New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-88 (25)C
Corporation Tax
November 10, 1988

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C880622B

On June 22, 1988, a Petition for Advisor Opinion was received from Peat Marwick Main & Co., 345 Park Avenue, New York, New York 10154.

Issues:

The issues raised pertain to section 1453(f) of Article 32 of the Tax Law and Subpart 18-3 of the Franchise Tax on Banking Corporations Regulations (hereinafter "Regulations") promulgated thereunder, which contain the provisions for an international banking facility ("IBF"). Specifically, the issues are:

1. (a) Under section 18-3.4(d) of the Regulations, does eligible gross income of an IBF include income derived from interest rate exchange agreements entered into with foreign persons, which are recorded on the financial accounts of the IBF, and entered into for the purpose of hedging IBF eligible loans and deposits against interest rate fluctuations; or alternatively,

   (b) Under section 18-3.5 of the Regulations, can the expenses (or negative expenses, when there is a net receipt to Bank X) generated by interest rate exchange agreements that are recorded on the financial accounts of the IBF be treated a[s] direct expenses of the IBF?

2. (a) Under section 18-3.4(d) of the Regulations, does eligible gross income of an IBF include income derived from financial futures contracts which are entered into for the purpose of hedging loans and deposits against interest rate fluctuations; or alternatively,

   (b) Under section 18-3.5 of the Regulations, can the expenses (or negative expenses, when such hedging activities generate a gain to Bank X) generated by financial futures transactions be treated as direct expenses of the IBF; or alternatively,

   (c) Under section 18-3.8 of the Regulations, can the expenses (or negative expenses, when such hedging activities generate a gain to Bank X) generated by financial futures transactions be treated as allocable indirect expenses of the IBF?

3. Would the difference between when a gain or loss on financial futures transactions is recognized under book versus tax reporting rules create any New York State tax implications with regard to the IBF?

Facts:

Assume Bank X is incorporated in a foreign country, but maintains and operates a New York and an International Banking Facility (IBF) branch within the United States.[1] Furthermore, assume that Bank X is a bank as defined under section 1452 of Article 32 of the Tax Law. In computing Bank X's entire net income, a deduction is made for the adjusted eligible net income of its IBF branch. (No election has been made under section 1454(b)(2) to use the IBF formula allocation method.)

Bank X has interest rate exposures because it has short-term variable rate liabilities and longer-term fixed rate financial assets. If interest rates were to rise, Bank X's liabilities would be more costly and the value of its assets would decline. In order to effect asset/liability management with respect to its banking business in both its New York and IBF branches, Bank X enters into interest rate exchange agreements. Under these agreements, Bank X enters into a contract with another party (generally a foreign person), whereby the other party agrees to pay Bank X a variable-rate amount and Bank X agrees to pay the other party a fixed rate amount, each amount determined by reference to a percentage of a notional principal amount specified in the agreement. By these transactions, Bank X is able to, in effect, convert a liability that is held at a fixed rate of interest into a floating rate obligation. In this way, Bank X is able to hedge its assets and liabilities against interest rate fluctuations.

The interest rate exchange agreements that are used to hedge New York branch assets and liabilities are booked in the financial accounts of the New York branch, whereas interest rate exchange agreements that are used to hedge IBF assets and liabilities are booked in the financial accounts of the IBF. Any gains or losses generated by these interest rate exchange agreements are booked in the branch where the agreement generating the gain or loss is booked.

Since these interest rate exchange agreements do not effect a perfect hedge, Bank X also purchases and sells financial futures contracts. These financial futures contracts are matched and intended to work in conjunction with the interest rate exchange agreements to more fully hedge the New York and IBF branches' assets and liabilities against interest rate fluctuations. These

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[1] Petitioner errs in its statement that an IBP is a branch. In section 204.8(a)(1) of the Board of Governors of the Federal Reserve System Regulations, an IBF is defined as "a set of asset and liability accounts segregated on the books and records of a depository institution, United States branch or agency of a foreign bank, or an Edge or Agreement Corporation that includes only international banking facility time deposits and international banking facility extensions of credit."

contracts are agreements to make or take delivery of a specified amount of three month Eurodollar obligations at a specified date or during a specified period under conditions established by the International Monetary Market. They are initially booked on the financial accounts of the New York branch.

Under generally accepted accounting principles, any gains or losses recognized by Bank X upon the sale of the financial futures contracts are deferred and accrued as income or expense over the original term of the futures contracts. For example, if the bank purchases a December 1988 contract in June of 1987 and sells this contract in September 1987, the gain or loss is realized in September 1987. Under generally accepted accounting principles, this gain or loss is amortized over the original term of the contract (i.e., from December 1988 through March 1989). However, for tax purposes Bank X would recognize the gain or loss upon the sale of the financial futures contract (i.e., September 1987 in the above example). This can result in the creation of a timing difference between book and tax income.

After the total net gain or loss on the financial futures hedging activities is determined for the year, Bank X allocates this gain or loss to the New York branch and the IBF. The net hedging gain or loss is then allocated to the IBF under an asset allocation formulas as follows:

> Bank X calculates the total dollar volume of the underlying financial transactions booked in the IBF being hedged by the financial futures contracts for the year. This amount is then divided by the total dollar volume of the financial transactions of the New York branch and IBF being hedged by the financial futures contracts for the year. This ratio is multiplied by the financial futures hedging gains or losses for the year, to arrive at the amount to be allocated to the IBF.

Any such gains or losses allocated to the IBF under this formula are recorded on the books and records of the IBP at year end.

Discussion:

Adjusted eligible net income of an IBF is determined by subtracting from the eligible net income of the IBF the ineligible funding amount and the floor amount. Eligible net income is the amount remaining after subtracting from eligible gross income the expenses applicable to such gross income.

Issue l(a) and 2(a)

Section 1453(f)(2) defines eligible gross income as the gross income derived by an international banking facility from:

(A) making, arranging for, placing or servicing loans to foreign persons, provided, however, that in the case of a foreign person which is an individual, or which is a foreign branch of a domestic corporation (other than a bank), or which is a foreign corporation or foreign partnership which is eighty per centum or more owned or controlled, either directly or indirectly, by one or more domestic corporations (other than banks), domestic partnerships or resident individuals, substantially all the proceeds of the loan are for use outside of the United States;

(B) making or placing deposits with foreign persons which are banks or foreign branches of banks (including foreign subsidiaries or foreign branches of the taxpayer) or with other international banking facilities; or

(C) entering into foreign exchange trading or hedging transactions related to any of the transactions described in this paragraph.

Section 18-3.4(d) of the Regulations states:

> [e]ligible gross income includes gross income derived from foreign exchange trading or hedging transactions that are solely entered into for or directly traceable to any of the transactions described in subdivisions (a), (b) or (c) of this section. [Such transactions are the making, arranging for, placing or servicing loans to foreign persons and the making or placing of deposits with certain foreign persons]. Gross income from foreign exchange trading or hedging transactions related to a deposit (as defined in subdivision (c) of section 18-3.2 of this Subpart) from a foreign person, is eligible gross income when such deposit can be traced directly to a transaction described in subdivision (a), (b) or (c) of this section. A foreign exchange trading or hedging transaction is not solely entered into for or directly traceable to any of the transactions described in subdivision (a), (b) or (c) of this section unless the foreign exchange trading or hedging transaction is recorded in the financial accounts of the IBF. The term "foreign exchange trading or hedging transaction" as used in this subdivision means:
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> (1) the purchase, sale or exchange of foreign currency; or
>
> (2) the acquisition, disposition or performance of any contract to purchase, sell or exchange foreign currency at a future date under terms fixed in the contract if the contract hedges a foreign currency denominated loan or deposit.
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> A forward contract hedges such foreign currency denominated loan or deposit if the effect of a change in the value of the foreign currency on the United States dollar value of the forward contract, either alone or in combination with other such contracts, offsets the effect of the change on the United States dollar value of such foreign currency denominated loan or deposit. A hedging relationship may be

> established by reference to particular facts and circumstances (for example, the amount of the forward contract, particular currency, initial date and maturity) indicating a hedging purpose, or by designating a contract as being intended for the purpose of hedging a loan or deposit.

Herein, interest rate exchange agreements and financial futures contracts are entered into to effect asset/liability management by hedging against interest rate fluctuations. In an interest rate exchange agreement, two parties agree to exchange amounts calculated as though there were interest on specified amounts of liabilities. However, such amounts are not interest because there is no loan or deposit involved in the agreement. No principal is actually exchanged and each party continues to be liable on its own offsetting liability.

The financial futures contracts are matched and work in conjunction with the interest rate exchange agreements. A financial future contract is an agreement to make or take delivery of a specified amount of three month Eurodollar obligations at a specified date or during a specified period under conditions established by the International Monetary Market.

The Regulations specifically state that eligible gross income from foreign exchange trading or hedging transactions is limited to such income derived from "(1) the purchase, sale or exchange of <u>foreign currency</u> or; (2) the acquisition, disposition or performance of any contract to purchase, sell or exchange <u>foreign currency</u> at a future date..." (emphasis added) to the extent that the transaction is solely entered into for or directly traceable to the making, arranging for, placing or servicing loans to foreign persons and the making or placing of deposits with certain foreign persons.

Clearly, the income derived from the interest rate exchange agreements and the financial futures contracts described herein do not constitute foreign exchange trading or hedging transactions. Therefore, the income derived from such interest rate exchange agreements and such financial futures contracts does not constitute eligible gross income for purposes of section 1453(f)(2) of the Tax Law.

<u>Issue l(b) and 2(b) and (C)</u>

Section 18-3.3(c) of the Regulations states:

> [e]xpenses applicable to the eligible gross income of the IBF are those expenses or other deductions (including expenses or other deductions from interoffice transactions) described in sections 18-3.5 through 183.8 of this Subpart that are directly or indirectly attributable to the eligible gross income of the IBF.

Section 18-3.5 of the Regulations describes the direct expenses of the IBF and section 18-3.8 of the Regulations describes the indirect expenses of the IBF.

As stated in the Regulations, only expenses that are directly or indirectly attributable to eligible gross income of the IBF may be subtracted in determining eligible net income. Since the income derived from interest rate exchange agreements and financial futures contracts does not constitute eligible gross income, the expenses attributable to such income, whether direct or indirect, may not be subtracted from eligible gross income when computing eligible net income.

Issue 3

There are no franchise tax implications under Article 32 of the Tax Lay with regard to an IBF as a result of the difference between when a gain or loss, on the financial futures transactions described herein, is recognized under book versus tax reporting rules.

DATED: November 10, 1988

s/FRANK J. PUCCIA
Director
Technical Services Bureau

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