

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

TSB-M-90 (4) C
Corporation Tax
July 13, 1990

Amendments to Article 9-A Regulations
Concerning Investment Capital and Investment Income

On November 16, 1989, the Commissioner of the Department of Taxation and Finance adopted amendments to the Business Corporation Franchise Tax Regulations to update those provisions concerning the nature and treatment of investment capital and investment income. The amended regulations deal with the treatment of various financial instruments such as futures contracts and forward contracts, repurchase agreements, money market mutual funds and stock options.

Generally, the amendments made by this regulation apply to taxable years beginning on or after January 1, 1990. However, the amendments which classify options as investment capital, and which classify as investment income the income from certain futures and forward contract transactions, income from certain short sales and premium income from certain unexercised covered call options, apply only to positions taken in taxable years beginning on or after January 1, 1990, except for any section 1256 contract which is marked to market pursuant to section 1256(a) of the Internal Revenue Code on the last business day of the taxpayer's taxable year immediately preceding its first taxable year beginning on or after January 1, 1990.

In general, investment capital is defined as the taxpayer's investments (including items held in book entry form) in stocks, bonds, and other securities issued by a corporation or by any governmental entity.

The phrase "stocks, bonds and other securities" includes: stocks; and similar corporate equity instruments such as units in certain publicly traded partnerships; debt instruments issued by a governmental entity; qualifying corporate debt instruments; options on the foregoing or on a stock or bond index or on a futures contract on such an index unless the option hedges the taxpayer's business or subsidiary capital; stock rights and stock warrants.

The amended regulations include a change that allows certain short-term investments to be treated as cash, cash may be treated at the taxpayer's election as either investment capital or business capital.

The taxpayer may elect to treat cash on hand or on deposit as investment capital if it has investment capital or as business

capital if it has business capital. A taxpayer may not elect to treat part of its cash as business capital and part as investment capital. No election to treat cash as investment capital may be made where the taxpayer has no other investment capital. Cash includes cash on hand and on deposit, shares in a money market mutual fund and certain short-term debt instruments described below.

Any debt instrument which otherwise qualifies as investment capital, including a certificate of deposit, a debt instrument of a governmental entity and a qualifying corporate debt instrument, which is payable by its terms on demand or within six months and one day from the date on which the debt was incurred is deemed to be cash on hand or on deposit. Any such debt instrument which is payable by its terms more than six months and one day from the date on which the debt was incurred is deemed to be cash on hand or on deposit on any day which is not more than six months and one day prior to its day of maturity.

A governmental entity includes 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.

Qualifying corporate debt instruments are all debt instruments issued by a corporation other than:

1. instruments issued by the taxpayer or a DISC;
2. instruments which constitute subsidiary capital in the hands of the taxpayer;
3. instruments acquired by the taxpayer for services rendered or for the sale or rental of property where the recipient of the services or property is the obligor on that debt instrument. However, investment capital includes instruments acquired by the taxpayer for the sale or transfer of property which is investment capital in the hands of the taxpayer (e.g., stock) if the instrument received is not otherwise excluded from investment capital;
4. instruments acquired for funds if the obligor is the recipient of the funds, the taxpayer is principally engaged in the business of lending funds and the instrument is acquired by the taxpayer in the regular course of the taxpayer's business of lending funds. A taxpayer is principally engaged in the business of lending funds if more than 50 percent of the taxpayer's 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, excluding return of principal and non-recurring extraordinary items;

5. accepted drafts (e.g., bankers acceptances) where the taxpayer is the drawer of the draft;

6. instruments issued by a member of the taxpayer's affiliated group. The term "affiliated group" means a corporation or corporations and the common parent of such corporation or corporations. The "common parent" of a corporation or corporations means an individual, corporation, partnership, trust or estate who or which owns or controls, either directly or indirectly, at least 80% of the voting stock of such corporation or of each of such corporations. An affiliated group also includes all other corporations at least 80% of the voting stock of which is owned or controlled, either directly or indirectly, by one or more of the corporations included in the affiliated group, or by such common parent and one or more the corporations included in the affiliated group; and

7. accounts receivable.

Items that are not included in investment capital are:

1. stocks issued by the taxpayer;

2. stocks, bonds or other securities constituting subsidiary capital;

3. securities of an individual, partnership, trust or other nongovernmental entity which is not a corporation (as such term is defined in Article 9-A), such as FNMA or GNMA pass-through certificates;

4. stocks, bonds and any other securities of a DISC, or any indebtedness from a DISC;

5. regular and residual interests in a REMIC;

6. futures contracts and forward contracts; and

7. stocks, bonds and other securities held by the taxpayer for sale to customers in the regular course of its business.

The amended regulations deal with the treatment of repurchase agreements. In a transaction between one party (the seller/borrower) and a second party (the purchaser/lender) the nature of the agreement will determine if the purchaser/lender will have in fact purchased the securities or if the transfer of funds to the seller/borrower will in fact constitute a loan collateralized by the securities. If the transaction is considered a sale of securities which constitute investment capital, the securities will constitute investment capital in the hands of the purchaser/lender. If the transaction is considered a collateralized loan, the debt instrument (which is issued by the seller/borrower) must be analyzed to determine whether it constitutes investment capital (e.g., whether it is a qualified corporate debt instrument), business capital, subsidiary capital or cash on hand or on deposit. The regulations contain a nonexclusive list of features of a transaction which can be used to determine if the transaction is a sale of securities or a collateralized loan.

The definition of business capital, section 3-4.3, subdivisions (d) and (e), is amended to provide that futures and forward contracts are not business capital, and to include a provision conforming to the definition of investment capital with regard to the items deemed to be cash on hand or on deposit which the taxpayer may elect to treat as investment capital or business capital. A taxpayer may not elect to treat part of its cash as business capital and part as investment capital. No election to treat cash as business capital may be made where the taxpayer has no other business capital.

The definition of investment income is amended to account for integrated transactions involving items of investment capital. Generally, investment income will include the gain or loss from futures contracts or forward contracts if they are entered into in order to substantially diminish the taxpayer's risk of loss from holding assets constituting investment capital or from making short sales of assets which constitute investment capital. Investment income also includes the gain or loss from selling investment capital short and premium income from an unexercised covered call option if the item which covers the call is investment capital. Investment income does not include the gain or loss from futures contracts or forward contracts which are not reasonably necessary to substantially reduce the taxpayer's risk of loss from holding positions in assets constituting investment capital or from making short sales of assets which constitute investment capital.

The issuer's allocation percentage of an option is the entity which is the issuer of the item which is the subject of the option. The issuer's allocation percentage with respect to an option on a stock or bond index, or an option on a futures contract on such an index, will be calculated by the Department in such a manner as reasonably to indicate the economic presence in New York State of the issuers of and obligors on the stocks, bonds or other securities included in the computation of the index. See TSB-M-90(3)C for information on issuers or obligors subject to tax under Articles 9, 9-A, 32 or 33.

The effect of amended regulations on previous Technical Service memoranda is as follows:

TSB-M-78(6)C (Rev.) is obsolete for taxable years beginning on or after January 1, 1990. The new regulations provide that a debt instrument acquired by the taxpayer for services rendered or property received, where the obligor is the recipient of the services or property, is not investment capital.

TSB-M-82(20)C is modified for taxable years beginning on or after January 1, 1990. Investments in regulated investment companies (money market funds or mutual funds) are cash and the taxpayer may elect to treat cash as investment capital or business capital. Dividends received from regulated investment companies are still eligible for the 50 percent exclusion (Tax Law Section 208.9(a)(2)) in determining entire net income.