

Increase to foreign bank's New York income allocation percentage rejected

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Overview

New York State's Tax Appeals Tribunal (Tribunal) recently ruled in favor of UniCredit S.p.A. (UniCredit),¹ a foreign bank, rejecting the New York State Department of Taxation and Finance's (Department) interpretation of certain regulations addressing the computation of UniCredit's income allocation percentage under prior law Article 32, New York's Franchise Tax on Banking Corporations (Bank Tax)² for the tax years 1999 and 2000 at issue. During these years, UniCredit's New York branch maintained an international banking facility (IBF). The Department disagreed with UniCredit's computation of its wage and deposit factors,³ asserting that UniCredit's interbranch transactions and other non-effectively connected income booked or deemed to have been booked by the IBF constituted "ineligible gross income," and therefore allowed for application of a "scaling ratio" that would have effectively increased such factors and the resulting tax due. The Tribunal, affirming the Administrative Law Judge's (ALJ) earlier opinion in this matter,⁴ rejected the Department's reading of the governing administrative regulations. This Tribunal opinion is now final and non-appealable.⁵

In this Tax Alert we summarize this Tribunal decision and provide some taxpayer considerations.

Background

During the tax years 1999 and 2000, UniCredit's New York branch maintained an IBF, which generally involved maintenance of a separate set of asset and liability accounts segregated on the books of the IBF's establishing entity. IBFs generally may be established by financial institutions in the United States to provide banking services to foreign customers, and often they are not subject to certain federal treasury regulation requirements (such as federal reserve requirements and interest rate caps). IBFs may also be afforded tax benefits in certain states, including New York under prior law Article 32.

During the tax years at issue, under the Bank Tax, a bank with an IBF could elect to calculate its taxable income using one of two methods: i) the Income Modification Method, or ii) the Formula Allocation Method.⁶ Under the Income Modification Method, a taxpayer could achieve a tax benefit by essentially removing from taxable income the IBF's net income from transactions with foreign persons. Under the Formula Allocation Method, a taxpayer could achieve a tax benefit by essentially removing the IBF wages, deposits, and receipts from the numerator of those income allocation factors while retaining such IBF amounts in the denominator of those factors in determining the portion of entire net income subject to the Bank Tax.

In this case, UniCredit had elected to use the Formula Allocation Method. The Department disagreed with UniCredit's computation of its wage and deposit factors, asserting that the concepts of "ineligible gross income" and the related scaling ratio found in N.Y. Comp. Codes R. & Regs. tit. 20, § 18-3.9 (which generally reduces the tax benefit allowed under the Income Modification Method where a taxpayer has both eligible and ineligible gross income) were applicable when computing such factors. The Department's adjustments increased the income allocation factor, thereby increasing UniCredit's resulting taxable income. The ALJ had previously concluded that the regulatory definition of "ineligible gross income" in N.Y. Comp. Codes R. & Regs. tit. 20, § 18-3.2(i) did not

¹ *Matter of UniCredit S.p.A.*, New York State Div. of Tax Appeals, Tax Appeals Tribunal, D.T.A. No. 824103 (May 19, 2015). This case may be accessed at [here](#).

² Article 32 was repealed for tax years beginning on or after January 1, 2015. Laws of 2014, ch. 59, § 1 (Part A).

³ The receipts factor is also a component of the income allocation factor. However, in this case, UniCredit did not dispute an adjustment by the Department of its receipts factor.

⁴ *Matter of UniCredit S.p.A.*, New York State Div. of Tax Appeals, ALJ. Unit, D.T.A. No. 824103 (Nov. 7, 2013).

⁵ N.Y. Tax Law § 2016.

⁶ [Former] N.Y. Tax Law §§ 1453(f); 1454(b)(2). Note that these Article 32 code sections are repealed for tax years beginning on or after January 1, 2015 pursuant to Laws of 2014, ch. 59, § 1 (Part A).

apply when using the Formula Allocation Method and thus the Department had improperly invoked the scaling ratio.⁷

New York State Tax Appeals Tribunal decision

The Tribunal explained that the disagreement between the parties is a matter of statutory and regulatory construction, and then cited traditional principles of statutory construction—such as focusing on “the intent of the Legislature in enacting the statute,” and the “wording of the statute itself”—stating that these principles also apply to the interpretation of administrative regulations. The Tribunal observed that both UniCredit and the Department based their respective arguments on their respective interpretations of N.Y. Comp. Codes R. & Regs. tit. 20, § 19-2.3(b), which discusses how taxpayers must compute their wage and deposits factors for purposes of the Formula Allocation Method.⁸ The Department asserted that the definition of “ineligible gross income” and the related scaling ratio are implicated under the Formula Allocation Method because N.Y. Comp. Codes R. & Regs. tit. 20, § 19-2.3(b) directs a taxpayer to exclude from the numerator of the factors IBF payroll and deposits “the expenses of which are attributable, *as provided in [s]ubpart 18-3 of this Title*, to the production of eligible gross income” (emphasis added). Because subpart 18-3 includes the scaling ratio (N.Y. Comp. Codes R. & Regs. tit. 20, § 18-3.9), the Department reasoned that the scaling ratio must be applied in computing the required adjustments under the Formula Allocation Method.

The Tribunal rejected the Department’s reasoning, stating that “[s]ubpart 18-3 is made applicable to [the Formula Allocation Method] only to the extent that it contains provisions specifically related to expense attribution.”⁹ The Tribunal then noted that, pursuant to N.Y. Comp. Codes R. & Regs. tit. 20, § 18-3.3(c), expenses applicable to eligible gross income of an IBF are those described in N.Y. Comp. Codes R. & Regs. tit. 20, § 18-3.5 through § 18-3.8 that are directly and indirectly attributable to the eligible gross income of the IBF—explaining that these sections expressly do *not* include the scaling ratio described in N.Y. Comp. Codes R. & Regs. tit. 20, § 18-3.9. In this respect, because this scaling ratio is distinctly removed from attributing expenses for purposes of the Formula Allocation Method, the Tribunal explained that the concept of “ineligible gross income” never becomes applicable. That is, if ineligible gross income cannot be identified within a proper reading of the Formula Allocation Method regulations,¹⁰ the scaling ratio is not relevant to the computation as all expenses would be attributable to eligible gross income. Moreover, the Tribunal noted that under former New York Tax Law § 1454(b)(2)(B) and N.Y. Comp. Codes R. & Regs. tit. 20, § 19-2.3(d), for purposes of the Formula Allocation Method, income from interbranch transactions is disregarded. Therefore, such income could not be treated as ineligible income based on a plain reading of statutory and regulatory authority, further demonstrating the inapplicability of the scaling ratio under these facts.

Accordingly, the Tribunal affirmed the ALJ’s opinion, holding that “a plain reading of the statutes and regulations governing the calculation of petitioner’s [a]llocable [t]axable [entire net income] indicates that the concept of ineligible income and the application of the [s]caling [f]actor that flows therefrom are not applicable to the Formula Allocation Method.”¹¹

Considerations

While the Bank Tax under Article 32 has since been merged into Article 9-A of New York’s Tax Law effective for tax years beginning on or after January 1, 2015, bank taxpayers with IBFs whose income allocation percentages may have been similarly increased on audit of prior years based on the Department’s improper application of the Formula Allocation Method regulations may want to consider filing refund claims for any open years.

Contacts

If you have questions regarding this New York ruling or other New York State tax matters, please contact any of the following Deloitte Tax professionals.

⁷ *Matter of UniCredit S.p.A.*, New York State Div. of Tax Appeals, ALJ Unit, D.T.A. No. 824103 (Nov. 7, 2013).

⁸ Note that N.Y. Comp. Codes R. & Regs. tit. 20, § 19-2.3(b) also explains how taxpayers must compute their receipts factor, but this was not at issue in this case.

⁹ *Matter of UniCredit S.p.A.*, New York State Div. of Tax Appeals, Tax Appeals Tribunal, D.T.A. No. 824103 at 25.

¹⁰ N.Y. Comp. Codes R. & Regs. tit. 20, § 19-2.3(b).

¹¹ Note that the Tribunal additionally concurred with the ALJ’s conclusion that the calculations presented by expert witness Stuart Zwerling, Esq., of Deloitte Tax LLP, pertaining to UniCredit’s deposit factor for 1999 should be sustained as part of UniCredit’s amount of tax due. However, this Tax Alert does not specifically address these calculations as this issue is beyond its scope.

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