STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **UNICREDIT S.P.A.** 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.	: : : : :	DETERMINATION DTA NO. 824103

Petitioner, UniCredit S.p.A., 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 1999 and 2000.

A hearing was commenced before Herbert M. Friedman, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, One Centre Street, New York, New York, on October 23, 2012 at 10:30 A.M., and continued to conclusion at the same location on October 24, 2012 at 9:15 A.M., with all briefs to be submitted by May 10, 2013, which date began the six-month period for the issuance of this determination. Petitioner appeared by Kramer Levin Naftalis & Frankel LLP (Maria T. Jones, Esq., Susan Jacquemot, Esq., and Pamela M. Capps, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Clifford M. Peterson, Esq., of counsel).

ISSUE

Whether the Division of Taxation properly determined that petitioner's international banking facility had ineligible gross income in the years 1999 and 2000 and, therefore, correctly applied scaling ratios pursuant to 20 NYCRR 18-3.9 to petitioner's payroll, deposits and receipts factors when calculating petitioner's entire net income allocation percentages for those years.

FINDINGS OF FACT

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 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.

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%.

<u>Petitioner's 2000 Returns</u>

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 of Taxation (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.[1] Under Treasury Regulation § 1.882-5, petitioner can deduct interest expense only to the extent that it is connected to its U.S. connected 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%.

---

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

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.

42. Petitioner submitted 60 proposed findings of fact and proposed conclusions of law A through E. In accordance with State Administrative Procedure Act § 307(1), petitioner's proposed findings of fact 1 through 3, 5 through 13, and 15 through 18 have been substantially adopted and incorporated herein. Proposed finding of fact 14 was modified to conform to the record. Proposed findings of fact 21 and 22 simply recite the parties' positions in the case. The remaining proposed findings of fact, which are in the nature of conclusions of law, and proposed conclusions of law A through E are not required to be ruled upon by SAPA.

SUMMARY OF THE PARTIES' POSITIONS

43. Petitioner argues that the interbranch transactions between its IBF and other branches, and transactions of the IBF that produced non-effectively connected income, should be disregarded and have no effect on its entire net income allocation factors. Petitioner maintains that its IBF had only eligible gross income, and no ineligible gross income as defined by statute or regulation, during the years at issue. Consequently, the Division erred in applying the scaling ratio called for in 20 NYCRR 18-3.9 for either year.

44. Petitioner concedes, however, that based on the evidence adduced at hearing, the amount of IBF deposits to be excluded from the numerator of its deposits factor for 1999 should

be reduced and that factor raised accordingly. Hence, for 1999, petitioner agrees it owes additional tax of $30,327.00 and an additional MTA surcharge of $5,156.00 (***see*** Finding of Fact 40). Additionally, petitioner concedes that the Division's adjustment to its receipts factor for 2000, discussed in Finding of Fact 33, is correct.

45. The Division maintains that petitioner recorded income in its separate account for its IBF that qualified as ineligible gross income under the regulations, and that since petitioner's IBF had both eligible and ineligible gross income for the years at issue, its allocation factors should have been calculated by application of the scaling ratio called for in 20 NYCRR 18-3.9.

CONCLUSIONS OF LAW

A. 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]). The basic tax is measured by the taxpayer's entire net income, or a portion thereof that is allocated to New York State (Tax Law § 1455[a]). Pursuant to Tax Law § 1453(a), entire net income includes total net income from all sources, which is the same as federal taxable income. Thus, federal taxable income is the starting point in computing entire net income (20 NYCRR 18-2.2[b]).

B. Tax Law § 1454 and its supporting regulations provide the rules for allocation where a banking corporation's entire net income, alternative entire net income or taxable assets are derived from business carried on within and without the state (***see also*** 20 NYCRR 19-2.1). In order to determine the portion thereof that is derived from business carried on within New York State, the taxpayer must multiply its entire net income by its ENI Allocation Percentage (20 NYCRR 19-2.1[a]). The taxpayer's ENI Allocation Percentage is determined by a formula consisting of a payroll factor, a receipts factor and a deposits factor (***id.***). The latter two factors are counted twice for purposes of calculating the ENI Allocation Percentage.

C. A banking corporation that has established an IBF, such as petitioner, has the choice of two methods for calculating its ENI Allocation Percentage (20 NYCRR 19-2.3). The first, the modification method, utilizes principles of separate accounting and treats the IBF as if it were a separate entity from the bank. The taxpayer computes its entire net income by deducting from its federal taxable income the adjusted eligible net income of its IBF, computed on a stand-alone basis (Tax Law § 1453[f]; 20 NYCRR 18-3.3[b]).

The second method for calculating a taxpayer's ENI Allocation Percentage is the formula allocation method (Tax Law § 1454[b][2]; 20 NYCRR 19-2.3[b]). This was the method chosen by petitioner during the years at issue and, therefore, applicable to the instant case. Under the formula allocation method, the IBF is treated as though it were a foreign branch of the bank. A taxpayer electing the formula allocation method does not modify its federal taxable income by deducting the income of its IBF. Instead, pursuant to Tax Law § 1454(b)(2)(A), the taxpayer may elect to modify its ENI Allocation Percentage as follows:

> (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,
>
> (ii) receipts properly attributable to the production of eligible gross income of the taxpayer's [IBF] shall not be included in the computation of receipts within the state, and
>
> (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.

20 NYCRR 19-2.3(b) directs the taxpayer to make these adjustments 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;
>
> (2) including in the denominator but excluding from the numerator of the receipts factor those receipts which are attributable, as provided in Subpart 18-3 of this Title, to the production of eligible gross income; and
>
> (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.

In sum, the payroll expenses, receipts, and deposits of the IBF that are attributable to the production of eligible gross income are excluded from the numerator of the fraction creating petitioner's ENI Allocation Percentage. Using the formula allocation method, petitioner calculated and reported an ENI Allocation Percentage of 69.7776% for 1999 and 68.7153% for 2000.

D. The Division, however, after an audit, made adjustments to petitioner's calculations by implementation of the "scaling ratio," an apportionment of expenses of the IBF called for by 20 NYCRR 18-3.9. That regulation provides that when an IBF has both eligible and ineligible gross income, 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. For 1999, the Division concluded that certain transactions by petitioner's IBF resulted in ineligible gross income in the amount of $20,130,961.00. These consisted of interbranch transactions and others that produced non-effectively connected income. For 2000, the Division, again pointing to interbranch transactions, determined that petitioner's IBF had transactions that produced ineligible gross income in the amount of $23,531,760.00. Thus, according to the Division, since there was both eligible and ineligible gross income, 20 NYCRR 18-3.9 mandated application of the scaling ratio, which resulted in a higher ENI Allocation Percentage for petitioner.

E. The critical question in this case is whether the Division correctly determined that the income from petitioner's IBF's interbranch transactions and other non-effectively connected income constituted ineligible gross income under the Tax Law, therefore allowing for application of the scaling ratio. The Division reached its conclusion based on its interpretation of the definition of ineligible gross income found in 20 NYCRR 18-3.2, which reads:

As used in this Subpart [18-3], the following terms have these meanings:

* * *

> (i) The term *ineligible gross income* means gross income (including gross income from interoffice transactions) of the IBF that is other than eligible gross income (emphasis in original).

The Division reasoned that petitioner's IBF's interbranch transactions and non-effectively connected income during the years at issue had to be ineligible gross income as it was, concededly, not eligible gross income. Consequently, the Division deduced that application of 20 NYCRR 18-3.9 was appropriate.

F. Based on the facts of this case, however, there are problems with the Division's reliance on the definition of ineligible gross income found in 20 NYCRR 18-3.2(i). First, as discussed, petitioner elected to proceed in both years at issue by using the formula allocation method called for under 20 NYCRR 19-2.3(b). The provisions for the formula allocation method, used by petitioner, are found in Tax Law § 1454, and are interpreted by 20 NYCRR subparts 19-1 and 19-2. Indeed, 20 NYCRR 19-1.1(a)(2) specifically provides that when a taxpayer elects to proceed under the formula allocation method found in 20 NYCRR 19-2.3, "such taxpayer is entitled to allocate its entire net income and alternative net income within and without New York State *pursuant to Subparts 19-2 and 19-3 of this Part, respectively* (emphasis added)." Meanwhile, as petitioner correctly points out, the definition of ineligible gross income used by the Division is found in 20 NYCRR 18-3.2, and is expressly subject to the limiting language, "[a]s used in this Subpart . . . ." Subpart 18-3 interprets the provisions found in Tax Law § 1453, which concern the modification method. Critically, the statute and regulations do not authorize the use of the definition of ineligible gross income found in 20 NYCRR 18-3.2(i) under the formula allocation method selected by petitioner and described in Tax Law § 1454 and 20 NYCRR 19-2.3(b).[2]

The Division attempts to cure this disconnect in several ways, none of which are effective. Initially, the Division maintains that the definition of ineligible gross income found in 20 NYCRR 18-3.2(i) is incorporated by direct reference in 20 NYCRR 19-2.3(b). A plain reading of 20 NYCRR 19-2.3(b), however, shows that the reference to Subpart 18-3 in that section is limited 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." Indeed, 20 NYCRR 18-3.5 through 18-3.8 discuss expenses that are directly or indirectly attributable to the eligible gross income of the IBF. Contrary to the Division's argument, 20 NYCRR 19-2.3(b) does not include a wholesale incorporation of Subpart 18-3.

Additionally, the Division asserts that 20 NYCRR 19-2.3(b) and 20 NYCRR subpart 18-3 are in pari materia and were intended to be read together (***see*** McKinney's Cons Laws of NY,

---

[2] Between 1985 (the date of statutory enactment of the formula allocation method) and 2003, a period that includes the years at issue, the Division's instructions for form CT-32 did not direct a taxpayer to apply the scaling ratio when it chose the formula allocation method. In 2003, without corresponding change to the statute or regulations, the Division revised the instructions to form CT-32 to add instructions directing a taxpayer to apply the scaling ratio in cases of formula allocation. Obviously, such directions require either statutory or regulatory support or enactment (***see Matter of Stuckless***, Tax Appeals Tribunal, August 17, 2006).

Book 1, Statutes § 221).[3] This general rule of construction cannot be invoked, however, where the language of the statute (or in this case, the regulation) is clear and unambiguous (***id.***). Here, the definition of ineligible gross income is expressly and unambiguously limited in application to 20 NYCRR subpart 18-3. Moreover, 20 NYCRR 19-1.1(a)(2) specifically carves out from 20 NYCRR subpart 18-3 the process for applying the formula allocation method. Likewise, Tax Law § 1454 distinctly removes the formula allocation method from Tax Law § 1453. Simply put, the requisite ambiguity compelling combination of the regulations, as espoused by the Division, is missing. In fact, the clear language in the regulations directs the opposite.

As noted above, there is no specific incorporation of the definition of ineligible gross income in Tax Law § 1454 or 20 NYCRR 19-2.3(b). It is a fundamental principle of statutory construction that words should not be expanded to enlarge their meaning to something which the Legislature could easily have expressed but did not, and new language cannot be imported into a statute to give it a meaning not otherwise found therein (***see*** McKinney's Cons Laws of NY, Book 1, Statutes § 94; ***see also Rossi v. Nyquist***, 59 AD2d 1001, 399 NYS2d 722 [3d Dept 1977]). In contrast, the definition of eligible gross income contained in Tax Law § 1453(f)(2) and 20 NYCRR 18-3.4 is specifically incorporated by reference in Tax Law § 1454(b)(2)(B) and 20 NYCRR 19-2.3(d) into the formula allocation rules. Both the Legislature and the Division had the ability and opportunity to similarly define ineligible gross income under Tax Law § 1454 or 20 NYCRR 19-2, but did not. If, as the Division argues, the Legislature intended that the definition of ineligible gross income found in 20 NYCRR 18-3.2(i) extended to the formula allocation method, it could have easily accomplished that goal by placing such a reference in the

---

[3]The "principals of statutory construction also apply to the interpretation of regulations" (***Matter of Genesee Brewing Company, Inc.***, Tax Appeals Tribunal, May 9, 2002).

statute. Instead, the applicable statute and regulation are silent on this point. Thus, it must be concluded that the definition of ineligible gross income found in 20 NYCRR 18-3.2(i), and expressly limited in application to 20 NYCRR subpart 18-3, does not apply to the instant case and, as petitioner did not have ineligible gross income, the Division acted incorrectly by invoking the scaling ratio of 20 NYCRR 18-3.9.

G. There is additional support for petitioner's argument that the Division incorrectly found the existence of ineligible gross income. The parties agree that the interbranch transactions and non-effectively connected income at issue do not constitute eligible gross income. Eligible gross income of the IBF includes income from certain defined banking activities conducted with "foreign persons," such as loans, deposits, and foreign exchange and hedging activities relating to foreign income and deposits (Tax Law § 1453[f][2]; 20 NYCRR 18-3.4). "Foreign persons" include nonresident individuals, foreign corporations, other IBFs, and, under the modification method, foreign branches of the bank (20 NYCRR 18-3.4). In fact, under the modification method, interoffice[4] transactions with foreign branches are recognized as includable in eligible gross income of an IBF (20 NYCRR 18-3.3[b]). However, interbranch transactions between an IBF and a domestic branch of a bank are not included in eligible gross income (20 NYCRR 18-3.4).

What the Division misses, however, is that Tax Law § 1454(b)(2)(B) and 20 NYCRR 19-2.3(d) alter the definition of eligible gross income and compel that an IBF's interbranch transactions with foreign branches are not to be considered at all for purposes of the formula allocation method chosen by petitioner. Tax Law § 1454(b)(2)(B) provides that eligible gross income under the formula allocation method is the same as defined under the modification

[4] Interoffice and interbranch are synonymous for purposes of this case.

method, “except that the term ‘foreign person’ as defined in [that provision] shall not include a foreign branch of the taxpayer and in no event shall transactions between the taxpayer’s [IBF] and its foreign branches be considered.” Likewise, 20 NYCRR 19-2.3(d) provides that for purposes of formula allocation, “the term *foreign person* . . . shall not include a foreign branch of the taxpayer, and no consideration shall be given to any transaction between the taxpayer’s foreign branches and its IBF.” The clear language of both the statute and regulation not only exclude transactions between an IBF and its foreign branches from eligible gross income, but also require that when computing the allocation percentage under the formula allocation method, interbranch transactions with foreign branches are not to be considered at all.

In response, the Division argues that the direction in Tax Law § 1454(b)(2)(B) and 20 NYCRR 19-2.3(d) to give no consideration to interbranch transactions should be interpreted to mean that income from such transactions simply does not constitute eligible gross income for purposes of formula allocation. This argument, however, is untenable as it eliminates meaning from the final clause of the statute and regulation. Since a foreign branch of the taxpayer is excluded from the term “foreign person,” transactions with a foreign branch, by definition, do not create eligible gross income. Section 1454(b)(2)(B), as well as the supporting regulation, however, go on to separately state, without limitation, that no consideration should be given to transactions with foreign branches. This language is redundant if the regulation is read as the Division maintains. It is well settled that “[i]n the construction of a statute, meaning and effect should be given to all its language, if possible, and words are not to be rejected as superfluous when it is practicable to give each a distinct and separate meaning” (McKinney's Cons Laws of NY, Book 1, Statutes § 231; ***see Matter of Felmont Oil Corporation***, Tax Appeals Tribunal, May 9, 1996). Furthermore, the Division’s position on this point directly contradicts its own guidance, where, when discussing the formula allocation method, it separately and expressly states that "[f]or purposes of computing the allocation percentages, in no event shall transactions between the taxpayer's IBF and its foreign branches be considered" (TSB-M-85 [16]C), February 10, 1986), as well as its Audit Guidelines, which read "[i]n no event shall transactions between the taxpayer's IBF and its foreign branches be considered when computing the allocation percentage" (NY Tax Reporter, ***NY Audit Manual Corporation Tax Audit Guidelines***, § 4.4.7.3[4] [March 1, 1998]). Hence, the Division erred by identifying interbranch transaction income as ineligible gross income, and using it to adjust petitioner's ENI Allocation Percentage by means of the scaling ratio, rather than disregarding interbranch transactions altogether as instructed by law.

H. Petitioner makes another compelling point in support of its case with regard to the nature of the income at issue. Tax Law § 1453(a) specifically instructs that the starting point for computing petitioner's entire net income is its federal taxable income under IRC § 882 (***see also*** 20 NYCRR 18-2.2). The parties agree that income or expenses from interbranch transactions between petitioner's branches and its IBF were not included in the computation of federal taxable income or New York entire net income for 1999 or 2000. Indeed, amounts recorded on the books of the IBF in connection with interbranch transactions did not create gross income because, as petitioner correctly points out, they were purely internal to the bank and did not represent an "accession to wealth" to the taxpayer (***see Commissioner v. Glenshaw Glass Co.***, 348 US 426 [1955]). The same principle holds true for petitioner's payroll expenses associated with interbranch transactions. Petitioner persuasively demonstrated that as its federal taxable income, and entire net income, do not include income or expenses attributable to interbranch transactions, for purposes of formula allocation, ineligible gross income of the IBF also cannot include such interbranch income or expenses. The same holds true for non-effectively connected income. Thus, income from interbranch transactions, as well as non-effectively connected income, identified by the Division on audit as ineligible gross income were, in fact, not income at all for purposes of New York State's entire net income or formula allocation method.

I. For the above reasons, the Division's adjustments, except for that to petitioner's receipts factor for 2000 discussed in Finding of Fact 33, must be disallowed. Additionally, petitioner concedes that, based on the evidence adduced at hearing, an additional adjustment to petitioner's deposits factor resulting in an increased tax liability is warranted for 1999. Its expert witness, Mr. Zwerling, testified that although petitioner's calculation of that factor was reasonable, the more accurate method is to determine the amount of IBF deposits that would be deemed to produce deductible interest expense attributable to its effectively connected income, in addition to the eligible gross income of the IBF, under Treasury Regulation § 1.882-5 and 20 NYCRR 18-3.6(c). Under this approach, Mr. Zwerling computed the percentage of the IBF's overall liabilities that would give rise to deductible interest expense under Treasury Regulation § 1.882-5 and 20 NYCRR 18-3.6(c), and then applied that percentage to petitioner's IBF's third-party deposits to determine the amount of deposits the expenses of which give rise to the production of eligible gross income.[5]

Treasury Regulation § 1.882-5 uses a three-step process to determine deductible interest expense. First, there is a determination of the amount of the bank's worldwide assets that

[5] In support of his conclusion on this point, Mr. Zwerling noted that the New York City Tax Appeals Tribunal used the same approach in considering a similar issue under the identical provisions of the New York City Tax Code and regulations (***see In re Credit Industriel et Commercial***, NYC Tax Appeals Tribunal, June 30, 2006). Decisions of the New York City Tax Appeals Tribunal are not binding precedent, but do have instructive value, as is the situation here.

produce income effectively connected with the bank's U.S. trade or business. Second, there is a determination of the bank's U.S. connected liabilities, which is the product of the bank's U.S. assets multiplied either by a fixed ratio or by the actual ratio of the bank's worldwide liabilities to worldwide assets. The third step involves the calculation of the allocable amount of interest expense under either the adjusted U.S. booked liabilities method or the separate currency pools method. Treasury Regulation § 1.882-5 provides that a transaction of any type between separate offices or branches of the same taxpayer does not create a U.S. asset or liability. Therefore, the first two steps of the section 1.882-5 calculation do not take interbranch transactions into account, and the third step does not permit the deduction of interest expense related to interbranch or non-effectively connected income.

Applying this method, Mr. Zwerling set forth his calculation of petitioner's IBF interest expense. For 1999, the IBF's total U.S. connected liabilities were $374,008,045.00, and its total booked liabilities were $463,566,618.00, comprised of third-party deposits of $262,057,598.00 and other third-party liabilities of $201,509,020.00. Under Treasury Regulation § 1.882-5, a taxpayer can deduct interest expense only to the extent that it is connected to its U.S. connected liabilities. Therefore, because the amount of petitioner's IBF's U.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 amount of the U.S. connected liabilities over the U.S. booked liabilities. In the instant case, that ratio is 80.68% for 1999. Applying that ratio to petitioner's IBF's third-party deposits of $262,057,598.00, Mr. Zwerling concluded that deposits in the amount of $211,429,482.00 would give rise to deductible interest expense under

Treasury Regulation § 1.882-5 and 20 NYCRR 18-3.6(c), and are properly deemed deposits, the expenses of which were attributable to the IBF's eligible gross income.

As a result, petitioner acknowledges that the correct amount of deposits to be excluded from the numerator of its deposits factor for 1999 was $211,429,482.00, that its deposits factor should be adjusted accordingly from 72.6719% to 77.9515%, and that its ENI Allocation Percentage for that year should be increased from 69.7776% to 71.8895%. These changes result in additional tax due in the amount of $30,327.00 and an additional MTA surcharge due in the amount of $5,156.00 for the year 1999 and it is determined that this adjustment must also be made to the notice of deficiency accordingly.[6]

J. The Division asserts that Mr. Zwerling's testimony should be given little to no weight despite its probative value. The Division first argues that Mr. Zwerling has a personal interest in the outcome of this case as several of his clients stand to benefit from a favorable determination for petitioner. Moreover, the Division attacks Mr. Zwerling's purported unfamiliarity with the United States Supreme Court's decision in ***Moorman Mfg. Co. v. Bair*** (473 US 267 [1978]). Neither argument is persuasive. Although it is obvious from Mr. Zwerling's experience and testimony that he has several international banks as clients, contrary to the Division's position, there was no evidence that he had a personal stake or interest in the outcome for this petitioner. In fact, Mr. Zwerling's testimony actually suggested a correction to petitioner's filings that creates an additional deficiency. It is well settled that the credibility of the expert and the weight and sufficiency of his testimony are matters for the trier of fact (***see Matter of Spallina***, Tax Appeals Tribunal, February 27, 1992), and based on this record, and

[6]Application of the same methodology to petitioner's deposits factor calculations for 2000 demonstrates that they were correct as reported (***see*** Finding of Fact 41).

observation, it does not appear that his testimony was biased or lacked credibility. Additionally, the Division's focus on Mr. Zwerling's unfamiliarity with the ***Moorman Mfg. Co.*** case is misplaced where, as here, the issue is whether the Division correctly applied the formula allocation rules as written in New York's Tax Law and regulations. Consequently, it is found that Mr. Zwerling's testimony was probative and credible, and must be considered in reaching this determination.

K. Finally, the Division also attempts to defend its statutory notice by arguing that case law dictates that a state's formulary apportionment process need not be correct or even accurate, but solely a rough approximation of the corporation's taxable income earned within the state. Citing several United States Supreme Court decisions, the Division argues that distortion does not exist in the results of its audit in the instant case and, therefore, the results must be upheld as constitutionally permissible. In making this argument, the Division misses the central issue in the case, however. Petitioner is not challenging the validity of New York State's apportionment scheme or the statutory notice on constitutional grounds. Instead, petitioner simply and correctly maintains that the Division misapplied and misinterpreted the Tax Law and regulations as written.

L. The petition of UniCredit S.p.A. is granted to the extent indicated in Conclusion of Law I, and the Division of Taxation is directed to modify the Notice of Deficiency issued to petitioner in accordance therewith.

DATED: Albany, New York
November 7, 2013

/s/ Herbert M. Friedman, Jr.
ADMINISTRATIVE LAW JUDGE