STATEMENT OF AUDIT PROCEDURE

GCT & UBT Treatment of Repurchase Agreements and Securities Lending and Borrowing Transactions for Financial Services Firms Regularly Engaged in Such Activities.

I. Statement of the Issues – Statutory and Regulatory Background

The law governing the New York City General Corporation Tax (“GCT”) and the Unincorporated Business Tax (“UBT”) defines investment capital as “investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business…” Administrative Code of the City of New York §11-602.4 and §11-501(h). Rules adopted in 1990 for purposes of the GCT elaborated on that definition, addressing among other items the treatment of repurchase agreements. Title 19 Rules of the City of New York (“RCNY”) §11-37. The 1990 rules are silent regarding the treatment of securities lending and borrowing transactions. Although the 1990 rules apply to the GCT, the Department generally applies those rules in comparable situations for purposes of the UBT.

Taxpayers are permitted to elect to treat “cash on hand or on deposit” as business or investment capital. Ad. Code §11-602.6 and §11-501(j). The 1990 rules treat qualifying corporate debt instruments that would otherwise qualify as investment capital as “cash on hand or on deposit,” subject to the cash election, if the remaining term of the instrument is six months or less or the instrument is payable on demand. 19 RCNY §11-37(a)(3). The expanded definition of cash does not expand the overall amount of investment capital a taxpayer has. However, it removes the short-term debt from the calculation of the investment allocation percentage while permitting taxpayers to allocate the income from cash (and the total investment capital that includes the cash) by the investment allocation percentage.

Section 11-602.5 of the Administrative Code defines investment income as income from investment capital less “in the discretion of the commissioner of finance, any deductions allowable in computing entire net income which are directly or indirectly attributable to investment capital or investment income” and
less a portion of the taxpayer’s net operating loss. Administrative Code section 11-501(1) contains a comparable definition for purposes of the UBT. The city rule, Title 19 RCNY section 11-69(b) definition of “Investment Income” (i)(A), reflects the exercise of that discretion by providing that “investment income must be reduced by any deductions, allowable in computing entire net income, which are directly or indirectly attributable to investment capital or investment income.”

This Statement of Audit Procedure provides guidance to auditors regarding the correct tax treatment of certain repurchase and reverse repurchase agreements and securities lending and borrowing transactions by financial services firms regularly engaged in such activities for purposes of the GCT and the UBT. This SAP is not intended to address the audit treatment of other taxpayers engaged in similar activities. The audit treatment of those taxpayers will depend upon the facts and circumstances of the taxpayers’ activities.

II. General Rules

A. As more fully described below, for financial services firms regularly engaged in both repurchase and reverse repurchase agreements, the auditor will treat reverse repurchase agreements that constitute qualified corporate debt instruments with durations of not more than six months as cash, and therefore subject to the cash election. In addition, for such taxpayers interest expenses arising out of repurchase agreements will be subject to a rebuttable presumption that such interest is directly attributable to reverse repurchase agreements. Therefore, if cash is treated as business capital; per the election, these expenses will be directly attributable to business capital; if cash is treated as investment capital, these expenses will be directly attributed to investment capital.

B. Where a financial services firm regularly engages in securities lending and borrowing transactions, the auditor will treat the income and expenses from those transactions as business income and expenses.

III. Audit Procedures

A. Repurchase Agreements

A Repurchase Agreement is a transaction in which one party sells securities, most often government securities, to a second party and simultaneously contracts to repurchase the same or equivalent securities from the second party. Existing regulations generally treat repurchase agreements as collateralized loans.¹ These transactions are usually of short duration, either overnight or for a few days, and almost never have a term exceeding six months. When the transaction is treated as a loan, the seller of the securities is in the position of the borrower while the purchaser of the securities, the holder of the reverse repurchase agreement, is in the position of the lender.

¹ Situations in which the transaction qualifies to be treated as an actual sale of the securities to the lender under 19 RCNY§11-37(f) are beyond the scope of this Statement of Audit Procedure.
Repurchase and reverse repurchase agreements represent a significant activity of the financial services sector. Taxpayers frequently report short-term reverse repurchase agreements as items of cash if they are otherwise qualifying corporate debt instruments\(^2\), and such agreements are usually treated as investment capital under the cash election.

1. In the audit of a financial services firm regularly engaged in repurchase and reverse repurchase transactions, the auditor will accept a taxpayer’s treatment of reverse repurchase agreements as cash subject to the cash election if the agreements otherwise qualify as qualifying corporate debt instruments.

2. On audit, the auditor will treat all interest expense incurred by the taxpayer from repurchase agreements with respect to government securities as directly attributable to reverse repurchase agreements with respect to government securities except to the extent that the taxpayer can demonstrate to the satisfaction of the auditor both (i) that the taxpayer’s activities with respect to repurchase agreements are segregated on the taxpayer’s books and records and on an operational basis from its activities with respect to reverse repurchase agreements and (ii) that the taxpayer’s entry into repurchase agreements is not related to any material degree, including as hedges, to its entry into reverse repurchase agreements, in which case, the auditor may take into account the particular facts and circumstances of the taxpayer in attributing the interest expense from repurchase agreements.

3. Compliance with this portion of the Statement of Audit Procedure does not preclude inquiry, on audit, as to whether the cash election and investment capital treatment are appropriate in a given situation.

B. Securities Lending and Borrowing Transactions

Financial services firms engage in securities lending and borrowing transactions for a variety of reasons, including: covering their own or customers’ short sales; covering failed sales by customers; obtaining securities to lend to a third party; and as a source of funds. Broker dealers lend securities from their own inventory or trading accounts. They also can use securities and cash held in customers’ margin accounts in these transactions. In general, for financial statement purposes broker dealers account for securities lending and borrowing activity the same way regardless of the source of the securities loaned or the use to which borrowed securities will be put. Broker dealers engage in a significant volume of both securities lending and securities borrowing activity.

\(^2\) Reverse repurchase agreements that are not qualifying corporate debt instruments cannot be treated as cash subject to the election. Title 19 RCNY §11-37(a)(3)
A stock loan consists of several elements:

- The lender of the stock transfers to the borrower title to the stock in exchange for the stock borrower’s collateral, which can be cash, a letter of credit, or government securities, generally adjusted on a frequent basis to equal the value of the stock borrowed plus a cushion.

- Where non-cash collateral is provided, the stock borrower is entitled to any income that may accrue on the collateral during the term of the transaction.

- Where the collateral is cash, the stock borrower receives an agreed-upon return on the collateral (commonly referred to as the “rebate fee”). The stock lender can retain any earnings from the use of the cash collateral.

- The stock borrower agrees to pay the stock lender an amount equal to any dividends declared on the stock during the term of the loan.

- The stock borrower must also pay the stock lender a fee (commonly referred to as the “borrow fee”).

- The net of the rebate fee and the borrow fee is ordinarily exchanged between the stock borrower and stock lender. The rebate fee will exceed the borrow fee, and the stock lender will pay the stock borrower the net amount. This net amount is typically reported as interest income to the stock borrower and interest expense to the stock lender.

When auditing a financial services firm that is a GCT or UBT taxpayer regularly engaged in stock lending and stock borrowing:

1. The auditor will require that the net of the rebate fee and the borrow fee be treated as business income to the stock borrower, and business expense to the stock lender. Where the parties do not net those fees, the gross amount of fees will be treated as business income and expenses to the respective parties. The payment made to the stock lender in lieu of the dividends declared similarly will be treated as a business expense of the stock borrower and business income to the stock lender.

2. Where the stock borrower provides cash as collateral for the transaction, the auditor will require the stock borrower to treat that cash as business capital and not as cash on hand or on deposit for purposes of the cash election.

3. For purposes of the receipts factor in the stock borrower’s or stock lender’s business allocation percentage, the auditor will require the various fees describe in item (1) above to be treated as having a source at the location of the payor. The auditor will require the taxpayer to net the amounts of payments of fees against the fee receipts for purposes of determining the receipts factor unless the auditor determines that the facts and circumstances indicate that such netting will result in an improper reflection of the taxpayer’s stock lending and borrowing activity in New York City.
4. The income received by the stock lender from the use of cash collateral is dependent on a separate transaction to which the stock borrower is not a party. Therefore, the stock lender's tax treatment of this income depends on the nature of the use of the cash collateral and is not governed by this Statement of Audit Procedure.

5. Other securities lending and borrowing transactions structured under arrangements that are similar to stock lending and borrowing transactions will be treated in a manner consistent with the foregoing procedures.

IV. Effective Date

This Statement of Audit Procedure reflects existing Department interpretations of applicable laws and rules. Therefore, this Statement of Audit Procedure applies to all open tax periods.