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STATEMENT OF AUDIT PROCEDURE

BANK TAX TRANSACTIONS BETWEEN AN IBF AND SHELL OF THE TAXPAYER

I. BACKGROUND

This procedure addresses the proper tax treatment of transactions between a taxpayer's international banking facility (IBF) and certain of its off-shore facilities (the shell) under the Banking Corporation Tax Law (Article 32 of the Tax Law)¹.

What is a shell?

- Under this procedure, a shell is typically an operation identified by the taxpayer as being carried on outside the United States that is neither a "bona fide office" as defined by §1-2.8 of the New York City Bank Tax Regulations (20 NYCRR § 16-2.8) or a "branch" as defined in §1-2.9 [16-2.9] of such regulations. (A taxpayer may have more than one shell.)
- In the taxpayer's books and records, a shell may be either reflected separately or as part of a bona fide office or a branch.
- Also a shell operation is one where none or nearly none of the activities associated with making the loans or maintaining the deposits, which are booked for the shell were actually conducted at the shell. Even though a shell may be recognized as a branch for certain bank regulatory purposes, it is not a branch for purposes of the bank tax.

¹ References in brackets are to comparable New York State law, regulations, officials, etc.

Where the taxpayer makes the IBF modification provided in Administrative Code § 11-641 (f) (Tax Law §1453 [f]), the issues are whether the transactions between the IBF and the shell generate eligible gross income and whether they constitute ineligible funding.

This statement of audit procedure addresses how this issue will be handled upon audit. This procedure, as an audit guideline, is being simultaneously issued by the Audit Division of the New York State Department of Taxation and Finance.

II. PROCEDURE

- To determine whether an item of gross income of an IBF qualifies as eligible gross income, Finance needs to know, among other things, whether the gross income derived by the IBF is from making, arranging for, placing or servicing loans to foreign persons or from making or placing deposits with foreign persons.
- To determine whether a liability or other source of funds of an IBF constitutes ineligible funding, Finance must know whether the liability or other source of funds is not owed to or received from a foreign person.
- The term "foreign person" is defined in law. (Administrative Code, § 11-641 [f][8]; Tax Law, § 1453 [f] [8]). A "foreign branch of a domestic corporation (including the taxpayer)" is included within the definition of foreign person.
- Since a shell is not recognized as a branch for New York City [State] bank tax purposes, loans made by an IBF to a shell and deposits an IBF places with a shell do not generate eligible gross income. In addition, any liability or other source of funds an IBF receives from a shell constitutes ineligible funding. However, an auditor may, upon authorization, treat a shell as an extension of all of the branches (as such term is defined in regulations § 1-2.9 [20 NYCRR 16-2.9] of the taxpayer and use the following methodology in auditing a banking corporation.
- Under no circumstances shall the loans made by an IBF to a shell be netted against any liabilities or other sources of funds the IBF receives from the shell.

A. Permissible methods:

Situation #1: A taxpayer has its home office in New York City [State], branches only in New York City [State], a shell and a New York IBF. The taxpayer has recorded on its IBF books transactions between the IBF and the shell.

Permissible Method: The shell may be treated as an extension of all the branches of the taxpayer. Since this taxpayer only has branches in New York City [State], the shell may be treated an extension of the New York City [State] branches. Transactions with the shell, therefore, are not treated as transactions with a "foreign Person" for purposes of computing the eligible gross income or the ineligible funding amount of the IBF under § 11-641 (f) of the Administrative Code [§ 1453 (f) of the Tax Law].

Situation #2: A taxpayer has its home office in New York City [State], other branches in New York City [State], a London branch, a shell and a New York IBF. Such taxpayer has recorded on its IBF books transactions between the IBF and the shell.

Permissible Method: The shell may be treated as an extension of all the branches of the taxpayer. Accordingly, the taxpayer's shell may be treated as an extension of its New York City [State] and London branches.

Since the London branch qualifies as a "foreign person" under Code § 11-641 (f) (§ 1453[f] of the Tax Law) and the New York City [State] branches do not, only a portion of the transactions between the IBF and the shell may be treated as transactions between the IBF and a "foreign person". The amount of eligible gross income the IBF may have as result of income it receives from the shell from making, arranging for, placing or servicing loans, or from making or placing deposits with the shell may be determined by subtracting from the gross income the IBF receives from the shell an amount determined by multiplying all such income from the shell by the ineligible shell percentage.

The amount of ineligible funding the IBF receives from the shell may be determined by multiplying the amount of all liabilities and other sources of funds as defined in regulations, § 3-3.10 (b) [20 NYCRR 18-3.10 (b)] the shell places with the IBF, by the ineligible shell percentage.

The ineligible shell percentage is the average of three percentage:

- The ineligible shell receipts percentage
- The ineligible shell payroll percentage and
- Ineligible shell deposits percentage.

The ineligible shell receipts percentage is determined by dividing (1) the taxpayer's receipts allocated to its United States branches using the principles set forth in regulations, Subpart 4-6 [20 NYCRR 19-6] excluding: (a) any shell receipts; (b) the eligible gross income of the IBF; and (c) receipts which the IBF receives from the shell (2) by the taxpayer's total receipts excluding: (a) shell receipts; (b) the eligible gross income of the IBF; and (c) receipts which the IBF receives from the shell. The ineligible shell receipts percentage shall include only receipts, which are included in alternative entire net income for the taxable year.

The ineligible shell payroll percentage is determined by dividing (1) 100 percent of wages, salaries and other personal service compensation of the taxpayer's employee, except general executive officers, attributable to its branches in the United States using the principles set forth in regulations Subpart 4-5 [20 NYCRR 19-5] excluding any wages, salaries and other personal service compensation of the taxpayer's employees attributable to the shell or to the production of eligible gross income of the IBF by (2) the total amount of wages, salaries and other personal services compensation of the taxpayer's employees, except general executive officers, excluding the wages, salaries and other personal service compensation attributable to the shell or to the production of eligible gross

income of the IBF.

The ineligible shell payroll percentage shall include only wages, salaries and other personal service compensation the expenses of which are included in the computation of alternative entire net income for the taxable year.

The ineligible shell deposits percentage is ascertained by dividing (1) the average value of the taxpayer's deposits maintained at its branches in the United States using the principles set forth in Regulations, Subpart 4-7 [20 NYCRR 19-7] excluding any deposits booked at the shell or at the IBF by (2) the average value of all the taxpayer's deposits maintained at branches excluding deposits booked at the shell or at the IBF.

The ineligible shell deposits percentage includes only deposits for which the expenses are included in the computation of alternative entire net income for the taxable year.

Situation #3: A taxpayer has its home office in a state other than New York, a branch in New York City [State], a shell and a New York IBF. Such taxpayer has recorded on its IBF books transactions between the IBF and the shell. The taxpayer has no branches outside the United States.

Permissible method: Same as situation 1.

Situation #4: A taxpayer has its home office in a state other than New York, a branch in New York City [state], a branch in London, a shell and a New York IBF. Such taxpayer has recorded on its IBF books transactions between the IBF and the shell.

Permissible method: Same as situation 2.

Situation #5: A taxpayer has its home office in Toronto, a New York City [State] branch, a shell and a New York IBF. Such taxpayer has recorded on its IBF books transactions between the IBF and the shell.

Permissible method: Same as situation 2 except the denominators of each factor shall be determined by computing alternative entire net income (Regulations, Subpart 3-4) [20 NYCRR 18-4] on a worldwide basis. If the taxpayer does not have worldwide receipts, payroll and deposit information maintained in substantial accordance with U.S. tax principles the auditor may, in his or her discretion, compute the ineligible shell percentage as follows:

Divide (1) the amount of gross income which was effectively connected or treated as effectively connected [including income described in Internal Revenue Code, §884(d) (2) and/or 894 (a)] with the conduct of a trade or business within the United States using the principles set forth in Regulations, Subpart 4-6 [20 NYCRR 19-6] excluding: (a) gross income of the shell; (b) the eligible gross income of the IBF; and (c) gross income which IBF receives from the shell by (2) the taxpayer's gross income from all sources excluding: (a) gross income of the shell; (b) the eligible gross income of the IBF; and (c) gross income which the IBF

receives from the shell.

The Auditor may be able to ascertain some of the information needed to make this calculation by examining the information the taxpayer supplies to its shareholders pursuant to Internal Revenue Code, § 861 (a) (2) (B).

Situation #6: A taxpayer has its home office in Toronto, a New York City [State] branch, a Chicago branch, a shell and a New York IBF. Such taxpayer has recorded on its IBF books transactions between the IBF and the shell.

Permissible method: Same as situation 5.

Situation #7: A taxpayer has more than one shell.

Permissible method: A taxpayer who has more than one shell may be subject to one of the above permissible methods except that the activities of all the shells shall be combined. In combining the activities of the shells, all transactions one shell has with another shell shall be eliminated.

B. Other Permissible Methods:

If the auditor finds that the methodology provided above does not produce a proper result, the auditor may, upon authorization, modify or employ a different methodology.

Examples where the above may not produce the proper result include, but are not limited to, situations where the auditor determines that the shell is not an extension of all of the branches of the taxpayer or where more than 50 percent of the gross income of the shell of an alien bank is effectively connected or deemed effectively connected (including income which is described in Internal Revenue Code, §§ 884(d) (2) and/or 894(a) to a trade or business within the United States.

III. Applicability

The concepts provided in this procedure will apply to pre-1985 taxable years as well as to taxable years beginning on or after 1985 and shall be limited to determining the eligible gross income and ineligible funding amount pursuant to Administrative Code, § 11-641 (f) [Tax Law, § 1453 (f)] arising from transactions between an IBF and a shell or shells of the taxpayer.