rules governs the calculation of the amount to be excluded where the taxpayer does not elect the Formula Modification but opts to use the Income Modification. Paragraph (3) of section 3-03(c) provides:

> (i)… The eligible net income of the IBF is the amount remaining after subtracting from the eligible gross income of the IBF… *the expenses applicable to such gross income* (See: §3-03(c)(5)—Direct expenses of the IBF, §3-03(c)(6)—Interest expense of the IBF, §3-03(c)(7)—Bad debt deduction of the IBF, and §3-03(c)(8)—Indirect expenses of the IBF, including head office expenses). When the IBF has eligible gross income and ineligible gross income for the taxable year, eligible net income of the IBF is computed by reducing eligible gross income by those expenses which are apportioned to eligible gross income pursuant to §3-03(c)(9). (Emphasis added.)
>
> …
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> (iii) *Expenses applicable to the eligible gross income* of the IBF are those expenses or other deductions (including expenses or

> other deductions from interoffice transactions) described in paragraphs (5), (6), (7) and (8) of this subdivision that are *directly or indirectly attributable to the eligible gross income* of the IBF. (Emphasis added.)

Under paragraphs (5) through (8), the expenses of the IBF fall into one of four categories:

1. expenses and other deductions that can be specifically identified with the gross income, gains, losses etc. of the IBF (paragraph (5));

2. interest expense of the IBF (paragraph (6));

3. bad debt deduction of the IBF (paragraph (7)); and

4. expenses of the *taxpayer* (not just expenses of the IBF) that cannot be specifically identified with the gross income, etc. of the IBF, or with a specific place of business of the taxpayer. Those expenses must be allocated between the IBF and the taxpayer using a method based on the gross assets or gross income (paragraph (8)). This apportionment is separate and distinct from the apportionment provided for in paragraph (9) described below.

Paragraph (9) reiterates the last sentence of section 3-03(c)(3)(i) providing:

> When the IBF has eligible gross income and ineligible gross income, the expenses that are applicable to eligible gross income shall be the sum of the following amounts:
>
> (i) the amount of direct expenses of the IBF… that are specifically identified with eligible gross income, and

> (ii) an amount computed by multiplying the sum of direct expenses of the IBF… that are not specifically identified with either the eligible gross income or the ineligible gross income of the IBF and all indirect expenses of the IBF… by a fraction, the numerator of which is the eligible gross income of the IBF … and the denominator of which is the gross income of the IBF….

Petitioner argues that in applying the Bank Tax Rules, paragraph (9) results in all of the CIC IBF's expenses being treated as attributable to the production of eligible gross income because, as the CIC IBF had only eligible gross income, the numerator and denominator of the fraction described in clause (ii) would be the same. It is noteworthy that, notwithstanding Petitioner's argument on this point, on Schedule F, lines six through 18, of its Bank Tax return for the Tax Year, Petitioner reported $0 in expenses applicable to eligible gross income.[12] Petitioner's argument ignores the plain language of paragraph (9) to the effect that it applies only where the IBF has both eligible and ineligible gross income. As the CIC IBF had only eligible gross income, paragraph (9) by its terms does not apply.[13] Petitioner's argument also ignores the first step in the analysis required by paragraph (3) of section 3-03(c), which is to identify those expenses of the IBF deductible for purposes of the Income Modification.

Unfortunately, the Bank Tax Rules are not as clear as might be hoped. Nothing in subdivision (c) explains how to determine which, or to what extent, expenses of the IBF determined under paragraphs (5) through (8) are directly or indirectly attributable to the eligible gross income of the IBF. It might be assumed that if an IBF has only eligible gross income, all of the expenses of the IBF determined under those four paragraphs should be

[12] Exhibit L.

[13] Petitioner takes exception to the CALJ's statement that the only direct interest expense of the IBF to which paragraph (9) applies is interest calculated under clause (ii)(A) of paragraph (6), which did not apply to the CIC IBF. As we find that paragraph (9) is not applicable, we do not need to address Petitioner's exception on this point.

treated as attributable to eligible gross income. However, if that were the intended result, the last part of subparagraph (iii) of paragraph (3) would be superfluous and the subparagraph could have been written merely as “Expenses applicable to the eligible gross income of the IBF are those expenses or other deductions … described in paragraphs (5), (6), (7) and (8) of this subdivision” omitting the last phrase “that are directly or indirectly attributable to the eligible gross income of the IBF.” The Bank Tax Rules contain no examples illustrating how subparagraph (iii) of paragraph (3) was intended to be applied.[14] Nothing in the Bank Tax Rules suggests that those paragraphs do not apply to an IBF having only eligible gross income.

The Record contains no information about the expenses shown on the books of the CIC IBF. Nevertheless, as interest is a significant expense incurred by a bank in accepting deposits, an examination of how paragraph (6) applies in determining the interest expense of an IBF for purposes of the Income Modification is an indicator of how much of the expenses of the CIC IBF deposits might be attributed to its eligible gross income.

Subparagraph (i) of paragraph (6) provides that “A taxpayer that determines its interest expense deduction for Federal income tax purposes pursuant to §1.882-5 of the Federal income tax regulations (26 C.F.R. 1.882-5) must compute the interest expense of the IBF for New York City tax purposes as described in subparagraph (iii) of this paragraph.”[15] The application of Treasury Regulation section 1.882-5 to the Bank Tax Rules is referred to

[14]We urge the Department to consider amending the Rules to set forth the calculation of expenses properly attributable to the production of eligible gross income and to clarify how that calculation relates to the factors for purposes of the Formula Modification.

[15]Non-U.S. taxpayers are subject to federal income tax on only their income effectively connected with a trade or business conducted in the United States. Generally, under Treasury Regulation section 1.882-5, the interest expense deduction of a non-U.S. taxpayer is determined using a three-step process: The first Step requires a determination of the value of the assets of the non-U.S. person effectively connected to its U.S. business. These are the U.S. assets. The second Step is to compute an amount of effectively connected liabilities as a portion of the U.S. assets using either a fixed or actual ratio. The third Step applies a blended interest rate, derived from the various interest rates paid by the taxpayer worldwide, to the calculated amount of U.S. liabilities.

hereinafter as the "882-5 Calculation." Because Petitioner calculated its interest expense for federal and City tax purposes under Treasury Regulation section 1.882-5, the interest expense of the CIC IBF would be determined under the 882-5 Calculation.

Subparagraph (iii) of paragraph (6) provides that a taxpayer computing its federal interest expense deduction under Treasury Regulation section 1.882-5 must compute its IBF interest expense:

> in the same manner, using the same liabilities-to-assets ratio, the same method (branch book/dollar pool or separate currency pools), the same interest rate or rates and the same method of valuation it actually used in the computation of its Federal interest expense deduction for the taxable year. In determining the IBF's interest expense for New York City tax purposes, the three-step process described in §1.882-5 of the Federal income tax regulations (26 C.F.R. 1.882-5) is applied using the following rules:
>
> (a) The term "interoffice" means the activities between the IBF and the separate branches, agencies, or offices of the taxpayer.…

Section 3-03(c)(6)(iii)(B) of the Bank Tax Rules further provides that the asset determination in Step one of the federal three-step process is "the average total value of all of the *IBF assets (including interoffice[16])* shown on the books that generate, have generated, or could reasonably have been or be expected to generate income, gain or loss *which is or would be included in the computation of entire net income for the taxable year….*" (Emphasis added.)

[16]The Bank Tax Rules depart from the federal rules in that for purposes of the federal three-step process under Treasury Regulation section 1.882-5, interbranch transactions do not create U.S. assets. Treas. Reg. §1.882-5(b)(1)(iv).

The Commissioner contends that the asset recorded on the CIC IBF books representing the amount due from the City Branch in the amount of the Excess Funds (the "Due From Asset") would not be included in Step one of the 882-5 Calculation under subparagraph (iii) because it is not an "interoffice" asset.[17] "Interoffice" is defined for this purpose as including only activities between the IBF and the "*separate* branches, agencies or offices of the taxpayer" (emphasis added) whereas, the Commissioner argues, the CIC IBF is not a separate branch from the City Branch but merely a segregated set of books.

Treasury Regulation section 1.882-5(b)(1)(iv) uses similar language excluding from the calculation of U.S. assets those resulting from transactions between "separate offices or branches of the same taxpayer...." As an IBF is not treated as a separate branch for federal tax purposes and as interbranch transactions are disregarded in determining U.S. assets for federal tax purposes, the federal regulations do not provide any guidance in this area.

For purposes of computing the interest expense of an IBF of a bank that does not determine its federal interest deduction under Treasury Regulation section 1.882-5, the Bank Tax Rules require interest to be imputed on borrowings or deposits from each "branch, agency or other office of the bank which established the IBF." 19 RCNY §3-03(c)(6)(ii)(B). No distinction is made for this purpose between the establishing branch and other branches of the establishing bank. As discussed below, the legislative history of the IBF provisions reflects a general intent to treat an IBF as if it were a branch of the establishing bank. There is no indication that, in promulgating the Bank Tax Rules, the Department intended to treat interbranch transactions differently for IBFs of foreign banks computing their federal interest

[17]Petitioner objects to the Commissioner's arguments regarding the 882-5 Calculation because they were not asserted on audit and on the basis that they are inconsistent with the parties' stipulation that the books and records of the IBF "accurately reflected the gross income, gains, losses, deductions, assets, liabilities and other activities of the IBF." (Stipulation ¶44). We do not agree with Petitioner. This Tribunal is free to consider new issues of law presented on appeal. Matter of Small, DTA 803077 (New York State Tax Appeals Tribunal, August 11, 1988). In addition, the parties merely stipulated that the books of the CIC IBF properly reflected the expenses and deductions of the IBF; they did not stipulate what if any, portion of those expenses or deductions were attributable to eligible gross income.

deduction under Treasury Regulation section 1.882-5 and IBFs of other banks in this regard. Thus we cannot conclude that the Due From Asset is not an interoffice asset of the CIC IBF for purposes of the 882-5 Calculation.

The Commissioner argues further that the Due From Asset should be excluded from Step one of the 882.5 Calculation because it did not and could not generate any income included in Petitioner's ENI. The CIC IBF received no income on the Due From Asset and the City Branch would have been prohibited by FRB rules from paying interest on it had it been a true demand deposit. However, the fact that an asset is not currently income-producing is not enough to exclude that asset as a U.S. effectively connected asset for purposes of Treasury Regulation section 1.882-5 if, under the circumstances, the asset is used in connection with a United States trade or business. Taiyo Hawaii Co. Ltd. v. Commissioner, 108 T.C. 590 (1997). In that case, the court found that because undeveloped real property was held in connection with a U.S. real estate business and would produce effectively connected income if sold at a gain, it was a U.S. asset for purposes of Treasury Regulation section 1.882-5.

The starting point in determining ENI is the taxpayer's federal taxable income. Code §11-641(a). Interbranch payments are not included in federal taxable income and the Code does not provide for any modifications to federal taxable income for amounts derived from interbranch deposits or other interbranch transactions.

Section 3-03(c)(3)(ii) defines eligible gross income of an IBF as:

> the amount of gross income (*including gross income from interoffice transactions*) derived from the activities described in §3-03(c)(4) *that would be includible in the computation of the*

IBF's entire net income for the taxable year, as if the IBF were a separate corporation. (Emphasis added.)[18]

In TSB-A-88(12)C (5/16/88), *modified by* TSB-A-88(12.1)C (11/8/90), the New York State Department of Taxation & Finance concluded that, because payments to the IBF from foreign branches of the taxpayer bank were included in eligible gross income, the State Commissioner of Taxation & Finance could exercise his discretion to add those amounts to the taxpayer's ENI to properly reflect the taxpayer's activity in the State. The State Department of Taxation & Finance concluded that the adjustment was necessary because without the adjustment, the Income Modification would permit the activities of the IBF to reduce the tax on the taxpayer's other activities, which was not intended by the legislature in enacting the IBF provisions. Thus, if an IBF receives income from an asset resulting from an interoffice transaction and that income would be eligible gross income if the IBF were treated as a separate corporation, that asset may be treated as generating income includible in the taxpayer's ENI for purposes of the 882-5 Calculation.[19]

That principle does not apply to the case at bar. Any interbranch payments on the Due From Asset would have been ineligible gross income. The definition of ineligible gross income in section 3-03(c)(2) of the Bank Tax Rules also includes gross income from interoffice transactions. However, because the Income Modification applies only to eligible income, there is no need for any comparable modification to ENI for ineligible gross income resulting from interbranch transactions as was required in TSB-A-88(12)C.[20]

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[18] The activities described in section 3-03(c)(4) of the Bank Tax Rules are those activities of an IBF that produce eligible gross income.

[19] Note, however, that for purposes of the definition of eligible gross income under the Formula Modification, transactions between an IBF and the foreign branches of the taxpayer are disregarded. Code §11-642(b)(2)(B).

[20] In any event, the City Branch did not make any payments to the CIC IBF on the Due From Asset and nothing in the statute, Bank Tax Rules or other authorities requires imputing any such income on the Due From Asset.

Petitioner argues that the Due From Asset produced income included in Petitioner's ENI because the Excess Funds were used by the City Branch to purchase government securities the income from which was included in Petitioner's ENI. However, this argument ignores the requirement of subparagraph (iii) that only "IBF assets" are to be considered in the 882-5 Calculation. The government securities purchased by the City Branch were not reported on the books of the IBF. Moreover, because the FRB Rules limit an IBF to holding IBF time deposits and IBF extensions of credit, the government securities purchased by the City Branch with the Excess Funds could not lawfully have been reported on the books of the CIC IBF. 12 C.F.R. §204.8(a)(1) & (3).

Petitioner's argument on this point also directly contradicts its argument that the City Branch's use of the Excess Funds to purchase government securities that produced income for the City Branch should be disregarded in determining whether the deposits of the CIC IBF are attributable to the production of eligible gross income. In its brief, Petitioner states:

> The Statute makes no reference to the income of the New York branch in determining which deposits in the IBF are properly attributable to the production of eligible gross income of the taxpayer's IBF. Rather the Statute plainly and clearly looks only to the income earned by the IBF.[21]

Thus, we agree with the Commissioner that the Due From Asset should not be treated as an IBF asset for purposes of the 882-5 Calculation because it did not generate any income includible in Petitioner's ENI.[22]

[21] Petitioner's Brief, at 15.

[22] We need not consider whether, had Petitioner acquired income-producing assets with the Excess Funds or merely held them as cash, those assets would be treated as IBF assets for purposes of the 882-5 Calculation.

Clause (C) of subparagraph (iii) of section 3-03(c)(6) of the Bank Tax Rules provides that the liability determination for purposes of Step two of the 882-5 Calculation is made by multiplying the average total value of IBF assets by the same percentage used for federal purposes. For the Tax Year, Petitioner used a fixed 95%.[23] As we have concluded that the Due From Asset should not be considered an asset of the CIC IBF for purposes of the 882-5 Calculation, the IBF liabilities would be 95% of the CIC IBF assets, determined without the inclusion of the Due From Asset.

The third Step in the 882-5 Calculation for the CIC IBF is to apply the interest rate used by Petitioner for federal purposes to the amount of liabilities calculated in Step two. The Record contains no evidence as to what interest rate Petitioner used for federal tax purposes. However, the overall impact of the 882-5 Calculation for the CIC IBF can be illustrated by the following example using a hypothetical 5% interest rate:

Step 1: IBF Assets:	Assets	Liabilities
Extensions of Credit to Foreign Persons:	$ 108,093,248	
Due From City Branch:	$1,265,695,410	
Deposits from Foreign Persons:		$1,373,788,658
Totals:	$1,373,788,658	$1,373,788,658
Less Due From Asset:	($1,265,695,410)	
IBF Assets for 882-5 Calculation:	$ 108,093,248	

Step 2: IBF Liabilities: 95% of IBF Assets ($108,093,248 X 95%) = $102,688,586

Step 3: IBF Interest Expense: Using a hypothetical federal interest rate of 5%, the IBF interest expense would be $5,134,429 (5% of $102,688,586) for purposes of the 882-5 Calculation and, therefore, only that amount would be deductible for purposes of the Income Modification.

[23] Exhibit K.

If we assume that the CIC IBF paid the same hypothetical 5% rate on all its deposits from Foreign Persons, for a total interest expense of approximately $68,689,433 (5% of $1,373,788,658), it is readily apparent that excluding the Due From Asset from the 882-5 Calculation would substantially limit the amount of the CIC IBF's interest expense that would be deductible under the Income Modification notwithstanding that the CIC IBF had only eligible gross income. Under the hypothetical, the IBF interest expense deduction of $5,134,429 is only about 7.5% of the total hypothetical interest expense of the CIC IBF ($68,689,433).

Section 3-04(a)(3)(ii)(C) of the Bank Tax Rules provides that for purposes of the deposits factor of the Formula Modification, the numerator of the factor does not include deposits "the expenses of which are attributable" to the production of eligible gross income as provided in section 3-03(c) of the Bank Tax Rules. As previously noted, the Bank Tax Rules do not provide clear guidance as to how that attribution is to be done. Because section 3-04(a)(3)(ii)(C) of the Bank Tax Rules uses the term "attributable" for purposes of the Formula Modification, the Bank Tax Rules suggest a flexible approach for purposes of the Formula Modification and provide a basis for a taxpayer or the Commissioner to argue that some amount of deposits should be excluded as properly attributable to the production of eligible gross income other than a purely mathematical proportion derived from the computations under section 3-03(c) of the Bank Tax Rules. Petitioner has not introduced any evidence as to the actual calculation of the CIC IBF interest or any other expenses under section 3-03(c) of the Bank Tax Rules; Petitioner reported $0 as the amount of expenses attributable to eligible gross income on its Bank Tax return for the Tax Year. Apart from its legal argument that all of the CIC IBF deposits should be excluded as attributable to eligible gross income, Petitioner has not offered any factual evidence disputing the amount of deposits asserted by the Commissioner as properly attributable to eligible gross income or supporting some other greater amount of deposits, nor has Petitioner requested that this matter be remanded to the ALJ Division for further fact-finding. The Department permitted Petitioner to exclude about 7.9% of the CIC IBF deposits from the numerator of the deposits factor, which is not inconsistent with our analysis of section 3-03(c)(6)(iii) of the Bank Tax Rules. Under the facts before us, we find the Commissioner's adjustment to the deposits factor to be consistent with the Bank Tax Rules and see no reason to remand this case to the ALJ Division for further action.

Petitioner argues, also, that its exclusion of the Excess Funds Deposits from the numerator of the deposits factor is consistent with the legislative history of the IBF provisions of the Bank Tax. The IBF provisions were enacted in two phases. The Income Modification was enacted in 1978.[24] In the 1960s, the federal regulations imposed on banks coupled with comparatively lower overseas tax rates on international banking activity made it less profitable for banks to conduct international banking activities from the United States and banks increasingly moved that business to offshore locations. The purpose behind the 1978 legislation was to reverse this trend, as indicated by the preamble to the bill:

> As a result of these regulatory and tax constraints, there has been a continuing outflow of employment from the international sector of New York's banking industry. Thus this act is being enacted to help attract the international banking business, and the attendant jobs and personal income, back to the United States, and particularly New York.

The effective date of the 1978 enactment of the IBF provisions was tied to, and contingent on, the modification of New York State banking laws and Federal Reserve System rules to facilitate the establishment of IBFs.

[24] Laws of NY 1978, Ch. 288.

In 1978, banks calculated their Bank Tax liability on a separate accounting basis, *i.e.,* banks determined the amount of income earned in the City and subject to the Bank Tax from their books and records. The Income Modification was consistent with that method by allowing banks to exclude from their City income subject to the Bank Tax the amount of income earned by an IBF from banking activity with foreign persons and related foreign exchange trading activity.

The IBF provisions were modified in 1985. These changes were part of a much larger legislative initiative intended to tax banks more like business corporations to reflect the entry of banks into lines of business traditionally conducted by business corporations and the expansion of interstate banking, which made separate accounting increasingly difficult.[25] Among other changes, the 1985 legislation replaced the separate accounting method for determining the amount of income taxable in New York under the State and City bank taxes with a three-factor allocation method similar, although not identical, to that applicable to general business corporations.

In the 1985 legislation, the IBF provisions were modified, first, to limit the benefits of the IBF provisions to IBFs located in the State, and second, to add the Formula Modification as an elective alternative to the Income Modification. The Memorandum in Support describes the election as follows:

> In calculating the factors … the taxpayer may treat its IBF as a foreign branch if it did not elect to reduce its Federal taxable income by the amount of the adjusted eligible net income of its IBF. Otherwise, the receipts, payroll and deposits

[25] *See,* Laws of NY, Ch. 298, Memorandum of State Executive Department, July 10, 1985; Report of NYC Division of the Budget, July 2, 1985.

> of the taxpayer's IBF are not reflected in the … allocation factors.[26]

While, as argued by Petitioner, the legislature intended the Formula Modification to produce the tax effect that would result if the IBF were a foreign branch of the bank, the legislative history indicates that Formula Modification was added to the IBF provisions to be consistent with the general adoption of formula allocation for banks out of a concern over the constitutionality of using the Income Modification where the taxpayer bank uses formula allocation, and not merely to give taxpayers a choice of whichever method produced a more favorable result.[27] The relevant provision of the bill was described in the Memorandum in Support as follows:

> Bill section 46 provides that if the IBF [income] modification is found to be unconstitutional, the modification shall be disallowed as if the IBF [formula modification] election … had been made.

In addition, while the legislature may have characterized the Formula Modification as equivalent to treating the IBF as if it were a foreign branch of the bank, the statutory language does not produce such a result in all respects, as noted by the CALJ and the Commissioner. The IBF provisions limit the exclusion from the deposits factor to those deposits *properly attributable to the production of eligible gross income*.[28] By contrast, if the IBF were in fact a foreign branch of the establishing bank, *all* deposits properly booked

[26] Memorandum in Support at 4.

[27] Memorandum in Support, at 8; *See also,* Memorandum of State Executive Department, McKinney's Session Laws of 1985, at 3037. NOTE: this version of the Executive Memorandum appears to relate to an earlier version of the bill rather than the version finally enacted as Ch. 298, but the provisions of that earlier bill relating to IBFs are comparable to those in the final bill.

[28] Similarly, under the Income Modification, not all net income of an IBF is deducted from ENI, only the adjusted eligible net income of the IBF is deductible and if the IBF generates a net loss, that loss must be added to the taxpayer's ENI. If a foreign branch generates a net loss, that loss is allowed to offset the income from the domestic branch in most cases.

in that foreign branch would be excluded from the numerator of the deposits factors without regard to what income the foreign branch may have derived from those deposits. 19 RCNY §3-04(g). Legislative history cannot trump the plain language of the statute. Leonard F. v. Israel Discount Bank of New York, 199 F.3rd 99 (2nd Cir., 1999). The legislature's shorthand description of the Formula Modification as treating the IBF as if it were a foreign branch of the establishing bank does not require us to ignore the plain language of the statute and to conclude that all of the CIC IBF deposits must be treated as properly attributable to its eligible gross income solely because it had no ineligible gross income. Under Petitioner's analysis of the statute, all of the CIC IBF's deposits of more than $1 billion would be excludible from the numerator of Petitioner's deposits factor regardless of whether it had $0, $1 or $100 million of eligible gross income solely because it had no ineligible gross income to which the deposits could be attributed.

When the legislature adopted formula allocation for banks in 1985, it recognized that the statutory formula allocation calculation might not always accurately reflect the activity of the taxpayer in New York. As a result, the legislature gave the State and City taxing authorities discretion to add or delete factors or to use another method "to effect a fair and proper allocation of the income or assets reasonably attributable to" the State or City. *See,* Code §11-642(a)(6). This authority extends to the Formula Modification.

In the case at bar, of the total deposits reported by Petitioner for the Tax Year of $2,190,605,951, almost two thirds, or $1,373,788,658, were generated by the IBF. However, on average, of the $1,373,788,658 in deposits received from Foreign Persons by the CIC IBF, more than 92% were "put with" the City Branch and, as readily conceded by Petitioner, used by the City Branch to purchase government securities. Those securities generated income for the City Branch and could not have been purchased by the CIC IBF under FRB rules. At the same time, on average, less than 8% of the total amount of deposits on the books of the

CIC IBF was lent to Foreign Persons. As a result, during the Tax Year, the CIC IBF generated only $3,756,473 of eligible gross income. That amount, when compared to the $1,373,878,117 received by the CIC IBF from deposits, represents a return on those funds of slightly more than one quarter of 1%. The bulk of the funds received by the CIC IBF from foreign depositors was used not by the CIC IBF but by the City Branch to generate City income.

While the Record does not indicate the amount of net income or loss shown on the books of the CIC IBF, given the disparity between the amount of deposits accepted by the CIC IBF and the amount of extensions of credit it made, as the CALJ concluded, "logic dictates" that the amount paid as interest on deposits from Foreign Persons greatly exceeded the earnings on those extensions of credit generating an overall net loss, which reduced Petitioner's ENI. In addition, the exclusion of the CIC IBF's deposits from the numerator of the deposits factor reduced that factor from about 95% to just over 37% and lowered Petitioner's overall allocation percentage from about 92.5% to about 69.4%. Thus, when viewed together, the activities of the CIC IBF generated significant income for the City Branch while significantly reducing Petitioner's Bank Tax liability on the City Branch's income.

The Commissioner did not rely on her discretionary authority under Code section 11-642(a)(6) as the basis for her adjustment to Petitioner's deposits factor and, as previously discussed, we find that the Commissioner's adjustment to Petitioner's deposits factor was adequately supported by the statute and rules. Nevertheless, under the circumstances, had the Commissioner justified her adjustment under her discretionary authority, we would uphold the adjustment as a reasonable exercise of that discretionary authority.[29]

[29]This Tribunal has previously held that it has jurisdiction to exercise the Commissioner's discretionary authority where appropriate. Matter of Just Born, Inc. TAT(E) 93-456(GC) (3/30/1998).

Accordingly, the CALJ Determination is affirmed and the deficiency for the Tax Year is sustained.[30]

Dated: June 30, 2006
New York, New York

____
GLENN NEWMAN
Commissioner and President

____
ELLEN E. HOFFMAN
Commissioner

[30] We have considered all of the other arguments raised by Petitioner and find them unpersuasive.