STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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| In the Matter of the Petition | : | |
| of | : | |
| **UNICREDIT S.P.A.** | : | DECISION<br>DTA NO. 824103 |
| for Redetermination of a Deficiency or for Refund of Franchise Tax on Banking Corporations under Article 32 of the Tax Law for the Years 1999 and 2000. | : | |

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on November 7, 2013. The Division of Taxation appeared by Amanda Hiller, Esq. (Clifford M. Peterson, Esq., of counsel). Petitioner appeared by Kramer Levin Naftalis & Frankel LLP (Susan Jacquemot, Esq., Maria T. Jones, Esq., and Pamela M. Capps, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioner filed a brief in opposition to the exception of the Division of Taxation. The Division of Taxation filed a reply brief. Oral argument was heard on November 19, 2014, in New York, New York, which date began the six-month date for the issuance of this decision.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

***ISSUE***

Whether the Division of Taxation correctly determined petitioner's entire net income allocation percentages for the years 1999 and 2000 and, therefore, correctly determined petitioner's tax due for those years.

## *FINDINGS OF FACT*[1]

We find the facts as determined by the Administrative Law Judge, except that we omit finding of fact 42, which discussed findings of fact submitted by petitioner to the Administrative Law Judge. Such facts are set forth below.

1. Petitioner, UniCredit, S.p.A., is, and at all relevant times was, a foreign bank with its home office in Milan, Italy. During the years 1999 and 2000, petitioner carried on business in New York, New York, as a U. S. branch of a foreign bank and was subject to tax under Tax Law Article 32, the franchise tax on banking corporations.

2. During 1999 and 2000, petitioner's New York branch maintained an international banking facility (IBF). An IBF is a separate set of asset and liability accounts segregated on the books and records of the banking entity that established the IBF.

3. In order to encourage the location of banks with IBFs in New York, both New York State and New York City have enacted statutes intended to allow IBFs to conduct specified international banking transactions without incurring state or local tax liability on the income from those transactions (***see*** Legislative Memorandum in Support, Governor's Bill Jacket, L 1978, ch 288).

4. Petitioner's IBF engaged in international deposit-taking and lending activities and

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[1] In its exception, the Division of Taxation (Division) objected to various findings of fact. The Division's primary objection was that certain findings of fact were, in actuality, conclusions of law. To the extent that any of the findings of the Administrative Law Judge may be considered conclusions of law, we have not disturbed such findings as the Division expressed no objection as to the content of the findings. Also, where the Division requested additional information be added to certain findings, we decline to do so, as these involved credibility determinations of the Administrative Law Judge (***see Matter of Spallina***, Tax Appeals Tribunal, February 27, 1992 ["While this Tribunal is not absolutely bound by an Administrative Law Judge's assessment of credibility and is free to differ with the Administrative Law Judge to make its own assessment, we find nothing in the record here to justify such action on our part (***see Matter of Stevens v Axelrod***, 162 AD2d 1025 [1990]").

accepted deposits from, and solicited and made loans to, "foreign persons" meeting the definition contained in Tax Law § 1454 (b) (2) (B).

5. While petitioner's IBF had transactions with petitioner's other branches in 1999 and 2000, petitioner's IBF did not have any domestic third-party transactions in either of the years at issue.

6. Petitioner's IBF maintained separate books and records in which it recorded the gross income, gain, losses, deductions, assets, liabilities, and other activities attributable to it.

7. For both of the years at issue, petitioner timely filed New York State form CT-32, banking corporation franchise tax returns, and form CT-32M, banking corporation MTA surcharge returns.

8. For both 1999 and 2000, petitioner elected to calculate the amount of its income taxable in New York, and its entire net income allocation percentage (ENI Allocation Percentage), by using the IBF formula allocation method provided in Tax Law § 1454 (b) (2) (A) and 20 NYCRR 19-2.3 (b). This method involved calculation and application of a deposits factor, a payroll factor, and a receipts factor pursuant to the statute.

9. On its form CT-32 for each of the years at issue, petitioner used its federal taxable income as reported on its federal corporation income tax return as the starting point for computing its New York entire net income (State ENI).

10. Petitioner's federal taxable income for 1999 and 2000 did not include any amounts attributable to either interbranch transactions or to non-effectively connected income.

11. Petitioner determined its interest expense deduction for federal corporation income tax purposes pursuant to Treasury Regulation § 1.882-5.

***Petitioner's 1999 Returns***

12. Petitioner calculated and reported an ENI Allocation Percentage of 69.7776% and total franchise tax due of $1,002,017.00 on its New York banking corporation franchise tax return for 1999.

13. As a part of calculating its ENI Allocation Percentage for 1999, petitioner computed its deposits factor. It determined an amount of $958,931,015.00 as the average value of deposits maintained at the New York branch (including the IBF). That amount did not include any interbranch deposits. From that amount, petitioner subtracted deposits totaling $262,057,598.00, which it calculated as those deposits the expenses of which were attributable to the production of the eligible gross income of the IBF, resulting in the amount of $696,873,417.00. Petitioner used that figure as the numerator of its deposits factor and divided it by $958,931,015.00, or the amount it computed as the average value of deposits maintained at branches within and without New York State. Thus, petitioner calculated its deposits factor to be 72.6719% for 1999.

14. Petitioner also computed its payroll factor as part of its ENI Allocation Percentage for 1999. It determined an amount of $5,080,222.00 as representing 100% of its payroll expenses for employees within New York State. From that amount, petitioner subtracted $1,205,878.00, which it calculated as payroll expenses attributable to the production of eligible gross income of its IBF, resulting in the sum of $3,874,344.00. Petitioner multiplied this figure by 80%, as instructed by Tax Law § 1454, to arrive at the amount of $3,099,475.00, which its used as the numerator of its payroll factor. Petitioner then divided that amount by $6,075,883.00, which it computed as the amount of its payroll expenses for employees within and without New York

State, and arrived at a payroll factor for 1999 of 51.0127%.

***Petitioner's 2000 Returns***

15. Petitioner calculated and reported an ENI Allocation Percentage of 68.7153% and total franchise tax due of $848,582.00 on its New York banking corporation franchise tax return for 2000.

16. In order to calculate its ENI Allocation Percentage for 2000, petitioner computed its deposits factor. It determined an amount of $1,323,843,294.00 as the average value of deposits maintained at the New York branch (including the IBF). That amount did not include any interbranch deposits. From that amount, petitioner subtracted $150,382,972.00, which it calculated as deposits the expenses of which were attributable to the production of the eligible gross income of the IBF, resulting in the amount of $1,173,460,322.00. Petitioner used that figure as the numerator of its deposits factor and divided it by $1,323,843,294.00, or the amount it computed as the average value of deposits maintained at branches within and without New York State. Thus, petitioner calculated its deposits factor for 2000 to be 88.6404%.

17. Petitioner also computed its payroll factor as part of its ENI Allocation Percentage for 2000. It determined an amount of $5,706,441.00 as representing 100% of its payroll expenses for employees within New York State. From that amount, petitioner subtracted $2,189,252.00, which it calculated as payroll expenses attributable to the production of eligible gross income of its IBF, resulting in the sum of $3,517,189.00. Petitioner multiplied this figure by 80%, as directed by Tax Law § 1454, to arrive at the amount of $2,813,751.00, which it used as the numerator of its payroll factor. Petitioner then divided that amount by $6,569,436.00, which it computed as the amount of its payroll expenses for employees within and without New York

State, and arrived at a payroll factor for 2000 of 42.8309%.

***The Division of Taxation's Audit***

18. Following a field examination of petitioner's banking corporation franchise tax returns for the years at issue, the Division issued to petitioner a notice of deficiency, dated August 10, 2009, asserting additional tax of $209,668.00, and interest as follows:

| Tax Year | Form | Tax | Interest |
|---|---|---|---|
| 1999 | CT-32M | $15,989.00 | $17,502.28 |
| 1999 | CT-32 | $94,051.00 | $102,949.46 |
| 2000 | CT-32M | $14,476.00 | $13,247.87 |
| 2000 | CT-32 | $85,152.00 | $77,930.96 |

19. In reaching its determination, the Division made no adjustments to petitioner's federal taxable income or its calculation of entire net income as reported on Schedule B of either of petitioner's forms CT-32.

20. Instead, the Division's adjustments for the years 1999 and 2000 centered on the revision of petitioner's deposits and payroll factors by reducing the amount of deposits and wages attributable to the production of eligible gross income that petitioner had excluded from the numerator of its deposits and payroll factors.

21. On audit, petitioner supplied the Division with a summary report of the total income it recorded in its separate IBF account for 1999. In the report, petitioner identified certain items of income as interbranch and others as non-effectively connected income. The Division determined that these items did not qualify for treatment as eligible gross income. Similarly, the Division determined that income items listed by petitioner as "Forex & Trading Gains" and

"Forex and Trading Losses," both identified by petitioner as "Third Party U.S. Source," also did not qualify as eligible gross income. Consequently, the Division concluded that as the aforementioned items were not eligible gross income, they had to be ineligible gross income pursuant to 20 NYCRR 18-3.2 (i).

22. The amounts attributable to the "Forex & Trading Gains" and "Forex and Trading Losses" netted to a loss on petitioner's books and did not result in federal taxable income.

23. The Division determined that petitioner, for purposes of its accounting records, recorded income of the IBF in the amount of $43,356,226.00 for 1999. The Division also determined that this amount was comprised of petitioner's IBF's transactions with foreign persons, as that term is defined in Tax Law § 1454 (b) (2) (B), in the amount of $23,225,265.00, and other transactions described in Finding of Fact 21 that produced ineligible gross income in the amount of $20,130,961.00.

24. Since the Division concluded that petitioner had ineligible, as well as eligible gross income for 1999, the Division computed a fraction described in 20 NYCRR 18-3.9 (b), and commonly known as the "scaling ratio." The scaling ratio is used to reduce the amount of deposits and wages that can be excluded from a bank's allocation factors when its IBF has both eligible and ineligible gross income. As directed by the regulation, the Division divided petitioner's recorded eligible gross income of $23,225,265.00 by its recorded total income of $43,356,226.00, resulting in a scaling ratio of 53.5685% for 1999.

25. The Division determined that the amount of petitioner's deposits attributable to the production of eligible gross income of its IBF in 1999 was actually $140,380,324.00 by multiplying petitioner's calculation of $262,057,598.00 by the scaling ratio of 53.5685%. As a

result, the Division only excluded $140,380,324.00 from the numerator of petitioner's deposits factor, which caused that number to increase from $696,873,417.00 (***see*** Finding of Fact 13) to $818,550,691.00. Consequently, the Division adjusted petitioner's deposits factor up to 85.3607% for 1999.

26. The Division similarly adjusted petitioner's payroll factor for 1999. On audit, the Division determined the amount of petitioner's payroll expenses attributable to the production of the eligible gross income of petitioner's IBF to be $654,971.00 by multiplying petitioner's amount of $1,205,878.00 by the scaling ratio. As a result, the Division only excluded $654,971.00 from the numerator of petitioner's payroll factor, which caused the numerator to increase from $3,874,344.00 (***see*** Finding of Fact 14) to $4,434,083.00. The Division then multiplied $4,434,083.00 by 80%, as directed by statute, to arrive at $3,547,266.00 as the numerator of petitioner's payroll factor. Thus, the Division increased petitioner's payroll factor to 58.3827% for 1999.

27. The Division did not adjust petitioner's calculation of its receipts factor for 1999.

28. The Division's adjustments to petitioner's deposits and payroll factors resulted in an increase in petitioner's ENI Allocation Percentage for 1999 from 69.7776% to 76.3271%.

29. As was the case with 1999, the Division reviewed a summary report of the total income petitioner recorded in its separate IBF account and made similar adjustments for 2000. It determined that petitioner, for purposes of its accounting records, recorded the income of the IBF in the amount of $58,998,627.00 for that year. Of that amount, the Division determined that the IBF had transactions with foreign persons as that term is defined in Tax Law § 1454 (b) (2) (B) in the amount of $35,466,867.00 and transactions that produced ineligible gross income

in the amount of $23,531,760.00. The ineligible gross income, according to the Division, arose from interbranch transactions.

30. Since the Division found that petitioner had ineligible, as well as eligible gross income for 2000, it computed a scaling ratio under 20 NYCRR 18-3.9. For 2000, the Division divided recorded eligible gross income of $35,466,867.00 by its recorded total income of $58,998,627.00, resulting in a scaling ratio of 60.1147%.

31. The Division determined that the amount of petitioner's deposits attributable to the production of eligible gross income of its IBF in 2000 was $90,402,272.00 by multiplying petitioner's calculation of $150,382,972.00 by the scaling ratio of 60.1147%. As a result, the Division only excluded $90,402,272.00 from the numerator of petitioner's deposits factor, which caused the numerator to increase from $1,173,460,322.00 (***see*** Finding of Fact 16) to $1,233,441,022.00. Consequently, the Division adjusted petitioner's deposits factor up to 93.1712% for 2000.

32. The Division also adjusted petitioner's payroll factor for that year. On audit, the Division determined the amount of petitioner's payroll expenses attributable to the production of the eligible gross income of petitioner's IBF to be $1,316,062.00 by multiplying the amount of $2,189,252.00 by the scaling ratio for 2000. As a result, the Division only excluded $1,316,062.00 from the numerator of petitioner's payroll factor, which caused it to increase from $3,517,189.00 (***see*** Finding of Fact 17) to $4,390,379.00. The Division then multiplied $4,390,379.00 by 80% to arrive at $3,512,303.00 as the numerator of petitioner's payroll factor. Thus, the Division adjusted petitioner's payroll factor to 53.4643% for 2000.

33. Additionally, the Division adjusted petitioner's calculation of its receipts factor for

2000 by decreasing eligible gross income in the amount of $8,489,248.00. This adjustment stemmed from the Division's determination that petitioner had improperly treated income that its IBF had earned from its foreign branches as eligible gross income, and resulted in an increase of petitioner's ENI Allocation Percentage for 2000 from 68.7153% to 71.6716%. Petitioner does not dispute this adjustment, which results in additional tax due of $36,508.00, and an additional MTA surcharge of $6,206.00 for 2000.

34. In total, the Division's adjustments to petitioner's deposits, payroll and receipts factors resulted in its ENI Allocation Percentage for 2000 being increased from 68.7153% to 75.6106%.

35. During the years at issue, the Division's instructions for form CT-32 did not direct a taxpayer to apply a scaling ratio or to use any other method to reduce IBF deposits to account for ineligible income when applying the formula allocation method.

36. In section 4.4.7.3 of the NY Audit Manual Corporation Audit Guidelines, when discussing its policy regarding the formula allocation method, the Division instructs that "[i]n no event shall transactions between the taxpayer's IBF and its foreign branches be considered when computing the allocation percentage."

37. At the hearing, petitioner presented the testimony of Stuart Zwerling, Esq., an attorney and certified public accountant licensed in the states of New York and Maryland. He also possesses an LL.M. in Taxation from the New York University School of Law. Mr. Zwerling is a partner with Deloitte Tax LLP, a firm with which he has practiced since 1985. The focus of Mr. Zwerling's practice throughout his career has been the federal and state taxation of foreign banks and he is responsible for the banking practice in the northeast sector for Deloitte. A large majority of Mr. Zwerling's clients are foreign banks with IBFs located in

New York City. Mr. Zwerling was offered and qualified as an expert on the taxation of foreign banking corporations and the tax treatment of IBFs under New York law.

38. Mr. Zwerling opined that the Division's audit reached an incorrect result because petitioner did not have ineligible gross income during the years at issue and, therefore, use of the scaling ratio was in error. He added that petitioner's approach in preparation of the returns in question was "reasonable." Nevertheless, he also testified that the more accurate methodology for calculating the deposits factor is to determine the amount of IBF deposits that would be deemed to produce deductible interest expense attributable to effectively connected income, as well as to eligible gross income of the IBF, under the approach set forth in Treasury Regulation § 1.882-5 and 20 NYCRR 18-3.6 (c). Under this approach of treating the IBF on a stand-alone basis, Mr. Zwerling computed the percentage of the IBF's overall liabilities that would give rise to deductible interest expense under the aforementioned regulations. He then applied that percentage to the IBF's third-party deposits to determine the amount of deposits the expenses of which give rise to the production of eligible gross income. Mr. Zwerling then applied the three-step process described in Treasury Regulation § 1.882-5 to determine deductible interest expense.

39. Mr. Zwerling set forth his calculation of petitioner's IBF interest expense using the foregoing methodology. For 1999, the IBF's U.S. connected liabilities, as determined under Treasury Regulation § 1.882-5, were $374,008,045.00. Meanwhile, its total liabilities as recorded on the IBF's books were $463,566,618.00.[2] Under Treasury Regulation § 1.882-5, petitioner can deduct interest expense only to the extent that it is connected to its U.S. connected

[2] Total liabilities were comprised of third-party deposits of $262,057,598.00 and other third-party liabilities of $201,509,020.00.

liabilities. Therefore, because the amount of petitioner's IBF's booked liabilities was greater than its U.S. connected liabilities, in order to determine the amount of interest expense that is deductible for federal income tax purposes, Treasury Regulation § 1.882-5 requires the application of a ratio consisting of the U.S. connected liabilities divided by the booked liabilities. For 1999, that ratio was 80.68%. Applying that ratio to the third-party deposits in petitioner's IBF, Mr. Zwerling concluded that deposits in the amount of $211,429,482.00, rather than the $262,057,598.00 claimed by petitioner prior to the hearing (***see*** Finding of Fact 13), are properly deemed deposits the expenses of which were attributable to the IBF's eligible gross income. Hence, based on Mr. Zwerling's calculations, the correct amount of deposits to be excluded from the numerator of petitioner's deposits factor for 1999 was $211,429,482.00, and he maintained that petitioner's deposits factor should be adjusted accordingly from 72.6719% to 77.9515%.

40. As a result of the adjustment to the deposits factor discussed in Finding of Fact 38, Mr. Zwerling explained that petitioner's ENI Allocation Percentage for 1999 should be increased from 69.7776% to 71.8895%, causing additional tax liability of $30,327.00 and an additional MTA surcharge of $5,156.00. This amount was not included in the notice of deficiency at issue.

41. Mr. Zwerling also concluded at hearing that, after applying the same methodology, petitioner's deposits factor for 2000 was correct as reported.

## *THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE*

The Administrative Law Judge explained that at issue in the current matter were adjustments made by the Division to petitioner's calculations of its Allocated Taxable ENI involving the utilization of the scaling ratio. The Division's regulation at 20 NYCRR 18-3.9

identifies the situation to which the scaling ratio is applicable as when a banking corporation has both eligible and ineligible gross income. This provision provides that direct expenses not specifically identified with eligible gross income and indirect expenses must be apportioned using a ratio, the numerator of which is the eligible gross income of the IBF and the denominator of which is the total gross income of the IBF. Thus, as explained by the Administrative Law Judge, the issue in this case was whether the Division correctly relied upon the definition of ineligible gross income, as "other than eligible income," contained in 20 NYCRR 18-3.2 (i), in determining that the application of the scaling ratio was appropriate.

The Administrative Law Judge determined that the Division's reliance on the definition of ineligible gross income found in 20 NYCRR 18-3.2 was inappropriate for numerous reasons.

First, the Administrative Law Judge found that Subparts 19-2 and 19-3 of the regulations, not Subpart 18-3, governed the Formula Allocation Method selected by petitioner. Also, the definition of ineligible gross income relied upon by the Division is limited to the use of that term in Subpart 18-3 of the regulations, which implement the Income Modification Method, not the provisions implementing the Formula Allocation Method selected by petitioner. In reaching these conclusions, the Administrative Law Judge discounted the Division's assertion that the definition of ineligible gross income found in 20 NYCRR 18-3.2 was incorporated by direct reference in 20 NYCRR 19-2.3 (b), by limiting such reference to determining the receipts and expenses "which are attributable, as provided in Subpart 18-3 of this Title, to the production of eligible gross income." The Administrative Law Judge also discounted the Division's argument that 20 NYCRR 18-3.2 and 20 NYCRR 19-2.3 (b) should be read *in pari materia*, by explaining that this rule of statutory construction cannot be invoked in a case where, as here, the language

of the statutes and regulations is not only clear and unambiguous, but leads to the opposite conclusion.

In support of his conclusion that the Division improperly relied upon the definition of ineligible gross income found in 20 NYCRR 18-3.2, the Administrative Law Judge noted that there is no specific incorporation of the definition of ineligible gross income in Tax Law § 1454 or 20 NYCRR 19-2.3 (b), in contrast to the definition of eligible gross income contained in Tax Law § 1453 (f) (2) and 20 NYCRR 18-3.4, which is specifically incorporated by reference in Tax Law § 1454 (b) (2) (B) and 20 NYCRR 19-2.3 (d) into the Formula Allocation Method. Thus, the Administrative Law Judge concluded that had the Legislature intended that the definition of ineligible gross income found in 20 NYCRR 18-3.2 (i) be applicable to the Formula Allocation Method, it could have referenced the same in the statute.

The ultimate conclusion of the Administrative Law Judge was that as the regulatory definition of ineligible gross income did not apply in this case, and as petitioner did not have ineligible income, the Division improperly invoked the scaling ratio.

The Administrative Law Judge discussed the fact that the parties agreed that the interbranch transactions and non-effectively connected income at issue does not constitute eligible gross income. Eligible gross income includes income from certain defined banking activities with foreign persons. Foreign persons under the Income Modification Method include foreign branches of the banking company and income from transactions with those foreign branches is included in eligible gross income, although income from transactions between the IBF and domestic branches is not (Tax Law § 1453 [f] [2]; 20 NYCRR 18-3.3 [b], 18-3.4). However, under the Formula Allocation Method, not only are foreign branches not considered foreign persons, but an IBF's transactions with foreign branches are not to be considered at all

(Tax Law § 1454 [b] [2] [B]; 20 NYCRR 19-2.3 [d]). The Administrative Law Judge did not agree with the Division's argument that these provisions meant that transactions with foreign branches were only not to be considered eligible gross income for purposes of the Formula Allocation Method, because that could have been accomplished without the addition of the limitation that the transactions not be considered at all.

Furthermore, the Administrative Law Judge pointed out that the nature of the income involved also supported petitioner's assertions. Specifically, interbranch transactions were not included in petitioner's calculation of its federal taxable income or State ENI because such internal transactions did not constitute gross income. Therefore, for purposes of the Formula Allocation Method, ineligible gross income of the IBF cannot include such transactions, and the same holds true for non-effectively connected income. Thus, the Administrative Law Judge concurred with petitioner's position that income from the interbranch branch transactions, as well as the non-effectively connected income, identified by the Division as ineligible gross income, were, in fact, not income at all for purposes of State ENI or the Formula Allocation Method.

The Administrative Law Judge then concluded, regarding petitioner's deposits factor for 1999, that based upon testimony from petitioner's expert witness, although petitioner's calculations were reasonable, there was a more accurate method to calculate that factor utilizing Treasury Regulation § 1.882-5 and 20 NYCRR 18-3.6 (c). The more accurate calculations resulted in $30,327.00 in additional tax due and $5,156.00 MTA surcharge due for the year 1999 and the Administrative Law Judge determined that such adjustment must be made to the notice of deficiency. The Administrative Law Judge dismissed the arguments of the Division that the testimony of petitioner's expert should be given little or no weight, due to his alleged

personal interest in the outcome of the case and his unfamiliarity with certain U.S. Supreme Court apportionment cases. The Administrative Law Judge found that while several of the witness' clients could benefit from a favorable determination for petitioner in this case, there was no evidence that he had a personal interest in the outcome of this case, indeed having suggested a correction that would increase petitioner's tax liability. Furthermore, as the issue in this case was the interpretation and application of New York laws and regulations, the U.S. Supreme Court cases on apportionment are not relevant. The Administrative Law Judge concluded that the testimony of the expert witness was "probative and credible, and must be considered in reaching this determination."

Finally, the Administrative Law Judge discredited the Division's argument that its adjustments should be upheld as constitutionally permissible, in that there was no assertion that the adjustments did not meet constitutional muster, but that such adjustments represented an incorrect interpretation and application of New York law.

***ARGUMENTS ON EXCEPTION***

The Division asserts that the definition of eligible gross income found in 20 NYCRR 18-3.2 (i), and thus the scaling ratio found in 18-3.9, are applicable to the Formula Allocation Method and that it properly calculated petitioner's wage expenses and deposits, the expenses of which were attributable to the eligible gross income of the IBF.

The Division relies upon the language of 20 NYCRR 19-2.3 [b] [1] and [3] wherein it is explained that if a taxpayer selects the Formula Allocation Method to reflect its IBF benefit, it must exclude from the numerator of its payroll and deposit factors "the expenses of which are attributable, as provided in Subpart 18-3 of this Title, to the production of eligible gross income." The Division asserts that the language "as provided in Subpart 18-3 of this Title,"

requires the inclusion of the concepts of ineligible gross income and the Scaling Factor found in Subpart 18-3.

The Division further asserts that petitioner cannot pick and choose between which definitions contained in 20 NYCRR 18-3.2 it will use. The Division explains that without such definitions, petitioner could not, for example, compute the wage expense attributable to its IBF absent the definitions of deposits, foreign, loan and United States in Section 18-3.2 (b), (e), (k) and (n). Therefore, the Division contends that the definition of ineligible gross income must also be applicable.

The Division urges this Tribunal to reject the analysis of Mr. Zwerling based on, among other reasons, his reliance on ***Matter of Credit Industriel Et Commercial*** (NYC Tax Appeals Tribunal, June 30, 2006), which is not precedential and is distinguishable in any event, and its contention that the Administrative Law Judge was incorrect in determining that he did not have a personal stake in the outcome of the case. The Division then urges this Tribunal to take judicial notice of the testimony of Mr. Leonard Blankopf in another matter currently before the Division of Tax Appeals.

The Division argues that, contrary to the Administrative Law Judge's specific mention that his determination is based upon the facts of the case, a holding that the definition of ineligible gross income set forth in 20 NYCRR 18-3.2 (i) does not apply to the Formula Allocation Method would actually be applicable to all instances where a banking corporation chose that method.

Petitioner contends that the Administrative Law Judge properly concluded that petitioner's IBF had no ineligible gross income and that, therefore, the Division's application of the scaling ratio was incorrect.

Petitioner asserts that for purposes of the Income Modification Method, when an IBF has both eligible and ineligible gross income, the scaling ratio is utilized to determine the amount of expenses that are attributable to the eligible gross income of the IBF, for purposes of computing the IBF's adjusted eligible net income under 20 NYCRR 18-3.3 (a). However, neither the statute nor the regulations explicitly authorize the use of the scaling ratio for purposes of the Formula Allocation Method.

Petitioner asserts that 20 NYCRR 19-2.3 (b) only incorporates those provisions of Subpart 18-3 concerned with determining which expenses are attributable to the production of eligible gross income (20 NYCRR 18-3.5 through 18-3.8).

Petitioner asserts that the Administrative Law Judge properly credited Mr. Zwerling's calculations and testimony. Petitioner further asserts that there is no provision in the statute or regulations that prescribes any methodology for calculating the amount of IBF's expenses attributable to the production of eligible gross income. Petitioner points out that while the Division argues that petitioner cannot tie specific IBF interest expense to specific IBF deposits, the Division states in its own brief that banking corporations are only required to determine which deposits have expenses "attributable to the production of a specific income stream of the IBF, i.e., the IBF's eligible gross income." Furthermore, Mr. Zwerling's calculations were based on either stipulated figures or supported by documentary evidence that was not challenged by the Division. As such, petitioner asserts that the Administrative Law Judge was correct in determining that Mr. Zwerling was independent, despite the Division's arguments that his testimony should not be entitled to much weight because he had a personal interest in the outcome. Indeed, the interest relied upon by the Division was that of other clients in similar circumstances, who, if petitioner prevails, will no longer have need of his services.

## *OPINION*

We affirm the determination of the Administrative Law Judge for the reasons set forth herein.

Article 32 of the Tax Law imposes a 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]).[3] The basic tax is measured by the taxpayer's State ENI, or the portion thereof that is allocated to New York State, the taxpayer's Allocated Taxable ENI (Tax Law § 1455 [a]).

Pursuant to Tax Law § 1453 (a), ENI includes total net income from all sources, which is generally the same as federal taxable income. Thus, federal taxable income is the starting point in computing Allocated Taxable ENI (Tax Law § 1453 [a]). Certain New York additions and subtractions not relevant to the current matter are then made to ENI to arrive at State ENI (Tax Law § 1453). For those banking corporations whose State ENI is "derived from business carried on within and without the state," their State ENI is then multiplied by the ENI Allocation Percentage to arrive at Allocated Taxable ENI (Tax Law § 1454 [a]). The ENI Allocation Percentage is determined by a formula consisting of a payroll factor, a receipts factor[4] and a deposits factor where the receipts and deposits factors are double-weighted (Tax Law § 1454 [a], [b]; 20 NYCRR 19-2.1, 2.2 [a]). The payroll factor is 80% of New York payroll divided by payroll everywhere. The deposits factor is the average value of deposits maintained in New

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[3] Article 32 was repealed subsequent to the years at issue in this matter (L 2014, c 59, pt A § 1, eff Jan. 1, 2015). Article 32 and the sections thereunder referred to in this decision are referenced without the technically correct modifier "former," in order to be more clear.

[4] With the exception of the adjustment of petitioner's receipt factor for 2000, which petitioner does not dispute (***see*** Finding of Fact 33), the receipts factor is not at issue herein.

York divided by the average value of deposits maintained everywhere (20 NYCRR 19-2.2 [b] [1], [3]).

Petitioner is a banking corporation subject to the franchise tax imposed by Article 32 of the Tax Law with "business carried on within and without the state." At the center of the current controversy is an IBF established by petitioner.

An IBF is a set of asset and liability accounts segregated on the books of the IBF's establishing entity (Tax Law § 1450 [c]; 3 NYCRR 19-1, 19-3; CFR 204.8 [a] [1]). In general, financial institutions in the United States establish IBFs in order to provide banking services to foreign customers without being subject to certain federal regulations such as reserve requirements and interest rate caps. The establishment of an IBF allows a financial institution to compete on the same level with offshore banking offices. Additionally, some states, including New York, have adopted favorable tax treatment for income from IBF activities in order to encourage the establishment of IBFs by financial institutions in their states (***see Activities of International Banking Facilities: The Early Experience***, Sydney J. Key, Federal Reserve Bank of Chicago, [1982]; ***U.S. Department of the Treasury, Related Organizations, Comptroller's Handbook*** [August 2004], p. 27).

The favorable tax treatment regarding income from IBF activities in New York is reflected in the calculations utilized by a banking corporation to arrive at Allocated Taxable ENI. In making those calculations, a New York banking corporation with an IBF may select to calculate its Allocated Taxable ENI using either the Income Modification Method or the Formula Allocation Method (Tax Law § § 1453 [f], 1454 [b] [2]).

The Income Modification Method allows a banking corporation to deduct the "adjusted eligible net income of an international banking facility" from its ENI (Tax Law § 1453 [f]) in

determining its State ENI. Tax Law § 1453 and 20 NYCRR Subpart 18-3 set forth the rules for determining the "adjusted eligible net income." These provisions effectively remove the income earned by the IBF in its transactions with foreign persons, less its expenses attributable to such income, from ENI to arrive at State ENI. Furthermore, in arriving at Allocated Taxable ENI from State ENI, a banking corporation selecting the Income Modification Method must exclude from both the numerator and denominator of its ENI Allocation Percentage the payroll, receipts and deposits of its IBF, as its adjusted eligible net income has already been excluded. In sum, the IBF is treated under the Income Modification Method similarly to how it would be treated if it were a separate corporation from the banking corporation (***State Taxation of Banks and Financial Institutions***, BNA Tax Management Portfolios [2008], § 1800.2, p. 19).

The Formula Allocation Method has no impact on the calculations that derive State ENI from ENI. Rather, as the name implies, it relates to the calculations that derive Allocable Taxable ENI from State ENI. The tax benefit derived from this method is based upon the removal of the IBF factors, i.e., the values attributable to the IBF's production of eligible gross income, from the numerator of the Allocation Percentage, while leaving such factors in the denominator (Tax Law § 1454 [b] [2]). In sum, the IBF is treated as a foreign branch of the banking corporation.

The object of both the Income Modification Method and the Formula Allocation Method is to provide a tax benefit to the banking corporation for the business, basically receiving deposits and lending funds, that the IBF is doing with foreign persons (***Is New York Bank Tax Ready for the 1990s?***, Marilyn M. Kaltenborn, Journal of State Taxation, Vol. 4:3 [Fall 1985], p. 229, n 26).

Petitioner in this matter chose the Formula Allocation Method to obtain the tax benefits

associated with its IBF. Tax Law § 1454 (b) (2) (A), the statute governing the Formula Allocation method, provides that:

> "(i) wages, salaries and other personal service compensation properly attributable to the production of eligible gross income of the taxpayer's [IBF] shall not be included in the computation of wages, salaries and other personal service compensation of employees within the state,
>
> * * * * *
>
> (iii) deposits from foreign persons which are properly attributable to the production of eligible gross income of the taxpayer's [IBF] shall not be included in the computation of deposits maintained at branches within the state."

Eligible gross income is defined for purposes of the Formula Allocation Method as having the same definition as it does for the Income Modification Method with the exception "that the term 'foreign person' as defined in paragraph eight of subsection (f) shall not include a foreign branch of the taxpayer and in no event shall transactions between the taxpayer's international banking facility and its foreign branches be considered" (Tax Law § 1454 [b] [2] [B]; ***see also*** 20 NYCRR 19-2.3 [d]). Eligible gross income is defined for purposes of the Income Modification Method as essentially income from loans to, and deposits from, foreign persons (Tax Law § 1453 [f] [2]; 20 NYCRR 18-3.4). Ineligible gross income is not defined in the statutes related to either the Formula Allocation Method or the Income Modification method. The regulations governing the Income Modification Method define ineligible gross income as "gross income (including gross income from interoffice transactions) of the IBF that is other than eligible gross income" (20 NYCRR 18-3.2 [i]).

The disagreement between the parties in this matter is how the wage and deposits factors are calculated. Both parties base their respective arguments on their interpretations of 20 NYCRR 19-2.3 (b), the regulations interpreting Tax Law § 1454 (b) (2). These regulations

direct the taxpayer to accomplish the exclusions from the numerator of the wage and deposits factors by:

> "(1) including, in the denominator . . . but excluding from the numerator of the payroll factor wages, salaries and other personal service compensation of the taxpayer's employees ***the expenses of which are attributable, as provided in Subpart 18-3 of this Title, to the production of eligible gross income***;
>
> * * * * *
>
> (3) including in the denominator but excluding from the numerator of the deposits factor, deposits ***the expenses of which are attributable, as provided in Subpart 18-3 of this Title, to the production of eligible gross income***" (Emphasis added).

The crux of this matter is the interpretation of the phrase "the expenses of which are attributable, as provided in Subpart 18-3 of this Title, to the production of eligible gross income." The argument has been framed in terms of whether petitioner's IBF has any ineligible gross income for purposes of the Formula Allocation Method. However, as pointed out by the Division, what is actually being decided, is whether the concept of ineligible gross income is applicable to the Formula Apportionment Method at all.

On its 1999 and 2000 banking corporation franchise tax returns, petitioner calculated the numerator of its deposits factor by: (1) determining the average value of deposits it maintained in its New York branch (including IBF deposits but not including any interbranch deposits); (2) determining the amount of deposits, the expenses of which were attributable to the production of the eligible gross income of the IBF; and (3) subtracting two from one. Petitioner then calculated the denominator of its deposits factor by determining the average value of deposits that it maintained everywhere (i.e., both within and without New York). Finally, petitioner calculated its deposits factor by dividing the numerator by the denominator.

On its 1999 and 2000 banking corporation franchise tax returns, petitioner calculated the

numerator of its payroll factor by: (1) determining the amount of its payroll expenses for employees within New York; (2) determining the amount of payroll expenses that were attributable to the production of the eligible gross income of the IBF; (3) subtracting two from one; and (4) multiplying three by 80%. Petitioner then calculated the denominator of its payroll factor by determining the amount of its payroll expenses for its employees everywhere (i.e., both within and without New York). Finally, petitioner calculated its payroll factor by dividing the numerator by the denominator.

The Division, on review of a summary report provided by petitioner of the total income recorded in its separate IBF account, concluded that certain items of income listed by petitioner were ineligible gross income. Based upon its conclusion that petitioner's IBF had both eligible and ineligible income for 1999 and 2000, the Division applied the scaling ratio to reduce the amount deducted from petitioner's deposits and wages representing the IBF, which decreases the benefit petitioner receives from the IBF and correspondingly increases petitioner's ENI Allocation Percentage, its Allocable Taxable ENI and ultimately petitioner's tax due.

Ultimately, the disagreement between the parties is a matter of statutory and regulatory construction. When construing a statute, the primary focus is on the intent of the Legislature in enacting the statute (McKinney's Cons Laws of NY, Book 1, Statutes § 92 (a); ***see Matter of Sutka v Conners***, 73 NY2d 395 [1989]; ***Matter of American Communications Tech. v State of N.Y. Tax Appeals Trib.***, 185 AD2d 79 [1993], ***lv granted*** 82 NY2d 653 [1993], ***affd*** 83 NY2d 773 [1994]). When that intent is clear from the wording of the statute itself, the inquiry ends (McKinney's Cons Laws of NY, Book 1, Statutes § 76; ***see Matter of American Communications Tech. v State of N.Y. Tax Appeals Trib.***; ***see also***, ***US v Ron Pair Enterprises., Inc.***, 489 US 235, 242 [1989] "[t]he plain meaning of legislation should be

conclusive, except in the 'rare cases' [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters"]). These principles of statutory construction also apply to the interpretation of regulations (***see Matter of Cortland-Clinton, Inc. v New York State Dept. of Health***, 59 AD2d 228 [1977]).

Neither the definition of ineligible gross income nor the scaling ratio are statutory; both are found in the regulations. 20 NYCRR 18-3.9, which sets forth the scaling ratio, is a calculation utilized to determine what expenses are applicable to eligible gross income when an IBF has both eligible and ineligible gross income. However, it is contained in 20 NYCRR Subpart 18-3, which applies to the Income Modification Method and not to the Formula Allocation Method. Subpart 18-3 provides the framework under the Income Modification Method for determining the amount of the adjusted eligible net income of the IBF, which is what is allowed as a deduction under the Income Modification Method. Thus, at first blush, the scaling ratio appears to be inapplicable to any calculation under the Formula Allocation Method.

However, the Division asserts that 20 NYCRR 19-2.3 (b) makes the definition of ineligible gross income contained in 20 NYCRR 18-3.2, and therefore also the scaling ratio contained in 20 NYCRR 18-3.9, applicable to the calculation of expenses attributable to the production of eligible gross income in 20 NYCRR 19-2.3. We disagree.

20 NYCRR 19-2.3 directs the taxpayer to accomplish the exclusions from the numerator of the payroll and deposits factor by excluding payroll and deposits "the expenses of which are attributable, as provided in Subpart 18-3 of this Title, to the production of eligible gross income," Subpart 18-3 is made applicable to such calculation only to the extent that it contains provisions specifically related to expense attribution. The definition of ineligible gross income, and the application of the scaling factor that flows from the incorporation of such definition, are

not specifically related to expense attribution. If, as the Division contends, the drafters of the regulations intended that the definition of ineligible gross income, and the inclusion of the scaling factor that flows therefrom, were to be applicable to the Formula Allocation Method, it would have been a simple matter to rearrange the clauses of the sentence so that it read: "the expenses of which are attributable . . . to the production of eligible gross income as provided in Subpart 18-3 of this Title."

Furthermore, this regulatory construction is evident from Subpart 18-3 itself. Specifically, section 18-3.3 (c), provides that "[e]xpenses applicable to eligible gross income of the IBF are those . . . described in sections 18-3.5 through 18-3.8 of this Subpart that are directly or indirectly attributable to the eligible gross income of the IBF" (20 NYCRR 18-3.3 [c]). The remaining sections of Subpart 18-3 do not contain attribution rules and are thus not made applicable to the Formula Allocation Method by 20 NYCRR 19-2.3 (b).

The inapplicability of the provisions of Subpart 18-3, other than the provisions specifically dealing with expense attribution, to the Formula Allocation Method is further demonstrated by Tax Law § 1454 (b) (2) (B) and 20 NYCRR 19-2.3 (d), which provide that for purposes of the Formula Allocation Method, no consideration is to be given to transactions between the IBF and the foreign branches of its establishing banking corporation. We agree with the analysis of the Administrative Law Judge regarding the plain reading of this language. Specifically, that if such transactions are not to be considered at all for purposes of the formula allocation method, they cannot be held to produce ineligible income (***see also*** TSB-M-85 (16)C [1986] ["for purposes of computing the allocation percentages, in no event shall transactions between the taxpayer's IBF and its foreign branches be considered when computing the allocation percentage"]).

Thus, a plain reading of the statutes and regulations governing the calculation of petitioner's Allocable Taxable ENI indicates that the concept of ineligible income and the application of the Scaling Factor that flows therefrom are not applicable to the Formula Allocation method.

The Division contends that the Administrative Law Judge improperly relied upon the testimony of Mr. Zwerling. It appears from our reading of the determination of the Administrative Law Judge that he relied upon Mr. Zwerling's testimony primarily to support additional calculations presented at the hearing regarding petitioner's deposits factor for 2000 (***see*** Findings of Fact 38 through 40). Mr. Zwerling's testimony in this regard is more in the nature of a factual witness than an expert, as he is presenting actual calculations of the deposits factor. Accordingly, we defer to the credibility determination of the Administrative Law Judge and based thereon, concur with the conclusion of the Administrative Law Judge that the calculations presented at the hearing should be sustained as part of the ultimate calculation of tax due.[5]

We did not rely on the testimony of Mr. Zwerling for our interpretation of the language of the statute and regulations at issue in this matter. Therefore, we decline to address the issue of the extent or the correctness of the Administrative Law Judge's reliance upon such testimony.

We also did not consider the testimony of Mr. Blankopfs in a hearing in another matter currently before the Division of Tax Appeals as there has not, as of yet, been a determination issued in that matter. As such, it would be inappropriate to consider taking judicial notice of such testimony in a case that this Tribunal may be called upon to review.

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[5] The Division's argument seems to conflate this issue regarding the calculation of the 2000 deposits factor with the central issue of the case. Having determined that the scaling ratio does not apply, and therefore that the Division's calculations are incorrect, this issue deals only with whether petitioner's original calculations or those it presented at the hearing were more accurate.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of The Division of Taxation is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petition is granted to the extent indicated in conclusion of law I of the Administrative Law Judge's determination; and

4. The Division of Taxation is directed to modify the notice of deficiency issued to UniCredit, S.p.A., in accordance with conclusion of law I of the Administrative Law Judge's determination.

DATED: Albany, New York
May 19, 2015

/s/ Roberta Moseley Nero
Roberta Moseley Nero
President

/s/ Charles H. Nesbitt
Charles H. Nesbitt
Commissioner

/s/ James H. Tully, Jr.
James H. Tully, Jr.
Commissioner