STATE OF NEW YORK
STATE TAX COMMISSION

ADVISORY OPINION PETITION NO. C860916B

On September 16, 1986, a Petition for Advisory Opinion was received from Morgan Guaranty International Finance Corporation, 37 Wall Street, New York, New York 10015.

The issue raised is whether, for purposes of Article 9-A of the Tax Law, forward contracts for the sale of foreign currencies, entered into by Petitioner solely to protect its net exposure to foreign exchange risk in respect of its investment in affiliated foreign corporations, should be considered "investments in the stock of subsidiaries" for purposes of the definition of "subsidiary capital" in section 208 of the Tax Law.

Petitioner is an "Edge Corporation" organized under section 25(a) of the Federal Reserve Act. It was organized to invest in the stock of foreign (primarily closely held) corporations. Petitioner is authorized by the Federal Reserve Board to carry on its activities and is limited to carrying on financing operations other than the banking business. Thus, with minor exceptions, Petitioner has confined its activities since inception to making equity investments in foreign corporations.

These investments are reported on Petitioner's consolidated financial statements. Petitioner states that the value of such an investment is the net worth of a foreign corporation ("Net Worth"), which is a function of both the foreign currency exchange value of that Net Worth plus earnings for the fiscal year. Consequently, to maintain the true value of its investments, Petitioner feels that it must neutralize to the extent possible the effect of foreign currency fluctuations, and that it must also convert the earning power of its foreign currency capital into U.S. dollar capital. Petitioner attempts to accomplish this neutralization through forward sale contracts of the foreign currencies in which it holds stocks.

Petitioner's forward sale contracts are for the sale of foreign currency in amounts which approximate the Net Worth of its investments. Petitioner's goal simply is to match its foreign currency exposure in its investments with foreign currency contracts. In fact, from year-end 1982 to year-end 1985, the aggregate amount of foreign currency contracts was only 2.4% less than Petitioner's aggregate net exposure.

Petitioner states that it enters into all of its foreign currency contracts to hedge the effects of changes in exchange rates on foreign investments and that the gain or loss on the currency contracts will offset any change in the value of the foreign investments. The accounting treatment on such contracts is required to be identical with the underlying investments.

In Petitioner's opinion, it has not engaged in the business of dealing in foreign currency contracts. Although its parent Morgan Guaranty Trust Company of New York engages in a comprehensive foreign exchange business, Petitioner did not enter into the foreign exchange contracts under consideration here to hedge ordinary business operations in the same manner as a business engaged in importing products wishing to protect the cost of its inventory against fluctuations in foreign exchange rates. Rather, Petitioner contends that it entered into the foreign currency contracts at issue solely to protect itself against foreign currency fluctuations relating to its capital position in stock of affiliated foreign corporations in which it has invested. It did this because, as an investor in such corporations, it wished to subject itself to the true risks of business success or failure that are applicable to a United States corporation that is a subsidiary of a United States bank. Thus, in this way it was able to convert those investments into the equivalent of U.S. dollar investments.

Petitioner contends that its attempt to neutralize currency fluctuations, to assure any true investment return in the value of its investment, by reducing its net exposure in foreign stocks through forward sale contracts is investing further in its foreign stocks and is really an integral part of owning the underlying stock and should be recognized as an investment in that stock.

Petitioner contends that federal income tax principles confirm that forward sale contracts entered into by Petitioner to protect its investment in foreign stocks should be considered an "investment" in those stocks for purposes of section 208 of the Tax Law. Thus, Petitioner contends, the federal courts and the Internal Revenue Service recognize that a foreign currency transaction and an underlying investment made with such currency must be integrated for purposes of determining the character of any gain or loss on the transaction. Petitioner cites National-Standard Co. v. Commissioner, 80 T.C. 551, aff'd 749 F.2d 369 and Hoover Co. v. Commissioner, 72 T.C. 206 as two examples.

Petitioner also contends that the legislative history of section 208 of the Tax Law indicates that "subsidiary capital" should be construed broadly for purposes of such section. Petitioner traces the history back to New York State tax reform legislation enacted in 1944 which repealed and re-enacted Article 9-A of the Tax Law, the franchise tax on business corporations. Specifically, Petitioner cites from a report to then Governor Dewey by the New York State Tax Commission and Advisory Group entitled "New York Taxes on Business Corporations, Investment Trusts and Holding Companies", dated November 12, 1943 (hereinafter "The Report").

The Report criticized New York State's tax structure as inequitable, and one that discouraged certain corporate operations in New York. The Report made general recommendations of reform in response to perceived problems with the existing statute.

> "Generally speaking, 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 the extent it is such. The arbitrary lines now dividing corporations into those three distinct classifications should be removed." Report at page 7.

The Report recommended a flexible income allocation formula and rate schedule to be applied to all three types of corporations. Consequently, a corporation would be treated as one of the three (business corporation, investment trust or holding corporation) to the extent its income was derived from the activities of such a corporation. The Report suggested exempting from a tax measured by income the gains from the sale or exchange of stock of a subsidiary, and reducing the tax on subsidiary capital.

The term "subsidiary capital" is defined in section 208.4 of the Tax Law as follows:

> The term "subsidiary capital" means investments in the stock of subsidiaries and any indebtedness from subsidiaries, exclusive of accounts receivable acquired in the ordinary course of trade or business for services rendered or for sales of property held primarily for sale to customers, whether or not evidenced by written instrument, on which interest is not claimed and deducted by the subsidiary for purposes of taxation under articles nine-a, nine-b, nine-c, thirty-two or thirty-three of this chapter, provided, however, that, in the discretion of the tax commission, there shall be deducted from subsidiary capital any liabilities payable by their terms on demand or within one year from the date incurred, other than loans or advances outstanding for more than a year as of any date during the year covered by the report, which are attributable to subsidiary capital.

Section 3-6.3(a) of the Business Corporation Franchise Tax Regulations further defines "subsidiary capital" as follows:

> The term "subsidiary capital" means the total of:
>
> (1) the investment of the taxpayer in shares of stock of its subsidiaries, and
> (2) the amount of indebtedness owed to the taxpayer by its subsidiaries, whether or not evidenced by written instrument, on which interest is not claimed and deducted by the subsidiary for purposes of any tax imposed by articles 9-A, 32 or 33 of the Tax Law....

Petitioner's purchase of forward contracts for the sale of foreign currencies is clearly neither an investment in shares of stock of a subsidiary nor indebtedness owed to the Petitioner by its subsidiaries as such terms are ordinarily understood.

Furthermore, in the Matter of Hoover Co. v. Commissioner, supra, cited by Petitioner, the taxpayer, like Petitioner, entered into forward sale agreements to offset (1) a potential decline in the value of its investment in certain foreign subsidiaries, whose home currencies may be or are devalued relative to the U.S. dollar, and (2) exchange losses required to be reported on petitioner's consolidated financial statement. The court, stated, that:

> Here ... there is no relationship between the currency contracts and the maintenance of stock value or the ability of petitioner's foreign subsidiaries to produce income in the future. The gains and losses from the futures represented a gain or loss to petitioner but had no protective impact on the subsidiaries' operations, their assets, or the value of petitioner's stock holding. If, as petitioner asserts, the stock value goes down after a devaluation, it would go down regardless of these currency transactions and whether gain or loss resulted from them.... (72 T.C. 242).

Thus, rather than lending authority for inclusion of the forward contracts as subsidiary capital, this case clearly establishes that such forward contracts lack the requisite relationship to the stock of the subsidiaries to transform such contracts into subsidiary capital.

Accordingly, the forward contracts for the sale of foreign currencies, entered into by Petitioner solely to protect its net exposure to foreign exchange risk in respect of its investment in affiliated foreign corporations are not attributable to the acquisition of the shares of stock of such affiliated foreign corporations and they do not meet the definition of subsidiary capital as defined in section 208.4 of the Tax Law and section 3-6.3(a) of the Business Corporation Franchise Tax Regulations. Therefore, Petitioner may not include such forward contracts as "investments in the stock of subsidiaries" when computing subsidiary capital pursuant to Article 9-A of the Tax Law.

DATED: January 15,1987

s/FRANK J. PUCCIA
Director
Technical Services Bureau

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.