

November 30, 2007

Mr. Daniel Smirlock
Deputy Commissioner and Counsel of Taxation and Finance
New York State Department of Taxation and Finance
Building, 9, W.A. Harriman Campus
Albany, NY 12227

RE: Draft Proposed Regulations on Repurchase Agreements and Securities Loans

Dear Mr. Smirlock:

This Securities Industry and Financial Markets Association (“SIFMA”)¹ urges the Department to withdraw its Proposed Regulations published in the New York State Register on October 24, 2007 addressing the treatment of repurchase agreements and securities loans under the New York State corporation franchise tax (“CFT”) and, in particular, with respect to their status as investment capital or business capital (“Proposed Regulations”). SIFMA submits that the Proposed Regulations are inconsistent with, and not authorized by, the Tax Law and that, if adopted, they will be invalidated by the courts.

Contrary to the Department’s statement in its regulatory impact statement accompanying the Proposed Regulations, the Proposed Regulations, if adopted, would result in a significant tax increase for the securities industry. Moreover, because taxpayers are likely to challenge the Proposed Regulations, for the reasons outlined below, their adoption may lead to years of controversy. Any anticipated additional revenues may be years away and may, in fact, never be realized.

SIFMA has submitted a proposal that addresses the issues with which the Department appears to be concerned. Under the proposal, broker/dealer income from reverse repurchase and securities borrow transactions would be treated as investment income for corporation franchise tax purposes to the extent of the lesser of 0.15% (15

¹ The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks, and asset managers. SIFMA’s mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public’s trust and confidence in the markets and the industry. SIFMA works to represents its members’ interests locally and globally. It has offices in New York, Washington, D.C., and London, and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

basis points) of the average amount invested in those transactions or 35% of the taxpayer's entire net income. We believe that this would result in treating as investment income an amount approximately equal to that part of the net income from transactions that would be treated as investment income under the statute on the assumption that all of these transactions are debt-financed.² In contrast to the approach taken in the Proposed Regulations, which addresses the Department's concerns by arbitrarily classifying all reverse repos and securities borrows as business capital without regard to whether they meet the statutory definition, the SIFMA approach addresses the issues through a methodology of allocating expenses to investment income, effectively limiting that allocation. Accordingly, the approach proposed by SIFMA clearly comes within the Department's statutory authorization in section 210.6 of the Tax Law to adopt rules relating to the attribution of expenses among investment and other types of capital. Thus, the SIFMA approach would result in immediate revenues for the State and would avoid the years of controversy that would result under the approach of the Proposed Regulations.

Historical Development of and Policy Behind the Investment Capital Rules

For over 60 years, the CFT has been structured to provide favorable tax treatment to income from certain securities holdings of any corporation subject to tax. The reasons for this favorable treatment are obvious: to encourage corporations – particularly headquarters companies – to locate in New York. The need for this tax treatment is particularly acute because the combined rate of the CFT and New York City's general corporation tax ("GCT") is the highest in the nation.

Historical Development of the Investment Capital Statutory Rules

In 1944, a major restructuring of the CFT occurred to implement the suggestions from a 1943 report provided to Governor Dewey by the State Tax Commission and an Advisory Group (the "Dewey Report"). Before the 1944 amendments, corporations were rigidly classified as holding corporations, investment trusts, or business corporations, and distinctive taxes were imposed on each. The Dewey Report noted that the "scheme of dividing business corporations, Investment Trusts and Holding Corporations into three separate, rigid classifications, by arbitrary, inflexible definitions, is unsound and unfair. A corporation failing by a hair's breadth to meet one of the special definitions falls completely within the general classification of a business corporation. Thus, a slight, even an insignificant, variance in corporate set-up or activity may result in a disproportionate increase in tax burden."³ To correct these flaws, the Dewey Report recommended that "a corporation should be treated as a business corporation to the extent it is such, as an Investment Trust to the extent it is such, and as a Holding Corporation to

² SIFMA does not accept as a matter of fact the proposition that all of these transactions are 100 percent-funded with repurchase agreement debt. We are prepared, however, to use this premise as the cornerstone of a proposal in the interests of resolving the controversy over the treatment of this type of income.

³ New York Taxes On Business Corporations, Investment Trusts and Holding Corporations, Report to Honorable Thomas E. Dewey, Governor, by State Tax Commission and Advisory Group, November 12, 1943, p. 7.

the extent it is such. The arbitrary lines now dividing corporations into those three distinct classifications should be removed.”⁴

The recommendations of the Dewey Report were largely enacted into law by Chapter 415 of the Laws of 1944, thus providing a more flexible system. Under the new system, most corporations were subject to the same tax with different treatment being afforded to different types of income earned and capital owned. Before the amendments, a corporation was considered an investment trust if 85 percent or more of its average gross assets were invested in stocks, bonds, or other securities or were cash on hand and on deposit.⁵ Cash on hand or on deposit was considered a type of capital that would not prevent a corporation from being taxed as an investment trust. After the 1944 amendments, corporate taxpayers could choose whether to treat their cash on hand or on deposit as investment or business capital – acknowledging cash on hand and on deposit as a separate and distinct category of assets.

The statute defines investment capital generally to include all “investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business, exclusive of subsidiary capital and stock issued by the taxpayer.” The Legislature considered the question of exemptions to the general rule and specifically provided for several. The statute does not treat companies in the securities business differently from manufacturing or other companies. Whether securities transactions are a company’s core business or merely a minor incidental activity and whether assets are used in an active or core business are irrelevant. The carve-out for inventory shows that the Legislature considered this issue and made a conscious decision to limit any exception to the general definition for regular business transactions to inventory assets without regard to the nature of the taxpayer’s business. The fact that the statute defines investment capital as “investments” in stocks, bonds and other securities is of no moment. If that language had been intended to exclude assets used in the taxpayer’s business, there would have been no need to carve out securities held as inventory. Moreover, the words “investments in” also appear in the definition of subsidiary capital in Tax Law section 208.4 and no one has ever seriously contended that stock in a subsidiary would not be subsidiary capital merely because the stock was held for business purposes (e.g., if it was stock of a supplier) and not for investment purposes. In fact, in the course of developing the present regulations, the Department considered whether the words “investments in” could be used to exclude assets held for business purposes and decided not to do so. In a memorandum from the Department’s Investment Capital Task Force to its outside consultants dated November 7, 1984, the Department said:

“In examining the statutory definition of investment capital, we discussed whether the regulation should define the phrase “investments in”. We studied several approaches, including the one set forth by the United States Supreme

⁴ Report to Governor Dewey, p. 8.

⁵ Tax Law section 208.4 (amended 1944).

Court in Corn Products Refining Co. v. Comm’r (350 U.S. 46). We rejected this approach as being subjective and very difficult to administer.”

The *Corn Products* case referred to by the Department had been interpreted by some to mean that assets held for business use and not as investments were not capital assets and that gain or loss on their sale was ordinary and not capital. In a later case, *Arkansas Best Corporation v. Comm’r*, 485 U.S. 212 (1988), the United States Supreme Court squarely rejected that reading of *Corn Products* and held that corporate stock purchased by another corporation was a capital asset regardless of whether the buyer’s purpose was to hold it as an investment or to use it for business purposes. The statutory language leaves no room for doubt that a company that holds some securities as inventory for sale to customers (which would be business capital) can also hold other securities as investment capital. The CFT places no limitations on the types of taxpayers to which investment capital treatment is available. Investment capital is not limited to surplus funds that are not used in the taxpayer’s core business.

The Policy Behind the Treatment of Investment Capital and Its Application to Securities Businesses

Most states and localities that impose income taxes distinguish between business and nonbusiness income. Business income is apportioned among the states in which the company does business, typically based on the relative amounts of property, payroll, and receipts that are attributable to each state. Each item of nonbusiness income, which is not limited to income from securities, is allocated to only one state. Nonbusiness income from tangible personal property is typically allocated to the state where the property is located. Nonbusiness income from intangible property, such as securities, is typically allocated to the state of the company’s commercial domicile.⁶ Under this approach, a state taxes all of the income from securities of a company that is headquartered there.

In contrast, New York’s scheme encourages companies with income from securities to locate in New York. Income from securities, generally defined as investment capital, is taxed to a corporation only to the extent that the issuers of the securities do business in New York. Thus, a corporation suffers no detriment with respect to the taxation of its investment income by having investment operations or its headquarters in New York. All other taxable income is apportioned among New York and other states based generally on the location of the company’s receipts.

Indeed, the Department of Taxation and Finance has acknowledged the New York “corporate headquarters tradition” that has led to the creation of and demands the preservation of this system of corporate taxation. In the context of expense attribution, the Department has stated that “the expense attribution rules are to be construed so as not to alter a system designed and intended to enable New York to attract and retain corporate activity by attracting capital and offering a unique and certain set of structures

⁶ See, e.g., section 1(a) of the Uniform Division of Income for Tax Purposes Act.

for the favorable treatment of many activities, such as the holding of subsidiaries and investments.”⁷

“Investment income” means “income, including capital gains in excess of capital losses, from investment capital, to the extent included in computing entire net income.”⁸ As stated above, investment capital includes all investments in stocks, bonds, and other securities issued by any corporation (other than the taxpayer or a subsidiary), any government, or any governmental entity if such investments are not held as inventory for sale to customers.⁹

Thus, the CFT scheme characterizes income strictly based on the type of capital from which the income flows and not based on the vagaries of the taxpayer’s reasons for entering into a particular transaction or the delineation of what constitutes working capital. The system is, for that reason, straightforward and easy to apply. As long as a corporate or governmental security is held for purposes other than for sale to customers in the regular course of business, that security is investment capital and all income derived there from is investment income.

The Present CFT Regulations Implement the Legislative Policy Goals

New York’s statutory rules for investment capital serve an important policy goal: lessening the burden of the combined rates of the CFT and GCT. This policy goal has been further implemented through the regulations promulgated by the NYS Department (and largely followed for the GCT) in 1989, providing broad definitions of investment capital and investment income. Furthermore, as described below, those regulations deliberately, and after extended detailed discussions between the State and City Departments and the business community, adopted a broad definition of cash and “deemed” cash assets – without which much of the investment capital regime would have little meaning for many New York businesses. Changing the rules would directly harm those businesses.

The CFT regulations and GCT rules – in place for more than a decade – define “investment income” broadly.¹⁰ By the 1980s, the prior regulations had become out-dated and failed to reflect the modern reality that there are many ways of holding equity and debt positions. The Departments worked with private sector representatives,

⁷ NYS Department Technical Services Bureau Memorandum, TSB-M-95(2)C (Jan. 8, 1996) (“Accordingly, under the Franchise Tax investment income generally is allocated to the State at a lower percentage than business income.”); NYC Department Statement of Audit Procedure, No. 96-1-GCT (Jan. 29, 1996) (further noting that “[c]onsistent with New York City’s longstanding tradition as a center of corporate headquarters, under the GCT and UBT, investment income generally is allocated to the City at a lower percentage than business income....”).

⁸ Tax Law section 208.6, Administrative Code section 11-602.5.

⁹ Tax Law section 208.5, Administrative Code section 11-602.4.

¹⁰ 20 NYCRR section 4-8.3; NYC Rule 11-37.

including members of the Securities Industry Association, SIFMA's predecessor, to develop regulations that reflected the modern financial instruments marketplace. Beginning with the CFT regulations promulgated in 1989 and in the soon-to-follow GCT rules, changes were made to acknowledge that investment capital and the income flowing from it should include not only "traditional" stocks and corporate equity and debt instruments but also a broad range of holdings that do not require actual ownership in the issuer of the security – such as options and other derivatives. This recognition materialized in the current regulations through the specific identification of units in publicly traded partnerships, debt instruments issued by a governmental agency, qualifying corporate debt instruments, options (subject to certain exceptions), and stock rights and warrants as each generating investment income.¹¹ The present regulations correctly interpret the law.

Equally important, the current regulations delineate the scope of what assets will be treated as cash and thus will be eligible for treatment as either business capital or investment capital at the taxpayer's election.¹² The regulations defining investment capital consider certain short-term debt instruments (i.e., payable on demand or within six months and one day) to be "deemed to be cash on hand or on deposit."¹³ Certificates of deposit, which generally have a definite term during which the holder will be penalized for an early withdrawal of the funds invested, are specifically enumerated as a type of debt instrument eligible for characterization as cash. The provision is not limited to amounts deposited with banks. These rules were worked out with private sector representatives in extended discussions. Just as with actual cash on hand and on deposit, a taxpayer may elect to treat deemed cash on hand and on deposit as either investment capital or business capital. The deemed cash created through a reverse repo interest or the cash posted as collateral on a securities borrow can be treated as investment capital or business capital as the taxpayer elects without regard to the nature of the transaction in which it was acquired or the nature of the use of the property that was transferred in exchange for it. Absent this acknowledgment, the regulatory definition of "stocks, bonds and other securities" would effectively prohibit investment capital treatment for many debt instruments,¹⁴ gutting the investment capital rules for many corporate taxpayers (including manufacturing, other non-financial, securities, and other financial services companies).

The regulations provide examples of investment *income* that indicate that the term includes any form of realizing a return on investment capital, not just current periodic payments. Income from investment capital "includes" dividends, interest, and capital gains, indicating that these are examples but by no means an exclusive list. For example, premium income from an unexercised covered call option is specifically defined as

¹¹ 20 NYCRR section 4-8.3; NYC Rule 11-37.

¹² Tax Law section 208.7; Admin. Code section 11-602.6.

¹³ 20 NYCRR section 3-3.2(a)(1); NYC Rule 11-37(a)(3).

¹⁴ 20 NYCRR section 3-3.2(c).

investment income as long as the property that covers the call is itself investment capital.¹⁵ Thus, if the holder of a debt security that is investment capital sells a third party the right to buy that security for a certain amount at a certain time and the party does not exercise its option, the premium that the holder receives for granting the option is investment income, even though no sale is made and the payment does not represent a current return on the security such as interest. It is treated as investment income because it is attributable to the holding of investment capital. Put another way, it is investment income because it is another way of realizing a return on the holding of investment capital, even though it does not involve current periodic income or gain on sale. Similarly, the holding of a reverse repo interest or an interest in cash collateral for securities borrowed may be, or be elected to be, investment capital.

These administrative promulgations were no accident. They were intentionally and specifically designed to give the statutory investment capital regime real meaning and to meet the legislative policy goal of lessening the heavy tax burden that might otherwise keep financial service businesses out of New York. For example, as part of the expanded definition of qualifying corporate debt instruments, reverse repurchase agreements may be qualifying corporate debt instruments if all other criteria are met. Furthermore, to put all cash equivalent investments on an equal footing, the regulations allow reverse repurchase agreements and similar short-term debt instruments that are payable within six months and one day to be deemed to be cash on hand and on deposit. Allowing reverse repurchase agreements to be covered by the cash election is good tax policy because otherwise corporate investors would favor investing their cash in corporations that have a lesser presence in New York State (because of their low issuer's allocation percentage), thereby making it harder for New York-based corporations (which are likely to have a high issuer's allocation percentage) to raise capital.

The Departments' regulations were developed in a collaborative effort with impacted taxpayers and, as is made clear by the specificity and depth of the regulations, as a result of much internal deliberation. The Departments knew then, as they do now, that certain of these provisions, such as the cash election, would necessarily decrease tax revenues. The same policy considerations that led the Departments to promulgate these regulations many years ago should restrain the Departments from attempting to dismantle them now.

Representatives of the securities industry were involved in the development of the regulations, and the Departments were well aware of the particular issues facing the industry in this area. To cite just a few examples, a meeting was held among Department representatives and representatives of the New York State Bar Association on August 7, 1985, at which two senior officials from a major investment bank made a presentation on the nature of repo and reverse repo transactions. The cited purpose of the meeting was to explain these transactions to the Department representatives. Repos were a major subject of discussion at a meeting of private sector representatives and the Department on January 5, 1987. The rule, cited above, that investment income should include income

¹⁵ 20 NYCRR section 4-8.3(a)(5);

from an unexercised premium on a covered call option was adopted by the Department, despite taking a prior contrary position, in direct response to a recommendation from the Wall Street Tax Association in a detailed letter dated February 9, 1989. Thus, the present regulations were developed with a full awareness of the transactions engaged in by the securities industry and with detailed input from that industry.

Beyond the fact that the particular transactions addressed in the Proposed Regulations are engaged in by all types of businesses, including manufacturing and other non-financial services businesses, corporations regularly engage in securities-related transactions in different ways. For example, a corporation that functions as a securities dealer may also function as a securities trader, trading in securities held strictly for its own account and not held for sale to customers. Securities-based businesses, as well as manufacturers, can hold securities for their own account and not for sale to customers. There is no tax or economic policy reason for discriminating against securities businesses. The securities industry has been a major contributor to the State and City economies. The securities industry should not be subject to less favorable tax treatment than that afforded to other financial services companies (e.g., hedge funds, financing subsidiaries of major corporations) and other industries.

The Present Regulations and Law

Under present law, the tax consequences of engaging in a repo, a reverse repo, or a securities loan are based on the economic relationships that are created by the transaction. For example, if the owner of a U.S. Treasury bond “sells” it to a counterparty in a repo and, because of the terms of the repo, the seller remains at risk with respect to changes in the security’s value because it will have to “repurchase” the security at a specified price on a specified date without regard to the security’s value on that date, the seller is deemed to have borrowed money from the counterparty, placing the security as collateral. The seller, as the owner of the security, is taxed on income from it and that income is deemed to be from investment capital if the security was investment capital in the seller’s hands. The position of the lender in a securities loan secured by cash collateral is the same as that of the seller in a repo. The buyer in a repo is deemed to have lent money to the seller secured by the security. If the seller is a corporation or a government and the loan otherwise qualifies under the regulations, the seller’s obligation will be investment capital in the counterparty’s hands and income received by the counterparty in the transaction will be investment income. The position of the borrower in a securities loan secured by cash collateral is the same as that of the buyer in a repo.

The present regulations properly reject the notion that all repos, reverse repos, and securities loans should arbitrarily be treated as one form of capital or another. Instead, they examine the economic realities of the transaction to determine whether the parties hold “stocks, bonds or other securities” within the meaning of the Tax Law.

Further, the present regulations correctly draw no distinction between broker/dealers and other types of taxpayers. Recognizing that no such distinction is made in the statute, the present regulations base the classification of income from these

transactions on the nature of the taxpayer's economic interest without regard to the nature of the taxpayer's business.

The Proposed Regulations

The Proposed Regulations adopt a dramatically different approach to the treatment of these transactions. All interests in repos, reverse repos, and securities loans are automatically treated as business capital if they are owned by broker/dealers without regard to the nature of the taxpayer's economic interest in the transaction. It does not matter whether the transaction amounts to a loan or a sale. Even if the taxpayer in a repo transaction is treated as having borrowed money secured by a security that it continues to own for income tax purposes (*i.e.* with respect to which it has the risk of loss if the security declines in value and the opportunity for profit if it increases in value), any income from the transaction reflecting income earned by the underlying securities would be treated as business capital, even if the security represented investment capital in the seller's hands. Further, despite the clear language of the statute, cash held under or acquired pursuant to the transaction would be business capital and would not be eligible for the election to be treated as investment capital.

The Proposed Regulations also provide that income from a repo, a reverse repo, or a securities loan is included in gross income from principal transactions and is allocable pursuant to Tax Law Section 210.3(a)(9)(A)(iii) without regard to whether the transaction is economically a sale or a loan. In applying this provision, interest expense is treated as part of the cost of acquiring securities purchased in a transaction and is subtracted from gross income in computing the gross income from a principal transaction. Further, interest expense in these transactions may not exceed the taxpayer's interest income from similar transactions.

The Proposed Regulations are Contrary to the Statute

In rejecting the transaction's underlying economic relationships in favor of an approach that arbitrarily classifies income as business income, the Proposed Regulations are directly contrary to the statutory language. Tax Law section 171, under the authority of which any regulations in this area would be adopted, requires that regulations be "not inconsistent with law." If the Proposed Regulations are adopted, the courts would hold them to be invalid. The courts have shown no hesitation in holding Department regulations that were contrary to the Tax Law to be invalid. See, e.g., *Dreyfus Special Income Fund, Inc. v. N.Y.S. Tax Commission*, 72 N.Y.2d 874 (1988); *Servomation Corp. v. State Tax Commission*, 51 N.Y.2d 608 (1980); *Building Contractors Ass'n, Inc. v. Tully*, 87 A.D.2d 909 (3d Dep't 1982).

Section 208.5 of the Tax Law provides that investment capital means "stocks, bonds and other securities." Under Section 208.6, income from investment capital is investment income. Therefore, the inquiry with respect to any item of income is whether it derives from investment capital. If it is attributable to "stocks, bonds or other securities," it is investment income. Tax Law Section 208.7(a) provides that cash on hand

and on deposit can be treated as either investment capital or business capital at the election of the taxpayer. This election is exclusive to the taxpayer and the Department has no power to reject a taxpayer election under this provision. The election can be made without regard to how the taxpayer acquired the cash (i.e., whether in an investment or a business transaction) or to the use that it makes of the cash. The flat declaration in the Proposed Regulations that a repo, a reverse repo, or a securities loan will always be business capital without regard to whether the taxpayer holds a stock, bond, or other security or has cash on hand and on deposit flies in the face of the statutory language and would be rejected by the courts.

A repo, a reverse repo, or a securities loan is a transaction. The question is whether the taxpayer's interest in assets created in such a transaction is investment capital.

The Legislature's intent was to treat income attributable to investment capital as investment income. Investment income is not limited to regular periodic returns on investment capital such as dividends and interest. Premium income from a covered call option that is not exercised is investment income.¹⁶ The reasoning is that this income is derived from an investment in a security. When the holder of cash posts it as interest-bearing collateral in a securities borrow transaction or lends it in a reverse repo, it is attempting to maximize its investment return on that cash. If the cash (or deemed cash) is elected to be treated as investment capital, then the resulting enhanced income flow is properly treated as investment income.

The Proposed Regulations, by arbitrarily classifying all income from repos, reverse repos, and securities loans as business income without regard to the economic relationships created by the transaction, is directly contrary to the statutory language.

The case law and other authorities in New York State support the view that the proper inquiry must be into the nature of the taxpayer's interest in the repo. The case of *C. Czarnikow Inc.* involved the pre-1989 regulations. The taxpayer bought U.S. government bonds from banks in repo transactions. The Tax Appeals Tribunal treated the taxpayer as having lent money to the banks. It described the taxpayer's holdings as "evidences of indebtedness." Under the regulations in effect at the time, the loan was a "security" and the taxpayer's income was held to be investment income. The Tribunal pointed out that a short-term loan could be investment capital. In conducting its analysis, the Tribunal examined the nature of the taxpayer's interest in the transaction.¹⁷

In *Transworld Corporation* the taxpayer bought securities from banks in repos, paying them cash. The terms of the transactions were from overnight to "a couple of months". The taxpayer was held to have lent money to the banks and not to have bought the securities. As short-term loans, the taxpayer's interests were held to be in cash on

¹⁶ 20 NYCRR section 4-8.3(a)(5).

¹⁷ TSB-D-91(7)C (NYS Tax Appeals Tribunal 1991).

deposit. Here, too, the Division of Tax Appeals examined the nature of the taxpayer's interest under the repo¹⁸

First Albany Corporation involved a request for an advisory opinion as to repo transactions. The Department examined the nature of the taxpayer's interest under the repo. It said that the issue was whether the taxpayer had purchased (and, hence, had become the owner of) the securities or whether it had made a loan. It concluded that the issue in each case would depend on the facts (*i.e.* on the underlying economics) and that it could not be addressed in an advisory opinion.

Thus, it is clear that under the existing statute a taxpayer's holding of a stock, bond, or other security is investment capital as long as the property is not held for sale to customers in the regular course of business. If a taxpayer's interest in a repo, a reverse repo, or a securities loan is in a stock, bond, or other security, its income from the transaction is investment income. If a taxpayer makes a qualifying loan to a corporate counterparty in one of these transactions or if it derives investment income from using an otherwise qualifying security as collateral or the subject of a loan, the statute mandates that its income be treated as investment income. If it receives cash, or a transaction creates an interest in cash, that cash is eligible for the election to be treated as either investment capital or business capital. There is no support in the statute for treating otherwise qualifying investment income as business income merely because of a label attached to the transaction.

The use that a taxpayer makes of collateral received in a transaction is irrelevant. If the taxpayer's interest amounts to a loan and the loan is to a corporation, its interest in that loan is investment capital. The nature of that interest is not changed by what the taxpayer does with the collateral that it receives in the transaction. To the extent that the taxpayer derives income from the use of the collateral in a short sale or another transaction, the nature of that income is determined under general tax principles applicable to that type of transaction. Moreover, the fact that a taxpayer makes many loans or makes loans in the ordinary course of its business is irrelevant under the statutory definition of investment capital.

The reverse repo interest that is created when cash is paid by the buyer of the security in a repo or the interest that is created when a security is borrowed is cash on hand and on deposit (or deemed cash if such interest is for no longer than six months and one day) in the taxpayer's hands and can be treated as either investment capital or business capital as the taxpayer elects. Whether the security that was purchased or borrowed was used in transactions related to business capital or investment capital is irrelevant. Any cash or deemed cash that is held by the taxpayer is eligible for the election under Tax Law section 208.7(a) without regard to the nature of the transaction in which the cash or deemed cash was acquired or, in the case of a reverse repo or securities borrow, the nature of the use of the property that was transferred in exchange for it.

¹⁸ NYS Division of Tax Appeals, Administrative Law Judge Unit (1989).

Further, there is no support in the statute for treating broker/dealers differently from other taxpayers. Where the Legislature sought to treat broker/dealers differently, as in certain apportionment rules, it specifically so provided.¹⁹ Repos, reverse repos, and securities loans are engaged in by a wide variety of taxpayers. There is absolutely no support in the statute for providing special rules for broker/dealers with respect to investment capital classification.

It is no answer to say that broker/dealers regularly engage in these transactions and that, therefore, their income from them should be treated as business income, whereas for other taxpayers these transactions are not an integral part of their business operations but are attributable to managing their investments. The Legislature obviously thought of this issue when the statute was being enacted, and it expressly excluded from the definition of investment capital stocks, bonds, and securities that were held by the taxpayer for sale to customers in the regular course of its business. Thus, the Legislature carved out an exception for inventory assets. The limited carve-out reflects a legislative intent that income from a taxpayer's core revenue-generating activities would be investment income as long as the securities involved were not part of the taxpayer's inventory.

The Proposed Regulations dealing with the apportionment of income are similarly defective. Proposed Regulations section 4-4.7(b) provides, without any economic analysis, that a broker/dealer's income from repos or securities lending transactions is included in determining gross income from principal transactions and is allocated to New York State pursuant to Tax Law Section 210.3(a)(9)(A)(iii), without regard to whether the transaction in fact involves the purchase or sale of such assets. Further, the Proposed Regulation indicates that interest expense from repos and securities loans is part of the cost to acquire the securities, disregarding the fact that interest is generally *not* treated as part of an asset's cost for income tax purposes. Moreover, there is no support for the position adopted in the Proposed Regulation that interest expense in these transactions may not exceed interest income.

Here, too, the Proposed Regulations totally ignore the transaction's economic realities in favor of an arbitrary approach based on labels.

Conclusion

The Proposed Regulations arbitrarily declare that income from repos, reverse repos, and securities loans is business income without regard to the economic realities of the transaction. They ignore the statutory language. Under the Proposed Regulations, investment income from a security that is clearly investment capital under the statute would nevertheless be treated as business income. The statutory cash election would be over-turned. The Department has no power to accomplish these results by regulations and the courts would so hold. Moreover, there is no authority in the statute for imposing special rules on broker/dealers that do not apply to other corporate taxpayers.

¹⁹ *See e. g.* Tax Law Section 210.3(a)(9).

In contrast, the approach suggested by SIFMA, which would be based on a different methodology for attributing expenses related to reverse repos and securities borrows to investment and other types of capital, would be within the Department's regulatory authority under section 210.6 of the Tax Law to adopt rules relating to the attribution of expenses. It would avoid the years of controversy and uncertainty of revenues that would undoubtedly result if the Proposed Regulations were adopted.

Please contact me at 212-618-0533, if you have any comments or need additional information.

Sincerely,

A handwritten signature in cursive script that reads "Nancy Donohoe Lancia".

Nancy Donohoe Lancia