NEW YORK CITY TAX APPEALS TRIBUNAL
ADMINISTRATIVE LAW JUDGE DIVISION

In the Matter of the Petition	:	**DETERMINATION**
of	:	**TAT(H)02-19(BT)**
CREDIT INDUSTRIEL ET COMMERCIAL	:	

Gombinski, C.A.L.J.:

Petitioner, Credit Industriel Et Commercial, filed a petition, dated June 12, 2002, requesting a redetermination of deficiencies of New York City ("City") Banking Corporation Tax ("BT") under Title 11, Chapter 6, Subchapter 3, Part 4 of the City Administrative Code ("Code") for the calendar years 1992, 1993 and 1994 ("Tax Years").

The parties consented, pursuant to 20 RCNY §1-09(f) of the City Tax Appeals Tribunal's Rules of Practice and Procedure, to have the controversy determinated on submission without a hearing. The parties submitted a Joint Stipulation of Fact, with accompanying exhibits. Each party thereafter submitted a brief and a reply brief. The final brief was received on October 7, 2004. On brief and at oral argument, held on October 14, 2004, Maria T. Jones, Esq., of Kramer Levin Naftalis & Frankel LLP and Jeffery Serether, Esq., of PricewaterhouseCoopers represented the Petitioner, and Robert J. Firestone, Esq., Assistant Corporation Counsel, represented the Commissioner. Marshall H. Fishman, Esq., of Kramer Levin Naftalis & Frankel participated in Petitioner's briefs, and Paul T. Rephen, Esq., Executive Assistant Corporation Counsel, participated in the Commissioner's briefs.

ISSUES

I. Whether Petitioner is entitled to the 22.5% deduction allowed under Code §11-641(e)(12) (the "Subtraction Modification") with respect to the interest income earned from U.S. government obligations Petitioner held as a trader.

II. Whether Petitioner is entitled to reduce the numerator of its deposits factor by excluding deposits from foreign persons with Petitioner's international banking facility ("IBF"), the proceeds of which were advanced by the IBF, on an interest free basis, to Petitioner's City branch (the "City Branch") which used those proceeds to generate City income.

FINDINGS OF FACT

1. During the Tax Years, Petitioner, Credit Industriel Et Commercial, formerly known as Compagnie Financiere De CIC Et De L'Union Europeene, was engaged in a banking business in New York State ("State") and the City as a State chartered branch of a foreign bank.

2. For each of the Tax Years, Petitioner filed Federal Income Tax Returns, Form 1120F, and City Tax Returns on Banking Corporations, Form NYC-1.

3. A Notice of Determination ("Notice") issued by the City Department of Finance ("Department"), dated March 29, 2002, asserted the following deficiencies against Petitioner (with interest calculated to April 15, 2002):

Tax Year	Tax	Interest
1992	$104,243.76	$116,079.86
1993	$5,451.12	$5,291.21
1994	$225,484.77	$184,048.29
	$335,179.65	$305,419.36

4. Of the $104,243.76 in additional tax the Department asserted for 1992, $95,313 was attributable exclusively to the Department's denial of the Subtraction Modification for a portion of the interest income Petitioner earned on U.S. government obligations held as trading securities. For 1992, Petitioner contests only this denial.

5. Of the $225,484.77 in additional tax the Department asserted for 1994, $218,234 was attributable exclusively to the Department's assertion that certain deposits from foreign persons recorded within the accounts of the IBF were not properly attributable to the production of eligible gross income of the IBF. As a result of this assertion, the Department increased by $1,265,695,410, the numerator of Petitioner's deposits factor in the allocation percentage used to calculate City entire net income ("ENI") and alternative ENI. For 1994, Petitioner contests only this adjustment.

6. On June 19, 2003, Petitioner was granted permission to amend the Petition to request refunds for 1993 and 1994 on the basis that it failed in its 1993 and 1994 tax returns to claim the Subtraction Modification with respect to interest earned in those years on certain United States obligations held as trading securities. *See,* Finding of Fact 9, *infra.*

The Subtraction Modification Issue

7. During the Tax Years, Petitioner purchased U.S. government obligations solely for its own account. For Generally Accepted

Accounting Principles ("GAAP") and bank regulatory purposes, those obligations were held in separate accounts based on Petitioner's intent at the time those obligations were purchased. U.S. obligations purchased by Petitioner with the intent to hold them in the bank's portfolio were held in an "Asset: Investment Securities" account and were carried on Petitioner's balance sheets at cost (adjusted for amortization of premiums and accretion of discounts). All other U.S. obligations purchased by Petitioner, which consisted principally of obligations purchased with the intent to sell them to generate profits on short term differences in price, were held in an "Asset: Trading Securities" account and were required to be marked to market.

8. Petitioner claimed a Subtraction Modification of $7,330,072 ($32,578,098 x 22.5%) in computing its ENI for 1992. At audit, the Department excluded $1,121,334 from the Subtraction Modification that Petitioner reported for 1992, which represents 22.5% of the $4,983,707 of interest income recorded in Petitioner's General Ledger account 5498, U.S. Treasury Note/Bond Income/Trading Securities.

9. Petitioner claimed Subtraction Modifications of $3,753,585 ($16,682,600 x 22.5%) for 1993 and $1,131,548 ($5,029,104 x 22.5%), for 1994. No Subtraction Modification was claimed, however, with respect to interest income on U.S. government obligations from Petitioner's "Trading Securities" General Ledger accounts. If Petitioner is entitled to the Subtraction Modification on such interest income, the Subtraction Modification would be $5,267,814 for 1993 ($23,412,507 x 22.5%) and $1,329,002 for 1994 ($5,906,675 x 22.5%).

10. Unlike broker/dealers who purchase U.S. obligations for inventory for sale to their customers, as well as to trade for

their own account, Petitioner did not hold U.S. obligations for sale to customers, resale to customers, or sale on behalf of customers.[1]

The IBF Issue

11. 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. The City Branch established the IBF in the State prior to 1992, in part, to receive increased access to foreign deposits as a result of an exemption from the Regulation D reserve requirements and the Regulation Q interest rate ceilings under the Regulations of the Board of Governors of the Federal Reserve System ("FRB"). For 1994, the IBF maintained separate books and records that accurately reflected the gross income, gain, losses, deductions, assets, liabilities and other activities of the IBF; with the IBF's asset and liability accounts containing only IBF time deposits and extensions of credit.

12. For 1994, Petitioner reported its interest expense deduction under 26 CFR §1.882-5 (as evidenced on its Federal income tax return, Form 1120-F, filed for that year). Petitioner also properly elected to use the formula allocation method (the "Formula Method") with respect to the taxation of the IBF.

13. During 1994, the IBF accepted deposits only from "foreign persons" as defined in Code §§11-641(f)(8) and 11-642(b)(2)(B) ("Foreign Persons"). Funds raised by the IBF through eligible deposits were initially put into the City Branch and used

[1] Petitioner has never: (a) been in the business of providing access to the purchase and sale of U.S. obligations to customers; (b) been licensed to engage in the sale or resale of U.S. obligations to customers; (c) had any customer accounts for the purchase and sale of U.S. obligations recorded on its books and records; (d) been a dealer, registered or otherwise, in U.S. government obligations; or (e) earned any commission income on the sale of U.S. obligations.

to repay Petitioner's foreign depositors or for other business or investment purposes, including making IBF loans to foreign persons.

14. During 1994, the IBF's only extensions of credit that paid interest were made to Foreign Persons. Thus, all of the income reflected in the books and records of the IBF during 1994 was eligible gross income from Foreign Persons.

15. If at the close of a business day, the amount by which the IBF's time deposits (as defined in 12 CFR §204.8(a)(2)) from Foreign Persons exceeded the amount of the IBF's extensions of credit (as defined in 12 CFR §204.8(a)(3)) to Foreign Persons, that difference, which averaged $1,265,695,410 during 1994 (the "Excess Funds"), was properly reported by the IBF as a "due from" the City Branch (i.e., as an "IBF extension of credit" under FRB D) and by the City Branch as a "due to" the IBF. The IBF received no interest from the City Branch on the Excess Funds.[2]

16. The Excess Funds were invested by the City Branch in liquid U.S. government obligations which 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 ENI and in the numerator of Petitioner's receipts factor for purposes of calculating its ENI and alternative ENI allocation percentages.

17. Because the Excess Funds were invested by the City Branch in liquid government obligations, those funds were more accessible

[2] FRBs 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 United States or foreign bank located outside the United States, or in other IBFs. 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. During 1994, Federal banking laws prohibited a bank from directly or indirectly paying interest on demand deposit accounts.

to Petitioner to make IBF loans, repay foreign depositors or for any other business purpose of the City Branch than if they had been loaned to or placed with unrelated foreign persons subject to specified maturity dates.

18. For 1994, Petitioner calculated its ENI and alternative ENI allocation percentages by including all deposits of the IBF in the denominator, but not the numerator, of the deposits factor. Thus, $816,817,293 was recorded by Petitioner as deposits maintained in branches in the City other than in the IBF, and $2,190,605,951 was recorded by Petitioner as deposits maintained in branches everywhere including the IBF.

19. At audit, for 1994, the Department increased the amount reported by Petitioner as deposits maintained in branches in the City other than in the IBF by the amount of the Excess Funds ($1,265,695,410); *i.e.,* from $816,817,293 to $2,082,512,703.

STATEMENT OF POSITIONS

Subtraction Modification: Petitioner asserts that the State Department of Taxation and Finance has consistently interpreted the phrase "held for resale" as referring only to obligations held for resale to customers. It argues that TSB-M-85(16)C (the "1985 TSB"), a nonbinding Technical Service Bureau Memorandum issued by the State Department of Taxation and Finance, as well as four opinions issued by its Counsel,[3] dated April 20, 1998, September 1, 1998, February 11, 2000, and March 16, 2000 (the "Prior Opinions of

[3] Although State Opinions of Counsel are not binding, 20 NYCRR §2375.4(c) provides that: "all operating business bureaus and divisions of the Division of Taxation . . . must follow . . . opinions [of counsel] where the factual situations are the same."

Counsel”), all hold that the Subtraction Modification is barred only with respect to interest from securities that are held by a bank as a dealer for sale to customers. Petitioner asserts that although the City was aware that the State’s position was contrary to the position it advocates, the City never issued any document evidencing such disagreement. Thus, Petitioner asserts, the City failed to comply with the Legislature’s desire to have uniformity and consistency between the State and City interpretations of the banking tax provisions under §47 of Chapter 298 of the Laws of 1985.

The Commissioner counters that the phrase “to customers” should not be added to the language of the statute since: (a) the statute as written has meaning; (b) the Legislature knew how to add those words when it wanted to; (c) for regulatory and accounting purposes, the term “resale” has been applied to securities held in trading accounts which are not sold to customers; (d) a deduction, being a matter of legislative grace, should only be allowed where a clear provision exists for such deduction; and (e) the State reversed the position taken in the 1985 TSB subsequent to the filing of Petitioner’s initial brief. The Commissioner further asserts that the City has been consistent in its position and that the State’s original position was merely a “blip on the screen” which the Petitioner never relied upon, as indicated by the filing positions taken in Petitioner’s original 1993 and 1994 tax returns.

IBF Issue: Petitioner argues that because the IBF earned only eligible gross income, all of the deposits of the IBF were properly attributable to the production of eligible gross income and should be excluded from the numerator of the deposits factor. It further asserts that the Commissioner’s own rules mandate that all expenses of an IBF are allocated to eligible gross income where that IBF does not have ineligible gross income. Petitioner claims that this result is consistent with the Legislature's intent to treat IBFs as foreign branches.

The Commissioner counters that since the Excess Funds were not used to make loans which generated eligible gross income, but were instead used by the City Branch to generate taxable income, the Excess Funds Deposits were not entitled to be excluded from the numerator of the deposits factor. The Commissioner further asserts that the rule relied upon by Petitioner, 19 RCNY §3-03(c)(9), first requires an allocation of indirect interest expenses because Petitioner reported its interest expense under 26 CFR 1.882-5. The Commissioner also argues that the Legislature did not mandate that IBFs be treated identically to foreign branches.

CONCLUSIONS OF LAW

Subtraction Modification. The Subtraction Modification found in Code §11-641(e)(12), along with its identical State counterpart, State Tax Law §1453(e)(12), were enacted as Chapter 298 of the Laws of 1985, which made comprehensive bank tax reforms to the State and City Bank Tax. Code §11-641(e)(12) allows a deduction in determining ENI of 22.5% of the interest income from obligations of the State, any political subdivision thereof, or of the U.S. ("Government Obligations") other than interest income from "obligations held for resale in connection with **regular trading activities**". (Emphasis added.)

Petitioner purchased U.S. obligations to be held in its portfolio (the "Investment Securities"). For GAAP and bank regulatory purposes, the Investment Securities were recorded in an account labeled "Asset: Investment Securities" and were carried on Petitioner's balance sheets at adjusted cost. The parties agree that Petitioner is entitled to the Subtraction Modification deduction with respect to interest income from the Investment Securities.

Petitioner also purchased U.S. obligations for the purpose of selling them to generate profits on short term differences in price (the "Trading Securities"). For GAAP and bank regulatory purposes, the Trading Securities were recorded in an account labeled "Asset: Trading Securities" and were required to be marked to market. The Commissioner asserts that the Subtraction Modification does not apply to interest income from the Trading Securities since Code §11-641(e)(12) precludes the Subtraction Modification from applying with respect to obligations held for resale in connection with regular trading activities.

Although Petitioner concedes that the Trading Securities were held in connection with its regular trading activities, it claims that the word "resale" in the statute implies "resale to customers." Therefore, Petitioner asserts, the Subtraction Modification should be disallowed only with respect to Government Obligations held by dealers in their inventory for sale to customers. In making this argument, Petitioner points to the absence of any City interpretation of this provision and relies on the State's 1985 TSB,[4] which concludes that the Subtraction Modification is applicable with respect to income from Government Obligations that are "not held by the taxpayer for resale to customers in the regular course of trading activities."

[4] The 1985 TSB has no legal force and effect and is not binding but is "intended to . . . advise and inform taxpayers, tax practitioners, personnel of the [State] department and members of the general public of the division [of taxation's] existing interpretations of provisions of the [State] Tax Law, related statutes and regulations adopted thereunder . . .." 20 NYCRR §2375.8.

However, after the filing of Petitioner's initial brief, the 1985 TSB was superceded by TSB-M-04(3)C, an Opinion of Counsel that was issued by the State Department of Taxation and Finance's Deputy Counsel, John W. Bartlett, on May 6, 2004 (the "2004 TSB"), which concludes that the view expressed in the Prior Opinions of Counsel [as well as, by implication, the 1985 TSB] "was not a proper interpretation of the statute:"

> A better reading of the statutory provision is that a banking corporation is not entitled to the 22 ½% deduction for interest earned on any government obligations it holds as inventory or it holds in its trading accounts. The government obligations held in both of these types of accounts are obligations "held for resale in connection with regular trading activities."

The position taken in the 2004 TSB is indeed a better reading of the statute for several reasons.

First, as a matter of statutory construction, since a deduction is a matter of legislative grace, a deduction is allowed "only as there is clear provision therefor" in the statute. *See*, Matter of Grace v. New York State Tax Commission, 37 NY2d 193, 197 (1975). As the Subtraction Modification is specifically disallowed with respect to "interest income from "obligations held for resale in connection with regular trading activities," and the disallowed interest was paid on Government Obligations held by Petitioner as trading securities in its trading account, no clear provision for the claimed deduction exists in the statute. To the contrary, the statute provides that the deduction is not allowed. The words "to customers" would have to be added to the statute after the words "obligations held for resale" for Petitioner to prevail.

Second, when the Legislature wanted to treat obligations held for sale to customers differently from obligations held for trading purposes, it added the words "to customers." *See*, Code §11-602.4

which defines investment capital as "investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business."[5] Had the Legislature wanted Government Obligations held for trading to be treated differently from Government Obligations held for sale to customers, it would have added the words "for resale to customers" in Code §641(e)(12).[6]

Third, while the word "resell" could be viewed to connote property being resold from inventory (*see*, Blacks Law Dictionary, 6th Ed (West Publishing Co. 1990), p. 1306), the term "resell" has also, as the Commissioner noted, been used in the banking industry to refer to assets held with the intent to resell them for a profit from short term price movement, regardless of whether such sale is to customers.[7] While Petitioner argues that the "City has failed to demonstrate that accounting or bank regulatory concepts played any role in the legislative language that was enacted," current banking and regulatory concepts are not being used for the purpose of determining their role, if any, in leading to the statutory language being interpreted. Instead, current banking and regulatory concepts are being referenced for the purpose of seeing whether they support

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[5] Similarly, when the federal government wanted to insure that only assets held by broker/dealers, and not by traders, receive ordinary income and loss treatment, Internal Revenue Code §1221(a)(1) was drafted to use the words "resale to customers."

[6] *See*, McKinney's Statutes, Vol. 1, §74: "A court cannot by implication supply in a statute a provision which it is reasonable to suppose the Legislature intended intentionally to omit; and the failure of the Legislature to include a matter within the scope of an act may be construed as an indication that its exclusion was intended."

[7] The Glossary to the instructions for Form FFIEC 002 - Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (1994) (Exhibit DD at p. G-37) (emphasis added) provides that: ". . . a trading account consists of securities and other assets acquired with the intent to resell in order to profit from short-term price movements, including, **but not limited to**, assets acquired with the intent to resell to customers."

Petitioner's expansive interpretation of the statute, which they do not.

Fourth, it "is not the function of this forum to 'add words to a statute which has a rational meaning as written.'" Matter of Ethyl Corporation, TAT(E) 93-97(GC), p. 23 (NYC Tax Appeals Tribunal, June 28, 1999), *quoting*, Richmond Contractors v. Tishelman, 61 NY2d 1, 6 (1983), *reh'g den.*, 61 NY2d 905 (1984). As written, the language of the statute has meaning. Banks that hold Government Obligations for long-term investment do so to obtain interest income. By increasing a bank's effective after-tax returns on such interest income, the Subtraction Modification can reasonably be expected to induce banks to increase their investment in Government Obligations. By contrast, banks that hold Government Obligations for sale as broker-dealers and traders primarily do so to obtain short term profit through an increase in value of such obligations. Since Government Obligations held by banks as traders are not held primarily to obtain interest income, it would be reasonable to conclude that the Subtraction Modification would not induce banks to substantially increase the amount of Government Obligations they purchase as broker/dealers and traders.[8]

While the State initially adopted Petitioner's interpretation of the statute, there is no indication that the City ever adopted that interpretation. Furthermore, the State subsequently changed its interpretation. While the change in the State's interpretation in the 2004 TSB was made effective only with respect to taxable years beginning on or after January 1, 2004, neither the Commissioner nor this Tribunal is bound by the State's prior

[8] Petitioner has not proffered any reason why Government Obligations held by banks on a **short term basis** as traders should be treated differently from Government Obligations held by banks on a **short term basis** as dealers, and should instead be treated identically to Government Obligations held by banks on a **long term basis** for investment.

erroneous interpretation of the statute. While the Legislature desired uniformity between the State and City, it did not unconditionally require such uniformity. New York Laws of 1985, Chapter 298, §47 provides that, with respect to the Bank Tax, the "state tax commission and the commissioner of finance of the city of New York shall use their best efforts . . . to take such steps as are appropriate to ensure that identical regulations and statutes are applied and interpreted uniformly and consistently." Such language cannot be used to require the City to follow an erroneous statutory interpretation that was taken by the State in a non-binding pronouncement that the City has neither adopted nor followed.

IBF Issue. The BT is imposed on that portion of a banking corporation's ENI which is deemed to have been earned in the City. Code §11-643.5(a). Prior to 1985, banks were required to use the separate or geographical method of accounting to allocate their income to the City. Under that method, a taxpayer's separate books and records were used to determine the amount of income the taxpayer earned in each jurisdiction. See, Sheraton Buildings, Inc. v. Tax Commission, 13 N.Y.2d 802 (1963); Matter of Just Born, Inc., TAT(E) 93-456(GC) (City Tax Appeals Tribunal, April 3, 1998). Under separate accounting, income generally was earned at the branch of the bank most responsible for its generation. Banks therefore had a tax incentive to conduct their foreign borrowing and lending activities in branches located outside the City.

To encourage banks to conduct their international banking business in the City, legislation was adopted in 1978 to permit banks to conduct their wholly foreign source business in the City without subjecting the income from that business to the BT (the "1978 Legislation"). This was accomplished through the "Modification Method" which permits banks to deduct the net income attributable to their IBFs so long as two primary conditions are met. Code §11-641(f). The first condition is that the income be foreign source; i.e., eligible gross income. Code §11-641(f)(2). The second condition is that the funds used to generate that foreign source eligible gross income also be obtained from foreign sources; i.e., the ineligible funding amount provision. Code §11-641(f)(5).

The Legislature, however, was concerned that the separate accounting method was too difficult to apply, resulted in numerous tax disputes, and made it difficult to predict with reasonable certainty what revenue would be generated by the BT. *See*, Memorandum Filed with Assembly Bill Number 3434-A, stamp dated July 10, 1985, p. 10 (the "Memorandum"). As indicated in the cover page to the Memorandum, the Legislature also wanted the taxation of banks to be "simpler, more predictable and consistent with the taxation of other businesses." Therefore, in 1985, legislation was enacted which amended the BT to require banks to attribute income to the City using the formulary apportionment method of accounting (the "1985 Legislation"). Under formulary apportionment, income is allocated to the City using an income allocation percentage ("BIAP") that is determined by comparing a bank's payroll, receipts, and deposits within the City to its total payroll, receipts, and deposits. Code §11-642(a).[9]

The 1985 Legislation also gave banks the option of continuing to use the separate accounting based Modification Method to determine their IBF benefit or electing, under Code §11-642(b)(2)(A), to use the new Formula Method to determine their IBF benefit. Under the Formula Method, banks are allowed in computing their BIAP, to treat the payroll, receipts, and deposits which are

[9] The deposits and receipts factors are weighted heavier than the payroll factor under the BIAP.

properly attributable to eligible gross income of their IBFs as if they were located outside the City. *See*, Code §11-642(b)(2)(A):

> . . . a taxpayer may, in the manner prescribed by the commissioner of finance, elect to modify on an annual basis its income allocation percentage in the manner described in clauses (i), (ii) and (iii) below:
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> . . . . .
>
> (iii)deposits from foreign persons which are **properly attributable to the production of eligible gross income of** the taxpayer's international banking facility shall not be included in the computation of deposits maintained at branches within the city. [Emphasis added.]

For 1994, Petitioner treated all of the deposits made with the IBF as being properly attributable to the IBF's eligible gross income, including the amount of the deposits that gave rise to the Excess Funds that the IBF advanced to the City Branch (the "Excess Funds Deposits"). As Petitioner excluded the $1,265,695,410 Excess Funds Deposits from its City Deposits, Petitioner reported City Deposits of only $816,818,293, or 37.29% of its total deposits. At audit, the Commissioner included the amount of the Excess Funds Deposit in Petitioner's City deposits factor, thus increasing Petitioner's City deposits factor from 37.29% to 95.07% of its total deposits. Petitioner argues that the Commissioner lacks the authority to make this adjustment under both the statute and the rules.

Petitioner argues that since the Excess Funds Deposits earned no income for the IBF, and the IBF earned only eligible gross income as a result of its other deposits, as a matter of statutory construction, there did not exist any ineligible gross income with respect to which the Excess Funds Deposits could be attributed.[10] The statute, though, does not provide that deposits can be excluded from City deposits so long as they do not produce **ineligible gross income.** Instead, Code §11-642(b)(2)(A)(iii) expressly requires that deposits must be specifically attributable to **eligible gross income** in order to be excluded from City deposits. As the Excess Funds Deposits (which constituted the vast majority of the IBF's deposits) were not advanced to Foreign Persons to generate eligible gross income, but instead were advanced to the City Branch as interest free extensions of credit, they were not attributable to the production of gross income.

Petitioner asserts that the Excess Funds Deposits should nevertheless be found attributable to eligible gross income because prudent business practice dictates that an IBF should accept more deposits than the amount of its loans to Foreign Persons to insure that funds are available to make additional loans to Foreign Persons as necessary. While some excess funds may be an ordinary and necessary part of an IBF's business, and the expenses thereof may therefore be related to the generation of eligible gross income, the amount of the Excess Funds Deposits ($1,265,694,410) was at least twelve times the amount used by the IBF to make loans to Foreign Persons.[11] Since no more than 8% of the deposits on which the IBF

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[10] Petitioner correctly asserts that the income on the U.S. obligations was not the IBF's income but was the City Branch's income, and that as the City Branch did not pay interest to the IBF on the Excess Funds (which would have constituted ineligible gross income), the IBF had no income as a direct result of the Excess Funds Deposits.

[11] The amount of Petitioner's reported deposits that could have been used by the IBF to make loans to foreign persons during 1994 was no more than $108,093,248, computed as follows:

Petitioner's Total Deposits	$2,190,695,410
Petitioner's Reported City Deposits	(816,817,293)
The Excess Funds Deposits	(1,265,694,410)
The Maximum Amount of Deposits Available to Make Loans to Foreign Persons	$108,093,248

paid interest could have been used by the IBF to generate eligible gross income, logic dictates that the IBF, on a stand alone basis, would have suffered a substantial loss during 1994. Given the magnitude of the disparity between the IBF's interest income and expense, and the lack of any evidence in the record to indicate otherwise,[12] it cannot be concluded that the IBF accepted the Excess Funds Deposits for the purpose of having funds available to make additional loans to Foreign Persons to generate eligible gross income and that the Excess Funds Deposits were, on this basis, properly attributable to the production of eligible gross income of the IBF.

Even if some of the Excess Funds Deposits had been accepted for the purpose of generating additional eligible gross income sometime in the future, and thus was arguably attributable to the production of eligible gross income, the statute does not require that a deposit merely be attributable to the production of eligible gross income to be excluded from the numerator of the deposits factor. Instead, it requires that the deposit be **properly** attributable to the production of such income. As all of the Excess Funds Deposits were used by the City Branch to purchase U.S. obligations which generated income which was not eligible gross income, those deposits bore a far closer relationship to the City Branch's income from those obligations than to the eligible gross income of the IBF. Under such circumstance, it was not inappropriate for the Commissioner to have treated all of the Excess Funds Deposit as not being properly attributable to eligible gross income.

Petitioner further asserts that the Legislature intended IBFs to be treated as foreign branches and that had the IBF been a foreign branch, the Excess Funds Deposits would have been excluded

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[12] No evidence has been offered with respect to what amount of deposits would have been reasonable and necessary for the IBF's business on a stand alone basis.

from the numerator of the deposits formula. However, as the Commissioner notes, the statute does not attempt to achieve total parity between IBFs and foreign branches. For example, even though the Legislature wanted IBFs to be treated similarly to foreign branches when the Modification Method was enacted in 1978, the Legislature provided that the substantial loss that the IBF would have incurred as a result of the Excess Funds Interest Expense would have to be added back to entire net income under Code §11-641(f)(7): "[i]n the event adjusted eligible net income is a loss, such loss shall be added to entire net income." Excluding the Excess Funds Deposits from the numerator of the receipts factor would, therefore, create an unnecessary disparity between the results under the Formula and Modification Methods.

Petitioner next asserts that had the Legislature intended to disallow an IBF's loss under the Formula Method in 1984, it would have enacted a provision similar to the Code §11-641(f)(7) loss disallowance provision. However, as the Formula Method is a formulary apportionment provision (and not a separate or geographic accounting provision as is the Modification Method), the Legislature did the functional equivalent by giving the Commissioner broad discretion in Code §11-642(b)(2)(A)(iii) to include in the numerator of the deposits factor those deposits of an IBF which are not "properly attributable to eligible gross income." Had the Legislature wanted to insure that all deposits of an IBF were excluded from the numerator of the deposits formula, the Legislature would not have limited the exclusion to deposits "properly attributable to eligible gross income," but would have excluded "all deposits" of the IBF.

The Commissioner therefore had the authority under the broad discretion granted in the statute to treat the Excess Funds Deposits as not being attributable to eligible gross income. The next question is whether the rules promulgated by the Commissioner limit that authority. While the parties agree that the Commissioner is bound by her rules,[13] they disagree as to the results thereunder.

The rules under the Formula Method provide that a deposit will be excluded from the numerator of the deposits factor, and thus meet the Code §11-642(b)(2)(A) standard of being "**properly attributable to the production of eligible gross income**" (emphasis and underlining added), if the expense of that deposit is "**attributable, as provided in Sec. 3-03(c) of these regulations, to the production of eligible gross income.**" 19 RCNY §3-04(b)(3)(ii) (emphasis and underlining added).[14] Although the provision referenced in the Formula Method rule, 19 RCNY §3-03(c), does not use the phrase "**expenses attributable to the production of eligible gross income,**" it uses a similar term "**expenses or other deductions directly or indirectly attributable to eligible gross income**" ("Attributable Expenses"), in two places, to direct that "adjusted eligible net income" (the "Modification Method Deduction") is computed on a net basis. 19 RCNY §3-03(c)(1)(ii)(A) and (c)(3)(iii). If a taxpayer's IBF benefit under the Modification Method was not computed on a net basis (i.e., was not reduced by Attributable Expenses), a double tax benefit would occur since Attributable Expenses reduce ENI and thus already provide a tax benefit.

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[13] *See*, General Electric Capital Corp., 2 N.Y.2d 249, 254 (2004)(citations omitted): "[w]here an agency adopts a regulation that is consistent with its enabling legislation and is not 'so lacking in reason for its promulgation that it is essentially arbitrary; . . . the rule has the force and effect of law."

[14] 19 RCNY §3-04(b)(3)(ii) provides:

> When the taxpayer elects . . . to reflect the results of its IBF operations in its entire net income allocation percentage in lieu of the IBF modification, such 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 Sec. 3-03(c) of these regulations, to the production of eligible gross income.

As the intent of 19 RCNY §3-04(b)(3)(ii) is to exclude deposits from the numerator of the deposits formula (and thus provide an increased IBF benefit under the Formula Method) only if the interest on those deposits is an Attributable Expense that would reduce the benefit under the Modification Method, the slight difference in language between 19 RCNY §3-04(b)(3)(ii) and 19 RCNY §3-03(c) is not material. However, 19 RCNY §3-03(c) not only fails to use the identical language as 19 RCNY §3-04(b)(3)(ii), it also fails to provide specific guidance as to how the term it does use, Attributable Expenses, is to be computed.

Attributable Expenses are referenced in 19 RCNY §3-03(c)(1)(ii)(A), which provides that in determining "adjusted eligible net income," eligible gross income must be reduced not only by the ineligible funding and floor amounts, but also by Attributable Expenses.[15] Attributable Expenses are also referenced in 19 RCNY §3-03(c)(3)(iii), which helps implement 19 RCNY §3-03(c)(3)(i),[16] which (like 19 RCNY §3-03(c)(1)(ii)) also defines the

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[15] 19 RCNY §3-03(c)(1) states:

> (i) Provided an election has not been made pursuant to Sec. 3-04(b)(3) of these regulations, a taxpayer which establishes an IBF . . . is allowed as a **deduction** in computing its entire net income the **adjusted eligible net income**, as determined in this subdivision, of such IBF. However, in the event the adjusted eligible net income of the IBF is a loss, the amount of such loss must be added to Federal taxable income in computing the taxpayer's entire net income.
>
> (ii) The **adjusted eligible net income** of an IBF is computed by **subtracting from eligible gross income** the following:
>
> (A) **expenses or other deductions directly or indirectly attributable to eligible gross income**;
>
> (B) the ineligible funding amount; and
>
> (C) the floor amount.

[16] 19 RCNY §3-03(c)(3)(i) provides:

> . . . The **adjusted eligible net income** of the IBF is determined by subtracting from the eligible net income of the IBF the ineligible

term "adjusted eligible net income." While the two definitions of "adjusted eligible gross income" are similar, 19 RCNY §3-03(c)(3)(i) reduces expenses **applicable** to eligible gross income ("Applicable Expenses") from eligible gross income, whereas 19 RCNY §3-03(c)(1)(ii)(A) reduces Attributable Expenses from eligible gross income. Moreover the definition of Applicable Expenses in 19 RCNY §3-03(c)(3)(iii) indicates that an expense cannot be an Applicable Expense if it is not an Attributable Expense:

> **Expenses <u>applicable</u> to the eligible gross income of** the IBF **are those expenses** or other deductions . . . described in paragraphs (5),(6),(7) ["**Direct Expenses**"] and (8) ["**Indirect Expenses**"] of this subdivision **<u>that are</u> directly or indirectly <u>attributable</u> to the eligible gross income of the IBF**. [Emphasis, brackets and underlining added.]

Normally, the wording of 19 RCNY §3-03(c)(3)(iii) would not provide guidance as to what constitutes an Attributable Expense. But typically the same term is not defined differently under the rules. Since 19 RCNY §3-03(c)(1)(ii) and (c)(3)(i) both define the term "adjusted eligible gross income," they are *in pari materia* with one another and should, if possible, be interpreted to produce an identical result. Otherwise, the amount of the Modification Method Deduction could be different under each provision, thereby creating a significant internal inconsistency within the rules. *See*, by illustration, McKinney's Statutes, Vol. 1, §236 (". . . where the

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funding amount . . . and the floor amount . . .. The **eligible net income** of the IBF is the amount remaining after subtracting from the eligible gross income of the IBF . . . **the expenses <u>applicable</u> to such gross income** (**See**: Sec. 3-03(c)(5)-Direct expenses of the IBF, **Sec. 3-03(c)(6)-Interest expense of the IBF**, Sec. 3-03(c)(7)-Bad debt deduction of the IBF, and Sec. 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 Sec. 3-03(c)(9). [Emphasis and underlining added.]

same word or phrase is used in different parts of a statute, it will be presumed to be used in the same sense throughout . . .”).

As demonstrated below, for adjusted eligible net income to be defined consistently, Attributable and Applicable Expenses must be identical:[17]

19 RCNY §3-03(c)(1)	**19 RCNY §3-03(c)(3)**
Eligible Gross Income	Eligible Gross Income
- Attributable Expenses	**- Applicable Expenses**
	= Eligible Net Income
- Funding Amount	- Funding Amount
- Floor Amount	- Floor Amount
= Adjusted Eligible Net Income	**= Adjusted Eligible Net Income**

For the definitions of Applicable and Attributable Expenses to be the same, every Attributable Expense must be a Direct or Indirect Expense. Otherwise, the term Attributable Expenses under 19 RCNY §3-03(c)(1)(ii) could be broader than the term Applicable Expenses under 19 RCNY §3-03(c)(3)(iii). *See,* 19 RCNY §3-03(c)(3)(iii) which provides that an Applicable Expenses is a Direct or Indirect Expense that is an Attributable Expense.

The Commissioner asserts that the Excess Funds Interest Expense is neither a Direct or Indirect Expense of the IBF; although she does so with regard to whether 19 RCNY §3-03(c)(9) applies. She asserts that because Petitioner is required to compute its interest expense under 26 CFR §1.882-5, the Excess Funds Interest Expense is not a Direct Expense of the IBF, but an expense of the Petitioner that can only be allocated to the IBF under the indirect expense

[17] The parties do not appear to disagree with this conclusion as they devote significant attention in their briefs to determining whether the Excess Funds Interest Expense is an Applicable Expense.

allocation rule provided in 19 RCNY §3-03(c)(8).[18] The Commissioner further asserts that under either the gross asset or gross income methods of allocating indirect interest expenses found in 19 RCNY §3-03(c)(8)(ii), the Excess Funds Interest Expense does not constitute an Indirect Expense of the IBF.

19 RCNY §3-03(c)(8), however, makes no reference to 26 CFR §1.882-5 (as does 19 RCNY §3-03(c)(6) which deals with direct interest expenses). Moreover, 19 RCNY §3-03(c)(8) expressly provides that the only expenses indirectly allocated thereunder are those expenses "which cannot be specifically identified with the gross income, gains, losses, deductions, assets, liabilities or other activities of the IBF or a place of business of the taxpayer." 19 RCNY §3-03(C)(8)(i).

As the Excess Funds Deposits were time deposits of the IBF recorded on the IBF's books as IBF liabilities, the Excess Funds Interest Expense can be specifically identified with the liabilities of the IBF and therefore is not an indirect interest expense that is allocable under 19 RCNY §3-03(c)(8). Similarly, as the Excess Funds Interest Expense was paid or accrued on deposits recorded on the

[18] 19 RCNY §3-03(c)(8) provides:

> (i) Expenses of the taxpayer, including head office expenses, which cannot be specifically identified with the gross income, gains, losses, deductions, assets, liabilities or other activities of the IBF or a place of business of the taxpayer, are indirect expenses and must be allocated on an indirect basis. Indirect expenses . . may include such items as interest. . ..
>
> (ii) Expenses that cannot be specifically identified with the IBF or any particular place of business of the taxpayer but are indirectly related to the gross income, gains, losses, deductions, assets, liabilities or other activities of the IBF, must be allocated by the method that properly reflects the allocation of such expenses to the IBF. Generally, the amount of indirect expenses allocable to the IBF is determined by multiplying such expenses by a fraction computed by either the gross asset method as described in subparagraph (ii)(A) of this paragraph, or the gross income method as described in subparagraph (ii)(B) of this paragraph.

books as IBF liabilities, it constitutes a direct interest expense of the IBF under 19 RCNY §3-03(c)(6)(i).[19]

19 RCNY §3-03 therefore does not provide explicit computational guidance for determining whether the Excess Funds Interest Expense is an Attributable Expense. 19 RCNY §3-04(b)(3)(ii), however, clearly indicates, by its reference to 19 RCNY §3-03, that deposits should be excluded from the numerator of the deposits factor only if the interest expense thereof would be an Attributable Expense under the Modification Method. Thus, the question arises whether the Excess Funds Interest Expense should be treated as an Attributable Expense under the Modification Method rules; i.e., whether the

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[19] 19 RCNY §3-03(C)(6) provides:

(i) Interest expense of the IBF includes interest paid or accrued on funds borrowed by the IBF and/or interest paid or accrued on deposits recorded on the books as IBF liabilities. A taxpayer that determines its interest expense deduction for Federal income tax purposes pursuant to Sec. 1.882-5 of the Federal income tax regulations (26 CFR 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. Every other taxpayer must compute the interest expense of the IBF for New York City tax purposes as described in subparagraph (ii) of this paragraph.

(ii) The interest expense of the IBF is the sum of the amount of interest expense determined in subparagraph (ii)(A) of this paragraph and the total deemed interest expense determined in subparagraph (ii)(B) of this paragraph.

(A) Interest expense on the borrowings and deposits from other than a branch, agency or other office of the bank which established the IBF is the interest expenses deduction on such borrowings and deposits that was allowed for Federal income tax purposes.

(B) [Addresses deposits placed with the IBF by a branch, agency or other office of the bank which established the IBF]

. . .

(iii) (A) A taxpayer that determines its interest expense deduction for Federal income tax purposes pursuant to Sec. 1.882-5 of the Federal income tax regulations (26 CFR 1.882-5) must compute its interest expense of the IBF for New York City tax purposes, in the same manner, using the same liabilities-to-assets ration, 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. . . .

statutory interpretation reached with respect to the Formula Method also would result in an appropriate result under the Modification Method.

Here, the Excess Deposits far exceeded the amount of the IBF's deposits which produced eligible gross income. Therefore, it is likely that the Excess Funds Interest Expense was significantly greater than the amount of the IBF's eligible gross income. As Attributable Expenses reduce the amount of an IBF's eligible gross income in computing the Modification Method Deduction, treating the Excess Deposits Interest Expense as being an Attributable Expense would probably eliminate Petitioner's entire IBF benefit under the Modification Method. This would not be the proper result since the Excess Funds Interest Expense effectively, albeit indirectly, gave rise to the City Branch's income from U.S. Obligations. Since the City Branch's income from U.S. obligation was included in ENI, the Modification Method Deduction does not need to be reduced by the amount of the Excess Funds Interest Expense to prevent a double tax benefit. Only the amount of the interest expense on deposits of the IBF other than the Excess Funds Deposits (the "IBF Interest Expense") needs to be reduced from eligible gross income to prevent a double tax benefit.

Since the Excess Funds Interest Expense should not be treated as an Attributable Expense under the Modification Method, it should not be treated as an Attributable Expense under the Formula Method. Therefore, the Excess Funds Deposits should not be excluded from the numerator of the deposits formula. This is an appropriate result since deposits which bear little, if any, relation to the generation of eligible gross income (like the Excess Funds Deposits), should not give rise to an IBF benefit under the Formula Method.

Petitioner disputes this result by relying on 19 RCNY §3-03(c)(9), which provides directives for computing Applicable

Expenses where a taxpayer has both eligible and ineligible gross income.[20] Petitioner claims that 19 RCNY §3-03(c)(9) indicates that where an IBF has no ineligible gross income, all expenses of an IBF are to be apportioned to eligible gross income and thus treated as Applicable Expenses. There are two significant problems with this argument. First, 19 RCNY §3-03(c)(9) only applies where a taxpayer has eligible and ineligible gross income and the IBF had no ineligible gross income. 19 RCNY §3-03(c)(9), therefore, does not apply in this case.

Second, even if 19 RCNY §3-03(c)(9) applied, the only direct interest expense covered thereunder is the interest expense described in 19 RCNY §3-03(c)(6)(ii)(A).[21] However, all of Petitioner's interest expense, including the Excess Funds Interest Expense, is computed under 26 CFR §1.882-5 and therefore is only described in 19 RCNY §3-03(c)(6)(iii)(A).[22] Since 19 RCNY §3-

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[20] 19 RCNY §3-03(c)(9)provides:

> 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 (as determined in Secs. 3-03(c)(5), **3-03(c)(6)(ii)(A)**, and 3-03(c)(7)) for the taxable year that are specifically identified with eligible gross income, and
>
> (ii) an amount computed by multiplying the sum of **direct** expenses of the IBF (as determined in Secs. 3-03(c)(5) and **Secs. 3-03(c)(6)(ii)(A)**) for the taxable year 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 (as determined in **Secs. 3-03(c)(6)** and 3-03(c)(8)) for the taxable year by a fraction, the numerator of which is the eligible gross income of the IBF for the taxable year and the denominator of which is the gross income of the IBF for the taxable year. [Emphasis added.]

[21] Although a new phrase "specifically identified with" is adopted in 19 RCNY §3-03(c)(9), again without being defined, 19 RCNY §3-03(c)(9) covers all 19 RCNY §3-03(c)(6)(ii)(A) direct interest expenses regardless of whether they are specifically identified with eligible or ineligible gross income.

[22] 19 RCNY §3-03(c)(9) does, however, include all indirect interest expenses described in 19 RCNY §3-03(c)(6) and (c)(8).

03(c)(6)(iii)(A) interest expenses are not included in the 19 RCNY §3-03(c)(9) allocation, none of the IBF's interest expense would be treated as an Applicable Expense thereunder, including the IBF Interest Expense which the Commissioner does not dispute is an Applicable Expense.

Since the IBF Interest Expense clearly should be an Applicable Expense, this cannot be the correct result. Therefore, although 19 RCNY §3-03(c)(9) appears to apply without regard to any other provision, it must be viewed in conjunction with 19 RCNY §3-03(c)(3)(iii) (which, like (c)(6),(8) and (9), is referenced in 19 RCNY §3-03(c)(3)(i)) to determine if an interest expense is an Applicable Expense. Since the IBF Interest Expense is an Applicable Expense under 19 RCNY §3-03(c)(3)(iii), it should be treated as an Applicable Expense which can be apportioned, if necessary, under 19 RCNY §3-03(c)(9), even though that provision technically does not apply. However, as the Excess Funds Interest Expense is neither an Applicable Expense under 19 RCNY §3-03(c)(3)(iii), nor is described in 19 RCNY §3-03(c)(9), it should not be treated as an Applicable Expense under 19 RCNY §3-03(c)(9).

As the above analysis indicates, the rules under the Modification Method are neither clear nor consistent.[23] Petitioner, however, clearly seeks a tax benefit (which serves as the equivalent of the Modification Method Deduction) on the basis that the Commissioner is bound by her rules even if they contravene the statute. Where the rule that applies does not contravene the statute, and the rule that might possibly contravene the statute

[23] For example, if the IBF had ineligible gross income and did not report its interest expenses under 26 CFR §1.882-5, the Excess Funds Interest Expense could be argued to constitute an Applicable Expense under the literal language of 19 RCNY §3-03(c)(9)(ii), although that would deny Petitioner an appropriate IBF benefit under the Modification Method and be inconsistent with the result that would occur if the IBF had no ineligible gross income.

does not apply for two distinct reasons, a different result cannot be reached under the rules than under the statute.

Because the Excess Funds Interest Expense is not an Attributable Expense under either the statute or the rules, the Excess Funds Deposits are not excluded from the denominator of Petitioner's deposits factor.[24]

ACCORDINGLY, IT IS CONCLUDED THAT:

A. Petitioner is not entitled to the Subtraction Modification with respect to interest income earned from U.S. obligations which it held as trading securities; and

B. Under both the statute and the rules, Petitioner is not entitled to reduce its deposits factor by excluding deposits from foreign persons which were recorded on the books as a liability of the IBF, but the proceeds from which were advanced to the City branch which used them, on an interest free basis, to generate City income.

The Notice of Determination dated March 29, 2002 is sustained in full and Petitioner's claims for refund are denied.

Dated: April 13, 2005
New York, New York

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STEVEN J. GOMBINSKI
Chief Administrative Law Judge

[24] All other arguments raised by the parties have been considered and are found to be unpersuasive.