REGULATORY IMPACT STATEMENT

DEPARTMENT OF TAXATION AND FINANCE

1. Statutory authority: Tax Law, sections 171, subdivision First; and 1096(a). Section 171, Subdivision First, provides for the Commissioner to make reasonable rules and regulations, which are consistent with law, that may be necessary for the exercise of the Commissioner's powers and the performance of the Commissioner's duties under the Tax Law. Section 1096(a) authorizes the Commissioner to make such rules and regulations as are necessary to enforce the New York State Franchise Tax on Business Corporations imposed by Article 9-A of the Tax Law.

2. Legislative objectives: The rule is being proposed pursuant to such authority and in accordance with the legislative objectives that the Commissioner administer the provisions of the Tax Law by interpreting how the business corporation franchise tax applies to repurchase agreements and securities lending agreements held by registered securities brokers and dealers. Specifically, as described in section 3, below, the rule interprets provisions of section 208 of Article 9-A of the Tax Law regarding investment capital and business capital. The rule also provides guidance on the application of receipts factor rules applicable to registered brokers and dealers contained in section 210.3(a)(9) of Article 9-A.

3. Needs and benefits: This rule sets forth what the Department views as a better interpretation of the application of certain Tax Law provisions to repurchase agreements and securities lending agreements held by a registered securities broker or dealer and provides consistent treatment for these similar agreements. The interpretation is based on a better understanding of these underlying transactions acquired through research and extensive discussions with industry members and their representatives over the course of several years. This rule also addresses the allocation of the income from such agreements under statutory receipts factor rules applicable to registered securities brokers and dealers.

The business corporation franchise tax imposed by Article 9-A of the Tax Law distinguishes investment capital and investment income from business capital and business income. Investment capital and investment income are allocated to New York according to the taxpayer's investment allocation percentage. Business capital and business income are allocated to New York according to its business allocation percentage. Since the business allocation percentage typically exceeds the investment allocation percentage, it is generally advantageous to a taxpayer to classify assets and income as investment capital and investment income rather than business capital and business income.

Under section 208.6 of the Tax Law, investment income is income from investment capital less, among other things, in the discretion of the Commissioner, any deductions allowable in computing entire net income (which is federal taxable income with certain modifications) that are directly or indirectly attributable to investment capital or investment income. Section 208.5 of the Tax Law defines investment capital, in part, as "investments in stocks, bonds and other securities". Business income means entire net income minus investment income (Tax Law, section 208.8). Cash on hand and on deposit may be treated as investment capital or as business capital as the taxpayer elects (Tax Law, section 208.7(a)). If it is treated as investment capital, the income therefrom is investment income; if it is treated as business capital, the income therefrom is business income.

A rule adopted in 1989 allowed certain short-term debt instruments to be characterized as cash on hand or on deposit subject to the election to be treated as investment capital. That rule allowed short-term repurchase agreements to be classified as cash and thus qualify for the election. A repurchase agreement is a transaction by which one party agrees to sell securities to a second party and simultaneously agrees to repurchase the same or substantially identical securities from that party at a later date. Although a purchase and repurchase in form, the current rule recognizes that, in substance, the transaction may in certain circumstances be considered a loan collateralized by the securities with the purchaser serving as a lender holding a debt instrument (the

purchaser/lender is often described as holding a reverse repurchase agreement). The agreements are usually for a short period of time.

Audits of securities brokers and dealers have shown that many have treated their cash, including qualifying reverse repurchase agreements, as investment capital. As a result, interest income from a reverse repurchase agreement gives rise to investment income. They have given similar treatment to securities lending agreements, which are not specifically addressed in the existing rule. A securities lending agreement is a transaction in which, by its terms, one party (the securities lender) transfers stock or other securities in exchange for "collateral," usually cash. The second party (the securities borrower) promises to return the same or substantially identical securities at a later date and the securities lender usually promises to return the cash plus interest to the securities borrower. While treating the income from reverse repurchase agreements and securities lending agreements as investment income, many brokers and dealers have deducted expenses related to these activities from business income rather than from investment income. This has resulted in an understatement of business corporation franchise tax.

The Department worked with the industry and the New York City Department of Finance, which administers similar provisions in its General Corporation Tax, to address the proper State and City tax treatment of these transactions. In June 2004, the State and City provided the industry with a document described as a "Vision for Investment Income and Capital." The document suggested that the rules should be amended to treat reverse repurchase agreements as business capital thus giving rise to business income and expenses and also to clarify that securities lending transactions likewise give rise to business income and expense. In September 2004, the New York City Department of Finance issued a Statement of Audit Procedure (SAP) setting forth the interpretation of current rules. The SAP indicated that the income and expense arising from securities lending transactions are business income and expenses. While recognizing that reverse repurchase agreements could qualify as cash on hand or on deposit subject to the election to be treated as investment capital, the SAP

indicated that interest expense related to this activity (namely, from repurchase agreements in which the taxpayer is the seller/ borrower) had to be matched to and deducted from the income from reverse repurchase agreements. The Department did not issue similar guidelines, but indicated in conversations with the industry that it subscribed to the interpretation. In 2006 the Department sent the industry a document, known as the "settlement paradigm", outlining a specific methodology for the matching of interest expense from repurchase agreements in which the taxpayer is the seller/borrower to interest income from reverse repurchase agreements.

Through this process, the Department has gained a better understanding of the way registered securities brokers and dealers use repurchase agreements and securities lending agreements in their business. The two types of agreements are very similar and a better interpretation treats them similarly. Also, the securities transferred to the purchaser in the repurchase agreement and to the securities borrower in the securities lending agreement typically may be transferred to third parties. These activities are a core part of a securities broker or dealer's business. For example, a securities broker or dealer uses the securities acquired in these transactions to cover short sales. As a result, the Department believes that a better interpretation of the statute is to characterize repurchase agreements and securities lending agreements as business capital.

4. Costs:

(a) Costs to regulated parties: The rule does not impose any new reporting, recordkeeping or other compliance costs on regulated parties. The change in interpretation of the statute may have an impact on the tax liability of particular taxpayers. This is a function of what the Department believes is a better interpretation of the statutory provisions and the particular circumstances of the taxpayer. The Department has determined that ultimately there is no measurable tax liability impact on an industry-wide basis between the interpretation of the current rule, with a proper matching of expenses to income, and this rule. The rule would facilitate voluntary compliance by providing a better interpretation of the business and investment capital provisions of the statute.

This would lead to the appropriate matching of business income and expenses as well as investment income and expenses.

(b) Costs to the agency and to the State and local governments for the implementation and continuation of this rule: It is estimated that the implementation and continued administration of this rule will not impose any costs upon this agency, New York State, or its local governments. The Department has determined that there is no measurable fiscal impact between interpretation of the current rule and this rule.

(c) Information and methodology: These conclusions are based upon an analysis of the rule by the Department's Office of Tax Policy Analysis, Office of Budget and Management Analysis, and Management Analysis and Project Services Bureau. The Department measures the tax liability and fiscal impact of the rule by applying the revenue that would result from the application of the current interpretation known to the industry (see Needs and Benefits) and comparing it to the revenue that would result from the proposed rule. When income and expense are appropriately matched, the results of treating repurchase agreement income and repurchase agreement expense as either business income and expense or investment income and expense are nearly identical. Since the difference or spread between the expenses associated with repurchase agreements and securities lending agreements and the earnings associated with the rate of return on these agreements is extremely small, if the specific methodology for direct matching is employed, whether this extremely small amount of income is treated as business income or investment income is a matter of little tax effect within the context of the income of registered securities brokers and dealers. The Department estimates that the tax effect is too small to reliably measure.

5. Local government mandates: The rule imposes no mandates upon any county, city, town, village, school, district, fire district, or other special district.

6. Paperwork: The rule imposes no reporting requirements, forms or other paperwork upon regulated parties beyond those required by existing law and regulations.

7. Duplication: There are no relevant rules or other legal requirements of the Federal or State governments that duplicate, overlap, or conflict with this rule.

8. Alternatives: In lieu of this rule, the Department could refrain from proposing a rule and continue with its current policy of allowing short-term repurchase agreements to be classified as cash and thus qualifying for the election to be treated as investment capital and treating all securities lending agreements as business capital. Currently, the income and expense associated with repurchase agreements are, because taxpayers usually elect to treat cash as investment capital, investment income and expense and the income and expense associated with securities lending agreements are business income and expense. The Department has concluded that both of these agreements are used by registered securities brokers and dealers in their core business operations and thus, both are business capital.

Another alternative considered by the Department was to allow both repurchase agreements and securities lending agreements held by registered securities brokers and dealers to be classified as cash and to require the income to be correctly matched with the expenses that generate the income. After learning more about these transactions, as engaged in by registered securities brokers and dealers, the Department concluded that both of these agreements are used by registered securities brokers and dealers in their core business operations and thus, both are business capital. Therefore, this alternative was not pursued.

An industry group suggested a proposal similar to the one mentioned in the previous paragraph. This proposal maintained that repurchase agreements and securities lending agreements should be treated as cash, but suggested a new method of matching expenses with income. Specifically, the industry suggested that the amount of expenses matched against the income should be reduced by amounts attributed to cash generated without interest expense and to equity. The alternative was not selected for the reasons described in the previous paragraph and because of administrative considerations.

9. Federal standards: The rule does not exceed any minimum standards of the Federal government for the same or similar subject area.

10. Compliance schedule: The amendments will take effect when the Notice of Adoption is published in the State Register and shall apply to reports required to be filed, without regard to extensions of time to file, on or after January 15, 2008.