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

TSB-A-98(15)C
Corporation Tax
September 9, 1998

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C980122C

On January 22, 1998, a Petition for Advisory Opinion was received from Private Export Funding Corporation, 280 Park Avenue, New York, New York 10017.

The issue raised by Petitioner, Private Export Funding Corporation, is whether the notes of corporate obligors held by Petitioner are investment capital under section 208.5 of the Tax Law.

Petitioner submits the following facts as the basis for this Advisory Opinion.

Petitioner, a Delaware corporation, located its headquarters in New York and began doing business in 1971. Petitioner was organized with the active support of the United States government in order to engage in the acquisition of medium and long-term fixed interest rate notes of foreign purchasers of United States exports ("Importer Notes"). The Importer Notes are characterized by fixed rates of interest, lengthy disbursement periods and long repayment periods. These Importer Notes carry the unconditional guarantee as to principal and interest of the Export-Import Bank of the United States ("Eximbank") pursuant to a special guarantee entered into between the two parties in 1971 ("PEFCO-Eximbank Guarantee Agreement"). Petitioner participates in the Importer Notes only after Eximbank has determined that alternative financing is unavailable at competitive rates.

Eximbank is an independent agency of the United States government that was founded in 1934 to facilitate and aid in financing exports and imports of products and services between the United States and foreign countries. The Attorney General of the United States stated, in an opinion dated September 30, 1966, that Eximbank's contractual liabilities constitute general obligations of the United States backed by its full faith and credit.

Because it relies entirely on the Eximbank guarantee, Petitioner is not involved in selecting the obligors of the Importer Notes, of monitoring the creditworthiness of the obligors or of taking a significant role in the negotiation of the relevant documentation. Specifically, Petitioner does not have marketing or account executives who approach United States manufacturers of export property or who seek Petitioner's investment in the notes that their customers expect to issue. Since Eximbank guarantees both the principal and the interest on the Importer Notes, Petitioner does not conduct an independent credit review and does not take a security interest in any of the assets of their issuers. Eximbank, rather than Petitioner, determines the requirements for the credit documentation with respect to the Importer Notes. Eximbank historically has dictated the use of its own standardized credit agreement format as a condition of providing its guarantee, and it drafts and negotiates virtually all of the covenants. Since Eximbank is taking the credit risk, the Importer Notes' fixed rates are determined by an Eximbank approved formula.

A typical Importer Note (credit agreement) provides that Petitioner has established an export financing credit pursuant to which Petitioner shall extend financing to the borrower. The availability of the Eximbank guarantee pursuant to the terms and conditions of the PEFCO-Eximbank Guarantee Agreement dated as of December 15, 1971, as modified, is a condition to Petitioner's extension of the credit. The Importer Note is signed by the borrower, Petitioner and Eximbank.

When Petitioner is required to disburse funds in accordance with the terms of an Importer Note, it typically obtains such funds by selling its own long-term secured notes (or, on certain occasions for temporary financing, by selling short-term commercial paper or by borrowing under a syndicated credit facility). Petitioner's long-term secured notes are guaranteed as to interest by Eximbank and are issued under a trust indenture that stipulates that the collateral backing such secured notes (primarily consisting of the Eximbank-guaranteed Importer Notes) must equal not less than 100 percent of the secured obligations outstanding. As a result, Petitioner states that it has a thin profit margin (i.e., the difference between the interest rate on the Importer Notes and the rate of interest on Petitioner's long-term secured notes).

Petitioner states that the relatively passive nature of its investment operations, as described above, is amply illustrated by its limited staffing requirements. Although Petitioner had approximately $3 billion of investments at December 31, 1997, it employed only 13 people (six professionals and seven support staff), none of whom are lending officers, credit analysts or support staff typically employed by lending institutions.

A letter from the Department of Taxation and Finance dated October 26, 1970, prior to Petitioner's commencement of active business in New York State, concluded that the Importer Notes of corporate obligors held by Petitioner would be investment capital as defined in section 208.5 of the Tax Law, as in effect in 1970.

In the entire 27 years since its organization, Petitioner has conducted its operations substantially as described above. During that time, Petitioner has invested in approximately $10 billion of Importer Notes.

Discussion

Section 208.5 of the Tax Law provides that the term "investment capital" means investments in stock, 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, provided, however, that, in the discretion of the commissioner, there shall be deducted from investment capital any liabilities which are directly or indirectly attributable to investment capital.

Section 3-3.2(c) of the Business Corporation Franchise Tax Regulations ("Regulations") states that "the phrase *stock, bonds and other securities*, means:

... (3) qualifying corporate debt instruments ..."

Section 3-3.2(d)(1) of the Regulations defines the term *qualifying corporate debt instruments* as all debt instruments issued by a corporation other than the following:

> ... (iv) instruments acquired for funds if:
>
> (*a*) the obligor is the recipient of such funds;
>
> (*b*) the taxpayer is principally engaged in the business of lending funds; and
>
> (*c*) the obligation is acquired in the regular course of the taxpayer's business of lending funds; ....

Section 3-3.2(d)(2) of the Regulations provides that for purposes of this subdivision, a taxpayer is *principally engaged in the business of lending funds* if during the taxable year more than 50 percent of its gross receipts consist of interest from loans or net gain from the sale or redemption of notes or other evidences of indebtedness arising from loans made by the taxpayer. For purposes of the preceding sentence, receipts do not include return of principal or nonrecurring, extraordinary items.

Accordingly, section 3-3.2 of the Regulations specifically excludes corporate debt instruments from investment capital if the instruments are acquired by a taxpayer, which is principally engaged in the business of lending funds, in the regular course of the taxpayer's business, provided that the obligor is in receipt of the loan funds.

The provisions of section 3-3.2 of the Regulations (formerly section 3-4.2 renumbered effective October 27, 1993)as amended in 1989, are structured so as to give presumably preferential treatment to portfolio assets. Therefore, the exclusion from investment capital contained in section 3-3.2(d)(1)(iv) of the Regulations was created because a taxpayer principally engaged in the business of lending funds has not made a portfolio investment in a debt instrument when it acquires a debt instrument from the recipient of such funds where the recipient is the obligor on the debt instrument. (See, Deloitte & Touche, Adv Op Comm T&F, September 5, 1995, TSB-A-95(15)C.)

The PEFCO-Eximbank Guarantee Agreement constitutes a part of an arrangement designed to utilize, for the financing of export transactions, certain sources of private capital which traditionally limit themselves to long-term investments. Petitioner established a pool of obligations issued by foreign importers to United States exporters bearing Eximbank's direct and unconditional guaranty as to principal and interest (the Importer Notes). Against this pool Petitioner issues its securities fully backed by a pledge of Importer Notes.

In this case, Petitioner dispenses the funds with respect to the Importer Notes, but Eximbank has control over the investments made by Petitioner. Petitioner is not involved in selecting the obligors of the Importer Notes. Eximbank determines the requirements for the credit documentation with respect to the Importer Notes. The Importer Notes' fixed rates are determined by an

Eximbank approved formula. Eximbank dictates the use of its own standardized credit agreement format as a condition of providing its guarantee, and it drafts and negotiates virtually all of the covenants. Eximbank, as well as the borrower and Petitioner, sign the Importer Notes.

Under the unique circumstances in this case, Petitioner is a specialized lender of funds. However, since Eximbank has control over the Importer Notes, these Importer Notes are not considered loans made by Petitioner for purposes of section 3-3.2(d)(2) of the Regulations. Therefore, Petitioner is not engaged in the "business of lending funds" as contemplated in section 3-3.2(d)(1) of the Regulations. Accordingly, the Importer Notes constitute qualifying corporate debt instruments pursuant to section 3-3.2(c)(3) of the Regulations, and Petitioner's investment in the Importer Notes continues to constitute investment capital pursuant to section 208.5 of the Tax Law.

DATED: September 9, 1998

/s/
John W. Bartlett
Deputy Director
Technical Services Bureau

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