STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

BARCLAYS GROUP, INC. (USA) & AFFILIATES :

for Redetermination of a Deficiency or for Refund of Franchise Tax on Banking Corporations under Article 32 of the Tax Law for the Years 1995, 1996, 1997, and the Short Period Ended March 31, 1998. :

DETERMINATION
DTA NO. 818789

Petitioner, Barclays Group, Inc. (USA) & Affiliates, f/k/a Barclays Bank of New York & Affiliates, c/o Group Tax, 222 Broadway, New York, New York 10038, filed a petition for redetermination of a deficiency or for refund of franchise tax on banking corporations under Article 32 of the Tax Law for the years 1995, 1996, 1997 and the short period ended March 31, 1998.

A hearing was commenced before Timothy J. Alston, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on December 16, 2002 at 9:00 A.M., and concluded before the same administrative law judge at the same location on December 17, 2002. All briefs in this matter were submitted by June 17, 2003, which date began the six-month period for the issuance of this determination. Petitioner appeared by Richard A. Leavy, Esq. and Arthur R. Rosen, Esq. The Division of Taxation appeared by Mark F. Volk, Esq. (Nicholas A. Behuniak, Esq., of counsel).

ISSUES

I. Whether, on its amended returns for the period at issue, petitioner properly reported, on a net basis, the assets of a member of its combined group, a wholly-owned subsidiary engaged in

business as a primary dealer in United States government securities, for purposes of the tax as measured by assets pursuant to Tax Law §1455(b)(1), thereby establishing entitlement to a refund of the franchise tax on banking corporations under Article 32.

II. Whether, on its amended returns for the period at issue, petitioner properly modified the receipts factor of its asset allocation percentage (thereby decreasing such allocation percentage) by netting the receipts of a member of its combined group, a wholly-owned subsidiary engaged in business as a primary dealer in United States government securities.

III. Whether the Division of Taxation improperly failed to consider, as an alternative basis for the granting of petitioner's claimed refund, adding petitioner's corporate parent, a foreign banking corporation with a branch operating in the United States, to petitioner's combined group, thereby violating the Foreign Commerce Clause contained in Article I, section 8, clause 3 of the United States Constitution.

FINDINGS OF FACT

1. Petitioner, Barclays Group, Inc. (USA) & Affiliates,[1] was a wholly-owned indirect subsidiary of Barclays Bank PLC. Barclays Bank PLC was a foreign bank carrying on various banking and non-banking business enterprises, both directly and through subsidiaries, throughout the world, including the operation of a banking branch in the United States.

2. For the calendar years 1995, 1996, 1997, and the quarter ended March 31, 1998 ("the period at issue"), petitioner filed combined banking corporation franchise tax returns under Article 32 of the Tax Law (Form CT-32-A). Petitioner also filed corresponding banking corporation MTA surcharge returns (Form CT-32-M) for the same period. Several subsidiaries of petitioner were joined in the group of corporations included in petitioner's combined returns.

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[1] During the period at issue herein, petitioner was known as Barclays Bank of New York & Affiliates.

Barclays Capital, Inc. ("Barclays Capital")[2] was among the subsidiaries included in petitioner's combined returns.

3. During the period at issue petitioner and its combined group were subject to the alternative minimum tax under Article 32 as measured by taxable assets allocable to New York pursuant to Tax Law § 1455(b)(1). Petitioner computed, reported and paid its tax liability accordingly.

4. Subsequently, in February 2001, petitioner filed amended banking corporation combined franchise tax returns and amended banking corporation MTA surcharge returns for the years 1995, 1996, 1997, and the quarter ended March 31, 1998. These amended returns reflected two changes to the banking corporation returns previously filed and claimed refunds of tax previously paid with respect to the period at issue.

5. The first change reflected in the amended returns was the netting of Barclays Capital's assets against liabilities for the purpose of computing petitioner's taxable assets. The second change was the adjustment of the receipts factor by netting the interest expense and interest income of Barclays Capital for the purpose of computing petitioner's taxable asset allocation percentage. Approximately 99 percent of petitioner's refund claim is attributable to the asset netting issue.

6. The amount of petitioner's refund claim as set forth in the amended returns is summarized below:

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[2] During 1995 and through July 1996, this corporation was known as Barclays de Zoete Wedd Securities, Inc. In July 1996 this corporation changed its name to BZW Securities, Inc. In March 1998, this corporation changed its name to Barclays Capital, Inc. This determination shall refer to this corporation at all times as "Barclays Capital."

Tax Year	NYS Tax	MTA Tax	Total
1995	$1,240,535.00	$196,178.00	$1,436,713.00
1996	1,111,224.00	184,300.00	1,295,524.00
1997	1,396,667.00	237,433.00	1,634,100.00
Qtr. ended 3/31/98	498,971.00	84,825.00	583,796.00
Total	$4,247,397.00	$702,736.00	$4,950,133.00

7. By letter dated September 14, 2001, the Division of Taxation ("Division") denied petitioner's refund claim with respect to the netting of assets. The Division requested additional information with respect to the portion of the refund claim attributable to the recomputation of the receipts factor.

8. During the period at issue Barclays Capital operated as a securities broker-dealer pursuant to a grant of authority by the Federal Reserve Board under the provisions of section 20 of the Glass-Steagall Act. Barclays Capital carried on business throughout that period almost exclusively as a primary dealer in United States government securities.

9. As a "Section 20 subsidiary" Barclays Capital and petitioner were subject to strict Federal Reserve Board restrictions, both legal and operational, designed to prevent the intermingling of banking and nonbanking activities and assets. The purpose of such separation is to insulate the banking business from the broker-dealer business.

10. A primary dealer in United States government securities is a broker-dealer authorized by the Federal Reserve to purchase United States securities and make a market for them by offering to resell them to the public. Banking institutions and broker-dealers registered with the Securities and Exchange Commission may operate as primary dealers of United States government securities.

11. When a broker-dealer engages in business as a primary dealer of United States government securities, its trading usually takes the form of entering into offsetting long and short positions in the securities, which together may be referred to as an integrated trading position. Such a position is a two-part transaction whereby each part of the transaction contributes to an overall "flat" position entered into by the primary dealer that allows the primary dealer to produce trading income without subjecting itself to the risks that accompany long and short positions that are not offset.

12. In the context of Barclays Capital's business, an integrated trading position arises when (i) a long position is taken in a United States government security through a purchase or reverse repurchase agreement and (ii) that long position is principally financed by entering into a short position in the same security through an agreement to sell a United States government security, such as a repurchase agreement.

13. In the instant context, a repurchase agreement is a financing agreement whereby a party sells United States government securities and simultaneously agrees to repurchase the same or substantially identical securities at the end of a specified repurchase term. A reverse repurchase agreement is an agreement whereby a party purchases a security and simultaneously agrees to sell the security back to the seller at the end of a specified term.

14. In a typical integrated trading position transaction a primary dealer purchases United States government securities from a party while simultaneously agreeing to sell equivalent or the same securities back to the seller at a future date under a reverse repurchase agreement. After entering into the reverse repurchase agreement, the primary dealer then sells the identical or nearly identical United States government securities pursuant to a repurchase agreement. The proceeds from the repurchase agreement are used to finance the reverse repurchase agreement.

15. Primary dealers in United States government securities do not invest their own capital to purchase securities. Such purchases, or long positions, are financed by the sale of the same security or a similar offsetting security. These are the aforementioned reverse repurchase and repurchase agreements. From the perspective of the primary dealer, a repurchase agreement is a borrowing transaction and a reverse repurchase agreement is a lending transaction. The goal of the primary dealer is to enter into a short position (repurchase agreement) at a better price. Or to use the borrowing/lending analogy, to lend at a higher rate than they borrow. Although the spreads on such trades are generally very small, such spreads are one of the ways that primary dealers make money.

16. Absent the use of the integrated trading positions described above (reverse repurchase and repurchase agreements), primary dealers would necessarily lose money. This is because the cost of funds to purchase the government securities would exceed the return on the securities during the period they are held before the required redelivery under the reverse repurchase obligation. Given the ability of the United States government to borrow money at the lowest rates, the only way for a business to borrow money at a cost low enough to profit on the purchase of United States securities is to borrow money as cheaply as the United States government does. Primary dealers accomplish this by using the United States government securities as collateral to borrow the funds used to purchase the security in the first place. Thus, given the liquidity of the United States government securities, such securities effectively finance themselves and provide the necessary financing for their acquisition.

17. Together, the long position and the short position constitute the integrated trading position discussed above. During the term of the integrated trading position, the primary dealer will realize trading gain or loss on the long position, incur expenses on the short position, and

earn income from the long position. Depending on price fluctuations in the underlying security, the prevailing repurchase rate, and the yield on the security, the primary dealer will recognize net income or expense and trading gain or loss on the integrated trading activity. The primary dealer seeks to have trading gain and net income exceed trading loss and net expense.

18. Primary dealers do not hold securities for investment, but rather generate income from trading the securities. By combining long and short positions in an integrated trading position the primary dealer seeks to eliminate the investment element from each side of the integrated position. The primary dealer selects a corresponding long or short position not for its individual attributes, but for its ability to match the corresponding position. The primary dealer takes a corresponding position almost immediately after entering into an initial position.

19. Due to the nature of United States government securities, the trading returns from a single integrated trading position are small as compared to the size of the component long and short positions. This is because price changes that occur in the United States government securities markets over relatively short periods are very small. Accordingly, a primary dealer in United States government securities depends upon a high trading volume to generate significant income.

20. Since the primary dealer seeks to fund its long positions by taking corresponding short positions, the dealer's ratio of net assets to gross assets is generally less than one percent. In contrast, a traditional bank maintains a typical ratio of net assets to gross assets of approximately eight to ten percent.

21. During the period at issue, there were three aspects to Barclays Capital's business of being a primary dealer in United States government securities: matched book business, inventory funding, and firm funding.

22. The matched book business consisted of entering into offsetting long and short positions in United States government securities primarily through repurchase and reverse repurchase transactions. Barclays Capital thus sought to enter into integrated trading positions in its matched book business.

23. The initial transaction, either repurchase or reverse repurchase, and the corresponding subsequent transaction are separate legal obligations. The initial and corresponding matched transaction do not have to be entered into at the same time, with the same party, for the same dollar amount, or for the same settlement dates.

24. Barclays Capital and other primary dealers generally use the matched book transaction model not because of any legal requirement but because this model serves to advance the dealers' business goals. That is, to make money not from investing in securities but from trading securities. This goal is served by the matched transactions, or as referred to earlier, integrated trading positions. As noted, Barclays Capital attempts to keep its overall long positions (reverse repurchase) and short positions (repurchase) equal and thereby the remove the investment component from its integrated trading positions.

25. Barclays Capital's inventory funding business involved funding Barclay Capital's purchase of United States government securities for sales to customers by entering into repurchase transactions with third parties. The inventory funding business also involved selling inventory that Barclays Capital did not yet own (selling short) through reverse repurchase transactions with third parties.

26. The firm funding aspect of Barclays Capital's business involved the use of repurchase and reverse repurchase transactions to fund petitioner's long and short positions in United States government securities.

27. Barclays Capital sought to offset, in the aggregate, its long and short positions in the inventory funding and firm funding components of its business.

28. Barclays Capital's profit or loss was generated by trading spreads from each transaction plus interest income less interest expense. Although the primary dealer is not holding the securities for investment it does seek to profit from trading spreads, that is, to buy low and sell high.

29. The Securities and Exchange Commission requires Barclays Capital to prepare annual audited financial statements, including balance sheets, in accordance with generally accepted accounting principles ("GAAP") and to file such reports with the SEC. Primary dealers not owned by banks are subject to the same requirements.

30. GAAP allows the above-the-line netting of an asset on a balance sheet where there are asset and liability positions with the same counter-party. Where there are different counter-parties the transactions are not permitted to be netted under GAAP. Accordingly, GAAP permits Barclays Capital to net certain matched book repurchase and reverse repurchase transactions and precludes Barclays Capital from netting certain other matched book repurchase agreements with other reverse repurchase agreements on its balance sheet.

31. The computation of the tax on assets on petitioner's original returns reflects above-the-line netting of Barclays Capital's assets where permitted under GAAP.

32. The separation of gross assets and liabilities under GAAP reflects counter-party risk, that is, the risk that the other side of the transaction will not fulfill its obligation. In the context of the United States government securities market, counter-party default is extremely infrequent.

33. Virtually all banks that have chosen to enter the business of being a primary dealer in United States government securities have done so through wholly-owned subsidiaries.

34. The Division submitted proposed findings of fact numbered “1” through “26”. Of these, proposed findings of fact “1” through “5”, “7” through “10”, and “12” through “20”, “22” and “26” are accepted and have been incorporated, in substance, into the Findings of Fact herein. Proposed findings of fact “6”, “11”, “21” and “23” through “25” are in the nature of conclusions of law and are therefore not accepted as facts herein.

SUMMARY OF THE PARTIES’ POSITIONS

35. Petitioner asserts that the Division abused the discretion granted under the Tax Law by failing to correct the asserted improper reflection of the assets of Barclays Capital within New York under Article 32 of the Tax Law.

36. Petitioner further asserts that the Division abused the discretion granted under Article 32 to make adjustments by failing to correct the disparate tax treatment afforded to Barclays Capital, as a securities broker-dealer operating under section 20 of the Glass-Steagall Act and taxable under Article 32 of the Tax Law, vis-a-vis similarly situated securities broker-dealers taxable under Article 9-A of the Tax Law.

37. Assuming the Division’s interpretation of the Tax Law is correct and the Tax Law does not permit a discretionary adjustment as urged by petitioner, petitioner asserts that the Division improperly enforced provisions of the Tax Law that facially discriminate against securities broker-dealers that operate under section 20 of the Glass-Steagall Act and are taxable under Article 32 of the Tax Law, vis-a-vis similarly situated securities broker-dealers taxable under Article 9-A of the Tax Law, in violation of the equal protection clause contained in the fourteenth amendment to the United States Constitution and the equal protection clause contained in section 11 of Article 1 of the New York State Constitution.

38. Petitioner also asserts that the adjustment to the receipts factor of its asset allocation percentage in the amended returns by netting the receipts of Barclays Capital was proper for the same reasons that the netting of Barclays Capital's assets was proper.

39. Petitioner further asserts that the Division failed to consider the alternative basis for allowing the refund of adding the Barclays Bank PLC United States branch to the combined return filed by petitioner, resulting in discrimination against a foreign banking corporation with a branch operating in the United States vis-a-vis similarly situated banking corporations organized under the laws of the United States and unfair apportionment of income in violation of the foreign commerce clause contained in Article I, section 8, clause 3 of the United States Constitution.

40. The Division asserts that Barclays Capital is a banking corporation under Tax Law § 1452(a) and that petitioner properly reported its liability under Article 32 on its original returns. The Division asserts that it does not have discretion under Tax Law § 1462(g) to make the adjustment to the assets of Barclays Capital (and thereby adjust petitioner's taxable assets) sought by petitioner. The Division further asserts that the disparate treatment accorded broker-dealers of United States government securities that are banking corporations under Article 32 and other broker-dealers taxable under Article 9-A of the Tax Law does not violate the equal protection clause of the United States constitution.

41. The Division also contends that petitioner has failed to prove that the adjustments to the receipts factor in the amended returns are warranted.

42. Finally, the Division contends that petitioner's request for an adjustment to add the Barclays Bank PLC United States branch to the combined return filed by petitioner should be

denied because petitioner has offered no evidence that the proposed adjustment is appropriate and because Tax Law §1462(f)(4) expressly precludes the proposed combination.

CONCLUSIONS OF LAW

A. Article 32 of the Tax Law imposes franchise tax on a banking corporation "[f]or the privilege of exercising its franchise or doing business in [New York State] in a corporate or organized capacity" (Tax Law § 1451[a]).

B. Tax Law § 1452(a) provides a detailed definition of "banking corporation" for purposes of Article 32. Of relevance to the present matter is the following definition contained in paragraph (9) of Tax Law § 1452(a), which includes within the term "banking corporation":

> [A]ny corporation sixty-five percent or more of whose voting stock is owned or controlled . . . by a corporation . . . subject to article three-a of the banking law, or registered under the federal bank holding company act . . . or registered as a savings and loan holding company . . . or by a corporation . . . described in any of the foregoing paragraphs of this subsection [Tax Law § 1452(a)(1)-(8)] provided the corporation whose voting stock is so owned or controlled is principally engaged in a business, regardless of where conducted, which (i) might be lawfully conducted by a corporation subject to article three of the banking law or by a national banking association or (ii) is so closely related to banking or managing or controlling banks as to be a proper incident thereto, as set forth in paragraph eight of subsection (c) of section four of the bank holding company act of nineteen hundred fifty-six, as amended [12 USC 1843(c)(8)] . . . .

C. During the period at issue, Barclays Capital was a banking corporation within the meaning of Tax Law § 1452(a)(9). As a wholly-owned subsidiary of a foreign bank, Barclays Capital unquestionably met the 65 percent ownership requirement of paragraph (9). In addition, Barclays Capital was principally engaged in a business which might be lawfully conducted by a bank (***see***, Tax Law §1452[a][9][i]). As discussed, during the relevant period, Barclays Capital was a primary dealer in United States government securities. Section 16 of the Glass-Steagall

Act (12 USC § 24)[3] expressly permits banks to underwrite and deal in United States government securities. Thus, contrary to the testimony of expert witnesses proffered by petitioner, Barclays Capital's business as a primary dealer in United States government securities was an activity which might be lawfully conducted by a bank. Furthermore, pursuant to Tax Law § 1452(a)(9)(ii), Barclays Capital's business as a primary dealer in United States government securities was "so closely related to banking . . . as to be a proper incident thereto" within the meaning of section 4(c)(8) of the Bank Holding Company Act of 1956 (12 USC §1843[c][8]). Insofar as relevant herein, the Bank Holding Company Act of 1956 generally precludes bank holding companies from owning shares in any nonbanking companies (***see***, 12 USC § 1843[a]). Section 4(c)(8) of the Act is an exception to the general rule and permits bank holding companies to own shares in companies whose activities have been determined by the Federal Reserve Board to be "so closely related to banking or managing or controlling banks as to be a proper incident thereto" (***see***, 12 USC § 1843[c][8]). The Federal Reserve Board approved the application of Barclays Bank PLC under section 4(c)(8) of the Bank Holding Company Act to underwrite and deal in United States government securities through its wholly-owned subsidiary, Barclays Capital (***see***, 76 Fed Reserve Bull 158, 159).[4] The Federal Reserve Board thus necessarily concluded that such activity was "so closely related to banking . . . as to be a proper incident thereto." Additionally, the Federal Reserve Board's Regulation Y, which governs the

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[3] Those provisions of the Banking Act of 1933 that separated the commercial and investment banking industries are known as the Glass-Steagall Act.

[4] The cited provision, 76 Federal Reserve Bulletin 158, is an order approving the application of, *inter alia*, Barclays Bank PLC to engage to a limited extent, through its subsidiary, Barclays de Zoete Wedd Securities, Inc. (referred to as Barclays Capital herein), in underwriting and dealing in certain bank-ineligible securities (i.e., securities that a bank is not permitted to underwrite or deal in under 12 USC § 24). That order refers to a previous order of the Federal Reserve Board granting Barclays Bank PLC, through Barclays Capital, to underwrite and deal in United States government securities. Neither party cited this previous order on brief and I have been unable discover it in my research.

corporate practices of bank holding companies and certain practices of state-member banks, specifically deems underwriting and dealing in obligations of the United States as an activity "so closely related to banking . . . as to be a proper incident thereto" (***see***, 12 CFR 225.28[b][8][i]). The business of Barclays Capital has thus been defined, by Federal Reserve Board order and regulation, to be a permissible activity under section 4(c)(8) of the Bank Holding Company Act of 1956 (***see***, 12 USC § 1843[c][8]). Given the Federal Reserve Board's "primary responsibility for implementing the Glass-Steagall Act and expert knowledge of commercial banking" (***see***, ***Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.***, 716 F2d 92, 95 [2d Cir 1983], ***affd*** 468 US 207), such order and regulation is persuasive and outweighs petitioner's expert testimony in support of the proposition that the business of Barclays Capital was not closely related to banking.[5]

D. As noted herein, petitioner and the members of its combined group, all banking corporations under Tax Law § 1452(a), filed franchise tax returns under Article 32. All members of petitioner's combined group were required to file on a combined basis pursuant to Tax Law § 1462(f)(2)(i) which provides, in relevant part:

> Any banking corporation or bank holding company which is exercising its corporate franchise or doing business in this state in a corporate or organized capacity, and
>
> (A) which owns or controls, directly or indirectly, eighty percent or more of the voting stock of one or more banking corporations or bank holding companies, or
>
> (B) whose voting stock is eighty percent or more owned or controlled, directly or indirectly, by a banking corporation or a bank holding company,

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[5] The fact that banks have entered the primary dealer business only through subsidiaries (***see***, Finding of Fact "33") does not undercut this conclusion, for the regulation speaks not of banking itself, but of activity which is "related" to banking, albeit "closely." Thus, it is not surprising that such activity would be undertaken through a separate corporation.

> shall make a return on a combined basis under this article covering itself and such corporations described in clause (A) or (B) and shall set forth such information as the tax commission may require unless the taxpayer or the tax commission shows that the inclusion of such a corporation in the combined return fails to properly reflect the tax liability of such corporation under this article.

Petitioner owned 100 percent of the stock of the members of its combined group, including Barclays Capital. Petitioner does not seek to exclude Barclays Capital from the combined group under Tax Law § 1462(f)(2)(i).

E. Article 32 imposes a tax measured by the greatest of: a basic tax on entire net income, an alternative minimum tax measured by taxable assets, a tax on alternative entire net income, or a fixed minimum (***see***, Tax Law § 1455). During the period at issue, petitioner and the members of its combined group paid tax as measured by taxable assets pursuant to Tax Law § 1455(b)(1). For purposes of Article 32, taxable assets are defined, in relevant part, as follows:

> The term "taxable assets" shall mean the average value of total assets . . . . Total assets are those assets which are properly reflected on a balance sheet the income or expenses of which are properly reflected (or would have been properly reflected if not fully depreciated or expensed or depreciated or expensed to a nominal amount) in the computation of alternative entire net income for the taxable year or in the computation of the eligible net income of the taxpayer's international banking facility for the taxable year. (Tax Law § 1455[b][1][v][A].)

The Division's regulations define "balance sheet" as used in Tax Law § 1445(b)(1)(v)(A), in relevant part, as follows:

> The term *balance sheet* . . . shall mean the balance sheet of the taxpayer prepared from the books and records of the taxpayer in accordance with generally accepted accounting principles and used for purposes of preparing the taxpayer's financial statements (20 NYCRR 18-5.2[d]).

F. On its originally filed returns, petitioner calculated its combined tax liability as measured by taxable assets in accordance with the relevant statutes and regulations. That is, except where netting was permitted under generally accepted accounting principles (***see***, Finding

of Fact "30"), petitioner's calculation of Barclays Capital's assets (and the assets of all members of the combined group) was a calculation of gross assets. Such calculation was consistent with generally accepted accounting principles and was consistent with Tax Law § 1455(b)(1) and section 18-5.2(d) of the Division's regulations (20 NYCRR 18-5.2[d]).

G. By its filed amended returns petitioner seeks an adjustment to its liability for the tax on assets. Specifically, petitioner seeks to net the assets of Barclays Capital in its calculation of petitioner's taxable assets in a manner similar to the calculation of tax as measured by the capital base pursuant to the franchise tax on business corporations under Article 9-A of the Tax Law.[6] Petitioner contends that Barclays Capital's business of purchasing long positions in securities while financing such positions with the creation of short positions increases Barclays Capital's taxable assets with each transaction, but does not increase its wealth or otherwise improve its financial condition. Petitioner thus contends that the calculation of taxable assets in accordance with Tax Law § 1455(b)(1) and section 18-5.2(d) of the Division's regulations (20 NYCRR 18-5.2[d]) distorts Barclays Capital's asset picture and that the netting of Barclays Capital's assets will better measure the taxable assets of Barclays Capital within New York State.

H. Petitioner asserts that the Commissioner of Taxation has discretion to make the proposed adjustment pursuant to Tax Law § 1462(g), which provides as follows:

> In case it shall appear to the tax commission that any agreement, understanding or arrangement exists between the taxpayer and any other corporation or any person or firm, whereby the activity, business, income or assets of the taxpayer within the state is improperly or inaccurately reflected, the tax commission is authorized and empowered, in its discretion and in such

[6] Tax Law § 210(1)(b) imposes a franchise tax on business corporations measured by a capital base. Tax Law § 210(2) provides that the amount of subsidiary, investment and business capital subject to tax shall be determined by taking the average value of the assets included therein less liabilities deductible therefrom. Article 9-A thus permits the netting of assets in computing tax as measured by the capital base. In addition, and in contrast to the tax on assets under Article 32, the amount of tax imposed under Tax Law § 210(1)(b) is subject to an annual cap of $350,000.00.

> manner as it may determine, to adjust items of income or deductions in computing entire net income or alternative entire net income and to adjust assets, and to adjust wages, salaries and other personal service compensation, receipts or deposits in computing any allocation percentage, provided only that entire net income or alternative entire net income be adjusted accordingly and that any asset directly traceable to the elimination of any receipt be eliminated from assets so as to accurately determine the tax. If however, in the determination of the tax commission, such adjustments do not, or cannot effectively provide for the accurate determination of the tax, the commission shall be authorized to require the filing of a combined report by the taxpayer and any such other corporations. Where (1) any taxpayer conducts its activity or business under any agreement, arrangement or understanding in such manner as either directly or indirectly to benefit its members or stockholders, or any of them, or any person or persons directly or indirectly interested in such activity or business, by entering into any transaction at more or less than a fair price which, but for such agreement, arrangement or understanding, might have been paid or received therefor, or (2) any taxpayer enters into any transaction with another corporation on such terms as to create an improper loss or net income, the tax commission may include in the entire net income or alternative entire net income of the taxpayer the fair profits which, but for such agreement, arrangement or understanding, the taxpayer might have derived from such transaction.

I. The Tax Commissioner (through the Division) properly declined to exercise the discretion granted under Tax Law § 1462(g) because petitioner's assets were neither inaccurately nor improperly reflected on the combined returns as originally filed. As discussed previously, Barclays Capital is a banking corporation within the meaning of Tax Law § 1452(a)(9) and petitioner's original returns were consistent with Tax Law § 1455(b)(1) and section 18-5.2(d) of the Division's regulations (20 NYCRR 18-5.2[d]) in computing tax due as measured by the asset base. There is no dispute herein that the taxable assets of Barclays Capital, as that term is defined in Article 32 and relevant regulations, were accurately reflected on that return. Accordingly, there is no justification for a discretionary adjustment.

Section 18-1.3 of the Division's regulations (20 NYCRR 18-1.3), promulgated under Tax Law §1462(g), supports the conclusion that there is no distortion and therefore no justification for a discretionary adjustment in the present matter. Subsection (c) of this regulation lists the

following factors to be considered in determining whether distortion exists under Tax Law §1462(g): Whether one of the parties to the "agreement, understanding or arrangement" giving rise to the alleged distortion controls the other; whether the "agreement, understanding or arrangement" reflects arms-length dealing despite the presence of control by one party; or whether the "agreement, understanding or arrangement" has an arbitrary or tax-avoidance purpose (***see***, 20 NYCRR 18-1.3[c]). The regulation thus considers whether the factor of control distorts the "agreements, understandings or arrangements" between the taxpayer and other parties. Here, the putative "agreements, understandings or arrangements" giving rise to a claim of distortion are Barclays Capital's long and short transactions with its customers. These are unquestionably arms-length transactions between unrelated parties for a reasonable business purpose. The factors listed in the regulation as indicative of distortion are not present in any of these transactions.

Additionally, section (d) of the regulation (20 NYCRR 18-1.3[d]) provides that the Tax Commissioner may make adjustments under Tax Law § 1462(g) using the principles and rules contained in sections 1.482-1 and 1.482-2 of the Federal income tax regulations. Such regulations set forth rules for the allocation of income and deductions among entities owned or controlled by the same interests. Also, like the statute itself, section (b) of the regulation (20 NYCRR 18-1.3[b]) permits the Commissioner to include in the income of a taxpayer the fair profits from transactions entered into without a reasonable business purpose. These subsections further underscore that an improper or inaccurate reflection of a taxpayer's "activity, business, income or assets" under Tax Law § 1462(g) results from arrangements between controlled taxpayers or arrangements at less than arm's length. Such is not the case in the present matter.

J. Petitioner asserts that a discretionary adjustment pursuant to Tax Law § 1462(g) is appropriate under the instant circumstances because the tax measured by assets “artificially inflates” Barclays Capital’s taxable assets. That is, because the tax is generally measured by gross assets, Barclays Capital’s long positions in United States securities are necessarily viewed in isolation from its short positions in computing its liability. Petitioner also argues that the discretionary adjustment is necessary because Barclays Capital is not a “true” bank engaged in a traditional banking business and that the difference in the ratio of net assets to gross assets generally maintained by a true bank and a primary dealer in United States government securities (***see***, Finding of Fact “20”) necessarily results in a significantly greater tax burden for the primary dealer in respect of the tax on assets.

Petitioner has amply demonstrated by way of numerous examples that, under certain circumstances, given two otherwise similarly situated primary dealers in United States government securities, one a wholly-owned subsidiary of a bank taxable under Article 32 and the other a business corporation, not owned by a bank, taxable under Article 9-A, the Article 32 corporation’s burden under the tax on assets will be significantly greater than the Article 9-A corporation’s burden as measured by the capital base (Tax Law § 210[1][b]). Such a difference in tax burden, however, does not necessitate the use of the discretionary adjustment, for the Tax Law empowers the Commissioner to make such an adjustment only if the assets are improperly or inaccurately reflected on the return. As discussed above, petitioner’s assets were neither inaccurately nor improperly reflected on the combined returns as originally filed.

K. Petitioner also argues that the discretionary adjustment is necessary to correct the disparate treatment afforded Barclays Capital vis-a-vis a similarly situated corporation engaged in business as a primary dealer in government securities but taxable under Article 9-A.

Petitioner asserts that Article 32 was intended to apply to corporations engaged in traditional banking activities and that the activities of Barclays Capital are not the type contemplated by the Legislature to be subject to tax under that Article.

Negative consequences in the form of higher tax liability relative to primary dealers subject to tax under Article 9-A is not an indication that the assets of Barclays Capital were improperly or inaccurately reflected on petitioner's original returns. Moreover, as discussed herein, Barclays Capital is a "banking corporation" as that term is defined in Article 32. Significantly, the definition in Tax Law §1452(a)(9) includes a corporation principally engaged in a business that is "so closely related to banking . . . as to be a proper incident thereto, as set forth in [section 4(c)(8) of the Bank Holding Company Act]." The Legislature thus chose to tie the definition of banking corporation under section 1452(a)(9) to the Federal Bank Holding Company Act. The Legislature was surely aware that interpretations of the Federal Bank Holding Company Act and the regulations promulgated thereunder are subject to change and that the Federal Reserve Board could, through its orders, expand the meaning of activity that is "so closely related to banking . . . as to be a proper incident thereto." The Legislature's decision to link the definition of banking corporation to the Federal Bank Holding Company Act indicates that the Legislature intended that the term "banking corporation" would be flexible enough to absorb changes at the Federal level and allowed for the possibility that certain corporations deemed banking corporations for Article 32 purposes would not be engaged in traditional banking activities. Accordingly, changes in the financial services industry and concomitant changes in the Federal regulatory landscape since the enactment of Article 32 do not compel the invocation of the discretionary adjustment under Tax Law § 1462(g).

L. Turning next to petitioner's constitutional claim, petitioner contends that, but for the matter of ownership, Barclays Capital and all primary dealers in United States government securities not owned by banks are similarly situated. Notwithstanding such similarity, Barclays Capital and such other entities face disparate tax burdens under Article 32's tax on assets and Article 9-A's capital base tax, respectively. Petitioner contends that the identity of a corporation's ownership is not a reasonable basis upon which to impose different tax treatment upon that corporation. Although petitioner does not directly challenge the constitutionality of Barclays Capital's classification as a banking corporation, petitioner does assert that such classification, "which is based solely on the identity of the owner," and which is the basis upon which to impose different tax treatment, is a question of constitutional import. Petitioner's specific constitutional contention is that the Article 32 tax on assets is unconstitutional as applied to Barclays Capital in violation of its rights under the equal protection clause. To remedy this claimed unconstitutional tax, petitioner does not propose that Barclays Capital be classified as an Article 9-A corporation, but asserts that the impropriety must be corrected by the exercise of the Commission's discretionary authority under Tax Law § 1462(g). Absent the exercise of such authority, the application of the tax as measured by assets under Article 32 (Tax Law § 1455[b]) discriminates against Barclays Capital as compared to a similarly situated primary dealer not owned by a bank and therefore taxable under the Article 9-A tax on the capital base (Tax Law § 210[1][b]).

Petitioner's constitutional arguments rest upon its assertion that corporate classification for tax purposes based upon corporate ownership is improper. While one effect of such classification is the disparate tax burden imposed by Tax Tax § 1455(b) as compared with Tax Law § 210(1)(b), it is the classification itself which is at issue. Indeed, the crux of petitioner's

argument is that since Barclays Capital and all primary dealers not owned by banks are similarly situated, they should be subject to the same tax on assets. Logically, however, if Barclays Capital and such other corporations are similarly situated, they should be subject to the same tax treatment in all respects - not merely the same tax on assets. Accordingly, it would be improper to determine simply, as petitioner frames the issue, whether Tax Law § 1455(b) is unconstitutional as applied. As petitioner's own arguments against ownership as a basis of classification suggest, the question of whether the treatment under Tax Law § 1455(b) is unconstitutional as applied depends upon whether Barclays Capital is properly classified as a banking corporation. If Barclays Capital's status as a banking corporation is constitutional, then it must be subject to all tax consequences under Article 32 flowing from such classification. Conversely, if such status is unconstitutional, then Barclays Capital is a business corporation subject to all tax consequences under Article 9-A. If this determination were to reach the result sought by petitioner, i.e., a discretionary adjustment netting petitioner's assets, the result would be to treat Barclays Capital as both an Article 32 corporation and, for purposes of the asset tax, a de facto Article 9-A corporation. There is no basis in the Tax Law for such hybrid treatment. Furthermore, it is improper to use the discretionary adjustment under Tax Law § 1462(g) to effectively reclassify a corporation from Article 32 to Article 9-A for the limited purpose of netting liabilities against assets in respect of the tax on assets. As discussed previously, the discretionary adjustment is available only where a banking corporation's income or assets are inaccurately or improperly reflected on returns. Here, the question that must be resolved to determine whether the tax on assets unconstitutionally burdens petitioner is whether Barclays Capital's status as a banking corporation under Tax Law § 1452(a)(9) is constitutional. If it is, then its assets have been properly reported. If it is not, then the proper resolution is reclassify

Barclays Capital as a business corporation subject to tax under Article 9-A and compute tax accordingly.

While it seeks to avoid the asset tax consequences of Barclays Capital's status as a banking corporation, petitioner does not seek reclassification of Barclays Capital as an Article 9-A business corporation.[7] Accordingly, this determination shall not address the issue of the constitutionality of Barclays Capital's status as a banking corporation, for even if petitioner were to prevail on this issue, such an outcome would necessarily invalidate Barclays Capital's status as a banking corporation, an outcome that petitioner does not seek.

M. Regarding petitioner's adjustment of the receipts factor of its asset allocation percentage, possibly because of the relatively small amount involved with respect to this issue (***see***, Finding of Fact "5"), petitioner failed to provide documentation in response to Division requests. Further, the documentation provided at hearing on this issue, a summary of the calculations resulting in the proposed adjustment, does not establish that the proposed asset allocation percentage will "affect a fair and proper allocation of . . . assets reasonably attributable to New York" (***see***, 20 NYCRR 19-8.4[b]). Accordingly, the proposed receipts factor adjustment is properly denied.

N. The Division of Tax Appeals lacks jurisdiction to consider petitioner's argument that the Division failed to consider the alternative basis for allowing the refund of adding Barclays Bank PLC United States branch to the combined return filed by petitioner and thereby violating the foreign commerce clause contained in Article I, section 8, clause 3 of the United States constitution. This claim, made pursuant to an amendment to the petition, is unrelated to

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[7] Presumably petitioner does not seek reclassification for Barclays Capital as an Article 9-A corporation because it considers its Article 32 status as advantageous.

petitioner's refund claim (i.e., amended returns) by which petitioner seeks to net the liabilities of Barclays Capital and to make an adjustment to its receipts factor. Petitioner's refund claim makes no reference to adding Barclays Bank PLC to its combined return and the amended returns do not seek to add Barclays Bank PLC to the combined group. Thus, with respect to this mis-characterized "alternative basis for considering the refund" there is, in fact, neither a refund claim nor a refund claim denial. Accordingly, the Division of Tax Appeals lacks jurisdiction to consider this question (***see***, Tax Law §§ 1089[c]; 2006[4]).

Even if the Division of Tax Appeals had such jurisdiction, the proposed combination of foreign with domestic corporations is specifically precluded by Tax Law § 1462(f)(4)(ii) and petitioner's contention, which asserts that the statutory prohibition is based solely on Barclays Bank PLC's status as a foreign corporation, is a challenge to the validity of Tax Law § 1462(f)(4)(ii) on its face. Statutes are presumed constitutional at the administrative level and the Division of Tax Appeals' jurisdiction does not encompass such a constitutional challenge (***see***, ***Matter of Fourth Day Enterprises***, Tax Appeals Tribunal, October 27, 1988).

O. The petition of Barclays Group, Inc. (USA) & Affiliates, f/k/a Barclays Bank of New York & Affiliates is denied and the Division's denial of petitioner's claim for refund dated September 14, 2001 is sustained.

DATED: Troy, New York
December 11, 2003

/s/ Timothy J. Alston
ADMINISTRATIVE LAW JUDGE