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

TSB-A-88 (6)C
Corporation Tax
March 17, 1988

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C871113A

On November 13, 1987, a Petition for Advisory Opinion was received from Dai-ichi Seimei America Corporation, 350 Park Avenue, New York, New York 10022.

Issues

1. Is interest income received on loans made to partnerships "business income" or "investment income" for purposes of the New York State Franchise tax under Article 9-A of the Tax Law?

2. If such interest income is considered to be "business income", prior to a merger would such interest income be New York source receipts for purposes of the receipts factor of the business allocation formula?

3. If such interest income is considered to be "business income", subsequent to a merger would such interest income be New York source receipts for purposes of the receipts factor of the business allocation formula?

4. If such interest income is New York source receipts for purposes of the receipts factor of the business allocation formula either before or after the merger, is it appropriate to modify the business allocation formula under these circumstances to reduce the adverse impact such treatment will have on Petitioner's New York Franchise Tax computation?

Facts

Petitioner is a Delaware corporation, qualified to do business in New York. Prior to September 15, 1987, Petitioner and Dai-ichi Seimei Fund Management, Inc. ("DSF"), a New York corporation, were both wholly-owned subsidiaries of a Japanese parent corporation. On September 15, 1987, Petitioner became a wholly-owned subsidiary of DSF.

Prior to September 23, 1987, Dai-ichi Seimei America Corporation ("DSA") was a New York corporation but had no employees in New York. It had employees at its office in Minneapolis, Minnesota (which was closed at the end of March, 1987) and at its office in Los Angeles, California.

For valid business reasons not connected with the issues to be considered herein, DSA was merged into Petitioner, effective September P3,]987 ("Merger Date"), and the separate corporate existence of DSA ceased. Immediately thereafter, Petitioner qualified to do business in New York. For federal income tax purposes, the merger qualifies es an "F" reorganization under section 368(a)(1)(F) of the Internal Revenue Code of 1986, as amended ("IRC").

Petitioner currently maintains an office in New York and has two officers at that office. It also maintains an office in Los Angeles, California where it has two officers and an additional employee, and where it presently keeps its books and records. (It is anticipated that, prior to the end of 1987, one of these officers will move to the New York office and that the books and records of Petitioner will then be maintained in New York.)

Petitioner is and prior to the merger date DSA was in the business of investing funds in real estate ventures by way of convertible loans or participating loans ("Loans") and equity investments. Prior to the Merger Date, DSA had made five loans, all of which were to out-of-state partnerships that owned real property located outside of New York. All of its equity investments were also made in real property located outside of New York. As of the present time, Petitioner owns no real property located in New York, either directly or indirectly, although, subsequent to the Merger Date, it has contracted for the acquisition of certain New York real property. No Loans have been made subsequent to the Merger Date.

Of the five Loans, four were made by DSA jointly with various pension trusts for whom Morgan Guarantee Trust Company of New York ("Morgan") acts as trustee, and one was with the Equitable Life Assurance Society of the United States ("Equitable"). The Loans were each made to a different out-of-state partnership in which unrelated third parties (corporations and/or individuals and/or other partnerships) were the general and/or limited partners. In connection with each of the Loans, Morgan and Equitable, respectively, represented DSA in connection with various aspects of the Loans in which they were involved, pursuant to various participation agreements.

The agreements with Morgan consisted of an Investment Management Agreement dated April 26, 1983, which was executed by Morgan and DSA's Japanese parent company, and a separate participation agreement for each of the four Loans, executed by Morgan and DSA and approved by DSA's Japanese parent company. Pursuant to the Investment Management Agreement, Morgan agreed to look for investment opportunities for DSA and to act as agent for DSA in the acquisition of such investment opportunities and in the subsequent management of the investments. DSA's participation in such investment opportunities was to be on a 50:50 basis with other investors for which Morgan acted as trustee or agent. If DSA decided to make the investment, it would notify Morgan to proceed on its behalf. The Investment Management Agreement provided that Morgan would retain certain documents, such as the deeds, notes, mortgages and other title and security documents, in trust for DSA and would otherwise administer the investment, for which it would receive an annual management fee.

Four participation agreements were executed between DSA and Morgan, one in 1983 (and subsequently amended in 1984), one in 1984 and two in 1986. Each participation agreement was governed by New York].aw. However, DSA's decision to participate in each of the Loans was made by its officers and directors located outside of New York. Pursuant to each participation agreement (which generally contain the same provisions), Morgan executed the loan and other related documents on behalf of DSA. Except for the notes, mortgages, option agreements and other title and

security agreements, all closing documents are executed in duplicate and DSA retains its copies at its office in Los Angeles. As for the enumerated documents, Morgan retains these documents at its offices in New York. Until recently, Morgan received payments of interest and principal on each Loan and deposited DSA's share in an account DSA maintained with Morgan in New York for this purpose. Upon instruction, such funds were transferred to DSA's bank account in Los Angeles. At the present time, Morgan, immediately upon receipt, transfers Petitioner's share, previously DSA's share, of such payments to Petitioner's bank account in Los Angeles.

The participation agreement between DSA and Equitable was executed in June, 1987. Pursuant to this agreement, DSA participated with Equitable on a 50:50 basis in a loan made by Equitable to a Texas general partnership. Equitable holds all loan and other documents in New York, collects payments of interest and principal in New York on its own behalf and on behalf of DSA and immediately transfers DSA's share into a bank account maintained by DSA in New York to facilitate the arrangement, where it is immediately re-transferred to DSA's bank account, now Petitioner's account, in Los Angeles. As in the case of the Morgan Loans, this arrangement whereby Equitable retains the documents and makes collection in New York was required by Equitable if DSA was to participate, and was not done at the request of DSA.

DSA has filed its New York State Franchise tax reports for the taxable years ended December 31, 1984, 1985 and 1986, and an estimated final report through the Merger Date by treating the interest income from the participating Loans as non-New York source income, thereby excluding such income from the numerator of the business receipts factor. Petitioner wishes to assure itself that such position is in accord with New York State Franchise tax law before the Merger Date, and that such position is in accord with New York State Franchise tax law after the Merger Date.

Discussion

Business income is defined in section 208.8 of the Tax Law as entire net income minus investment income. Investment income is defined in section 208.6 of the Tax Law as income from investment capital to the extent included in the computation of entire net income less certain deductions.

Investment capital is defined in section 3-4.2 of the Business Corporation Franchise Tax Regulations ("regulations") as the total of the average fair market value of the taxpayer's investments in stocks, bonds and other securities issued by any corporation (other than the taxpayer, a subsidiary or a DISC) or by the United States, any state, territory or possession of the United States, the District of Columbia, or any foreign country, or any political subdivision or governmental instrumentality of any of the foregoing. Investment capital does not include stocks, bonds and other securities held by the taxpayer for sale to customers in the regular course of business nor does it include investments in securities of an individual, partnership, trust or other nongovernmental entity which is not a corporation. "Other securities" are limited to securities issued by governmental bodies and securities

issued by corporations of a like nature as stocks and bonds, which are customarily sold in the open market or on a recognized exchange, designed as a means of investment, and issued for the purpose of financing corporate enterprises and providing a distribution of rights in, or obligations of, such enterprises.

Section 3-4.3 of the regulations provides that business capital is the total average fair market value of all the taxpayer's assets, exclusive of treasury stock or assets constituting subsidiary capital or investment capital, less certain liabilities. Subdivision (d) of such section further provides that investments in securities of an individual, partnership, trust or other nongovernmental entity which is not a corporation shall be treated as business capital.

Article 9-A and the regulations provide that investment income must be derived from investment capital. Therefore, it must be determined whether the Loans constitute investment capital or business capital. Each Loan is a participating loan made to a partnership by DSA prior to its merger into Petitioner. Since a loan made to a partnership does not meet the definition of investment capital under Article 9-A, the Loans made by DSA constitute business capital and the income derived therefrom is business income of DSA.

Section 4-1.1 of the regulations provides that generally business income and business capital are allocated by the business allocation percentage determined by a three-factor formula consisting of: property, payroll and receipts. Subpart 4-4 of the regulations provides the rules for determining the receipts factor of such percentage.

Section 210.3(a)(2)(D) of the receipts factor provides that the numerator of the receipts factor includes "other business receipts" (e.g., other than from sales of tangible personal property, the performance of services, and from rents and royalties) "earned within the state." The interest income here in question falls within the category of "other business receipts."

In CIT Financial Corporation, State Tax Commission Advisory Opinion, March 8, 1983, TSB-A-83(7)C, it was determined that the precise portion of interest income from a loan that is to be included in the numerator of the receipts factor is a question of fact not susceptible of determination in an Advisory Opinion. An Advisory Opinion merely sets forth the applicability of pertinent statutory and regulatory provisions to "a specified set of facts." Tax Law, §171, subd. twenty-fourth; 20 NYCRR 901.1(a). However, the opinion does give guidance in making such determination by stating that where the labor needed to establish and maintain (make and service) a loan J s performed at more than a minimal level, in both New York and another state, the interest income derived from such loan is "earned within" both New York and such other state. To determine what portion of the income is attributable to New York, consideration should be given to such activities as solicitation, investigation, negotiation, approval and administration. The activity of loan approval can be of negligible import; as where it is merely pro forma, or of the highest importance, depending upon the circumstances of any given loan transaction. As stated in Walter E. Heller & Co., Decision of the State Tax Commission, September 19, 1980, TSB-H-80(29)C, "[i]t is the situs

where...the financing...[is] performed which is determinative of whether the receipts are includible in the numerator of the receipts factor .... "

Accordingly, where the activities conducted in connection with a Loan transaction were performed both within and without New York State, the portion of the interest income attributable to such loan that is properly includible in the numerator of the receipts factor of DSA is a question of fact and as such can not be determined within the context of an Advisory Opinion, but may be determined by applying the above guidelines to the circumstances of the particular Loan.

Where DSA has an Investment Management agreement with Morgan, whereby Morgan acted as an agent for DSA in the acquisition of its investments, Morgan's activities as well as DSA's activities attributable to a particular loan must be considered when applying the guidelines. In the case of the participation loan with Equitable, it appears that DSA merely purchased a portion of a loan made by Equitable and that Equitable was not acting as agent for DSA when Equitable made the loan. Therefore, when applying the guidelines to this loan, only DSA's activities in connection with the loan should be considered.

It should be noted that the guidelines provided are broad in nature, by necessity, because of the complex and varying characteristics of loans. Therefore, Petitioner should maintain documentation to substantiate determination of the amount of interest income from loans that is includible in the numerator of the receipts factor.

Pursuant to section 208.9 of the Tax Law, entire net income is computed by starting with the entire taxable income required to be reported for federal income tax purposes and making the modifications required by such section. Since there is no modification required when a reorganization occurs under section 368(a)(1)(F) of the IRC, such reorganization would, for purposes of section 208.9, be treated the same as it was treated for federal income tax purposes. In addition, the treatment accorded a particular item of income prior to a tax-free reorganization under section 368(a)(1)(F) of the IRC would not change because of such reorganization.

Accordingly, after the reorganization, the Loans would continue to constitute business capital of Petitioner and the interest income from the Loans would be business income of Petitioner. Such interest income would be sourced in New York State after the reorganization to the same extent as it was sourced in New York State before the reorganization. Therefore, Petitioner would include interest income from the Loans in the numerator of the receipts factor to the same extent as DSA included interest income in its receipts factor prior to the reorganization.

Since the interest income at issue constitutes business income both before and after the Merger Date, Petitioner requests that the business allocation percentage be modified to reduce the adverse impact such determinations will have on its tax computation.

Section 210.8 provides that

> If it shall appear to the tax commission that any business.., allocation percentage determined as herein above provided does not properly reflect the activity, business, income or capital of a taxpayer within the state, the tax commission shall be authorized in its discretion, in the case of a business allocation percentage, to adjust it by (a) excluding one or more of the factors therein, (b) including one or more other factors,... (c) excluding one or more assets ....

However, the question of whether a discretionary adjustment should be granted in the present case is a question of fact dependent upon Petitioner's specific facts and not easily resolved within the context of this advisory opinion.

Accordingly, any modification to Petitioner's business allocation percentage will be determined in a separate proceeding based upon Petitioner's specific circumstances.

DATED: March 17, 1988

s/FRANK J. PUCCIA
Director
Technical Services Bureau

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