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October 8, 2009

Mr. Robert Plattner
Deputy Commissioner
New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Bldg. 9, State Campus
Albany, NY 12227

Re: NY State Tax Reform

Dear Mr. Plattner:

On behalf of the Institute we thank you and your staff for the taking the time to explain the Department's corporation tax reform proposal and for discussing with our members their various questions and concerns. In our September 14th video-conference you requested additional information on three items. The first was with respect to our comment that New York should follow the U.S. tax treaties with foreign countries as the starting point for computing entire net income, the second was the computation of interest expense under U.S. Treasury regulation section 1.882-5 when the U.S. branch of a foreign corporation is included in a New York combined return, and third you requested suggestions as to the definition of includable corporations for purposes of the proposed water's edge group election. The following are our responses to your questions:

Application of U.S. Tax Treaties

The Institute's members understand that under the tax reform proposal the starting point for computing entire net income ("ENI") of an alien bank or other alien corporation will be federal taxable income that is "effectively connected income" ("ECI"), as is currently the rule under Article 32. We support this proposal because we believe that starting with ECI for alien corporations will achieve the Department's goals of simplicity and ease of administration by conforming to U.S. federal income tax concepts in arriving at ENI.

For similar reasons, we strongly suggest that in the case of an alien corporation that is eligible for the benefits of an income tax treaty with the United States, the starting point for determining ENI should be the income that the alien corporation reports on its



federal income tax return pursuant to the treaty. In general, this will be the profits that are attributable to the corporation's U.S. permanent establishment (e.g., in the case of a bank, its U.S. branch(es)). This amount excludes income that is "effectively connected" to a U.S. business but is not attributable to the permanent establishment. On the other hand, depending on the facts, it may also include income that would not be ECI but is attributable to the permanent establishment.

In general, apart from New York tax requirements, an alien corporation that is eligible for the benefits of an income tax treaty calculates only its taxable income that is attributable to the U.S. permanent establishment, and does not separately calculate ECI, nor does it track the relevant information for determining disparities between the treaty-based rules and ECI. Thus, it is a burden for these taxpayers to identify, track and compute the variances between the treaty-based rules and ECI, and it complicates the auditors' job as well.

It is likely that recent treaty-related developments will significantly exacerbate the problems of separately calculating ECI and income attributable to a permanent establishment, due to the availability of a treaty-based method to determine an alien bank's deductible interest expense in lieu of using the rules under U.S. Treasury regulation section 1.882-5.

As you know, the most significant deduction item for a bank typically is its interest expense, which in the case of an alien bank is determined under the formula set forth in U.S. Treasury regulation section 1.882-5. Very generally, under this three-part formula, a non-U.S. bank computes its interest expense deduction for federal income tax purposes by, first, determining the total amount of its U.S. assets for the taxable year; second, determining the total amount of its U.S.-connected liabilities during the taxable year (by multiplying the amount of its U.S. assets determined in Step 1 by either (x) the actual ratio of its worldwide liabilities to its worldwide assets, determined under U.S. tax principles, or (y) the fixed ratio of 95%); and third, determining the amount of interest expense in respect of the U.S.-connected liabilities determined in Step 2 under either one of two methods (the adjusted U.S. booked liabilities method or the separate currency pools method). These calculations can be very complicated.

Under Article 7 of many recently negotiated U.S. income tax treaties (i.e., those with the United Kingdom, Japan, Germany and Belgium), an alien bank is permitted to utilize an alternative, OECD-developed method to determine its deductible interest expense. This method is conceptually similar to Treasury regulation section 1.882-5 in that it requires that a bank's equity capital and debt be proportionately allocated among its various offices and branches for purposes of determining its interest expense, but instead of making the allocation based on ratable U.S. tax basis (or fair market value) numbers, the allocation is based on the risk-weighted capital allocations that are used for bank regulatory purposes. One important objective of this method is to achieve consistent results in the various taxing jurisdictions around the world.



We respectfully submit that whatever method a bank elects to follow in computing its federal taxable income – including a treaty-based OECD-risk-weighted allocation method – should be utilized for purposes of determining ENI. Whatever method is adopted by a bank, the calculations thereunder are extraordinarily complex, and it would be a very serious and unreasonable burden to require banks to maintain parallel systems for computing interest expense under both a treaty-authorized method and under Treasury regulation section 1.882-5.

More fundamentally, we respectfully submit that neither the calculation of interest expense nor any other differences between ECI and a treaty-based determination of federal taxable income should be treated any differently than any of the myriad elections that taxpayers can make, or special rules to which they might be subject, for federal income tax purposes. In each case, unless there is an important New York tax policy reason for having a different rule, simplicity and ease of administration provide compelling reasons for having ENI follow the federal taxable income of the taxpayer. For example, New York follows the federal income tax treatment adopted by the taxpayer in respect of inventory accounting (e.g., LIFO vs. FIFO), market discount bonds (current inclusion vs. realization-based accounting), cash vs. accrual accounting, and numerous other items, notwithstanding that these choices can have a significant effect on taxable income.

Similarly, we do not perceive there to be any special New York tax policy consideration that would warrant departure from the choices that a taxpayer is permitted to make under a tax treaty in determining its federal taxable income, particularly in view of the significant burdens, costs and audit issues that would arise if alien corporations were required to disregard those choices in computing ENI.

Treas. Reg. 1.882-5 and New York Combined Reporting

You raised the question as to would there be a need for a U.S. branch of a foreign bank to re-compute its 1.882-5 interest expense computation because under the proposal the branch would be included in a New York combined return with its domestic affiliates. We believe the answer is clearly no, there would be no need or reason to do a New York “as if” 1.882-5 computation for any U.S. branch included in a New York combined return.

The purpose of the 1.882-5 computation is to determine the amount of the bank’s interest expense attributable to its U.S. operations. While loans to U.S affiliates could be included in the branch’s stand alone 1.882-5 computation, this is proper to fairly reflect the branch’s U.S. interest expense and its computation of federal taxable income reported on its 1120-F tax return. The 1.882-5 computation from a sourcing perspective would not be distorted because the branch is included in a combined return with its U.S. affiliates. The computation should properly reflect all U.S. assets of the bank including loans to members of the combined return in order to properly reflect the branch’s U.S. source interest expense. This is no different than looking at the interest expense of a domestic



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company included with other domestic companies in a combined return. The stand alone interest expense of each company is used to determine each company's federal taxable income, regardless of any intercompany assets or liabilities.

Further, to the extent there is intercompany interest income and expense among the members of a combined group such amounts effectively eliminate in combinations and the same would be true for combination with the U.S. branch. In addition, we reviewed the rules in several water's edge unitary states, including California, which include only the U.S. branch of a foreign bank in the combined return. None of the other states require any re-computation or adjustment to the U.S. branch's 1.882-5 interest expense computation.

Includable Corporations

Under the water's edge method of combined reporting used in most states, the unitary business group includes only those affiliated companies that have income attributable to their U.S. operations. New York should adopt the same basic principal for includable corporations where a water's edge election is made. The group should include only those companies regardless of where they are formed (U.S. or foreign) that are commonly controlled, have income attributable to their U.S. operations taxable for U.S. purposes, and are engaged in a unitary business. Common control should be determined based on direct or indirect ownership by the same interests of greater than 50% of the voting stock of a company.

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The Institute is generally in favor of the overall direction of the tax reform proposal and would be pleased to continue working with the Department towards needed reforms. If you have any questions or require additional information with respect to the above information or any other issues as they arise, please contact the undersigned or Amy Solomon at McKenna Long & Aldridge LLP (amy.solomon@mckennalong.com; 518-935-2418).

Very truly yours,

A handwritten signature in black ink that reads "Lawrence R. Uhlick". The signature is written in a cursive, flowing style.

Lawrence R. Uhlick
Chief Executive Officer