New York State Department of Taxation and Finance
Office of Counsel
Advisory Opinion Unit

TSB-A-09(1)C
Corporation Tax
February 27, 2009

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C071214A

Petitioner Knight Trading Group, Inc. (Petitioner) asks whether, for New York State corporate franchise tax purposes for tax years 2000-2002, Petitioner's distributive share of the market-making-related income received from flow-through subsidiary Knight Financial Products (The Company) should be treated as income derived from investment capital. We conclude that The Company's specialist/market-making-derived income should be treated as income derived from business capital, as explained below.

Facts

The facts below are based on review of the Petition for Advisory Opinion submitted on December 14, 2007, as well as a review of Petitioner's website materials. During the period in question, The Company was a limited liability company treated as a partnership for federal and New York State purposes[1]. Petitioner and its affiliates made markets in equity securities on NASDAQ, the OTC Bulletin Board, the New York Stock Exchange, the American Stock Exchange, and other exchanges. As a registered securities dealer, Petitioner made markets in nearly all equity securities and 70 percent of all option classes. On active days during 2002, for example, Petitioner executed more than 1 million trades with volume exceeding one billion shares. The Company during the period in question was an options[2] market maker and a registered securities dealer that acted as a specialist on the Chicago Board Options Exchange (CBOE), the International Securities Exchange (ISE), Pacific Stock Exchange, and the Philadelphia Stock Exchange. The Company was the owner of seats on, and an equity holder in, many of these exchanges. For example, The Company was a founder and an equity shareholder in the ISE, the world's largest equity options exchange. The Company was sold to Citigroup in December, 2004 for $237 million.

Market makers have special functions in the securities markets. Generally, a market maker is an owner of an exchange seat and a dealer who is authorized and required by applicable exchanges to regularly quote both bid and ask prices and to make a two-sided market for a specified instrument. The CBOE website defines a market maker as an exchange member whose function is to aid in the making of a market, by making bids and offers for his account in the absence of public buy or sell orders.

All options exchanges have rules that guarantee market makers a proportion of each order when its quote is equal to the best price on the exchange. These "specialist guarantees" reward market-making firms willing to perform the obligations of a specialist by ensuring that they will be able to interact as principal with a certain percentage of incoming orders. Specialist guarantees are intended to attract and retain well capitalized

[1] For part of the period that is the subject of this Advisory Opinion, the Company was also a disregarded entity.
[2] Options are instruments that generally provide the holder, in exchange for the payment of a premium, with benefits of favorable movements in the underlying asset or index with limited or no exposure to losses from unfavorable price movements. Typically, options provide for cash settlement, rather than the delivery of the underlying asset.

firms, such as The Company, that are responsible under exchange rules for assuring fair and orderly markets and fulfilling other responsibilities that enhance the exchange.[3]

The CBOE has also established policies on trading by market makers in options to which the trader is not appointed (Rule 8.7(c) *Classes of Option Contracts other than those to which appointed)*. CBOE has construed this rule to mean, with respect to distribution of trading activity, that at least 75 percent of a market maker's total contract volume must be in option classes to which it has been appointed. In addition, CBOE and other exchanges require that the market maker segregate its trading accounts over which it exercises investment discretion.

During the audit period, The Company and other market makers on the options markets competed for order flow by offering cash or noncash inducements, known as payments for order flow, to other dealers to send their orders to a particular exchange for execution (see SEC definition of payment for order flow, 17 CFR 240.10b-10d). According to the ISE website, "payment for order flow" began when some market makers started to pay order entry firms for their customer orders, independently of any exchange on which they traded. Under a typical payment for order flow arrangement, a market maker offers an order entry firm cash or other economic incentives to route its customer orders to that market maker's exchange because the market maker knows it will be able to trade with a portion of all incoming orders, including those from firms with which it has payment for order flow arrangements.

Issue

The issue raised by Petitioner is whether its flow-through income from The Company is income derived from investment or business capital for Article 9-A franchise tax purposes.

Analysis

The New York Article 9-A corporation franchise tax is determined by calculating the highest tax that will result from application of the tax rate to four different bases (entire net income, minimum taxable income, capital, and a fixed dollar minimum base). The capital base is the amount of the taxpayer's business capital and investment capital that is allocated to the State. The entire net income and minimum taxable income bases are derived from the business income and investment income of the taxpayer that are allocated to the State. In general, investment income is the income derived from investment capital, and business income is the income derived from business capital. Investment capital and business capital are allocated to New York in distinctly different manners. Investment capital is allocated to the State on the basis of the percentage of capital used in New York by the issuers of instruments held by the taxpayer. Business capital is allocated on the basis of the taxpayer's New York percentage of receipts. Thus, a taxpayer may have widely varying allocation percentages for the two forms of capital. See Tax Law section 210.3.

Tax Law section 208(5) defines investment capital to mean "investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business, exclusive of subsidiary capital and stock issued by the taxpayer…."(see also 20 NYCRR §3-3.2). The Department's regulations define "stocks, bonds and other securities" to include: options on stocks and debt

[3] See generally, SEC Concept Release: Competitive Developments in the Options Markets, Release No. 34-49175, 2003).

instruments not described in section 3-3.2(a)(2), or on a stock or bond index, or on a futures contract on such an index, "unless the options are purchased primarily to diminish the taxpayer's risk of loss from holding one or more positions in assets which constitute business or subsidiary capital" (see 20 NYCRR §3-3.2(c)(4)).

Petitioner states that the options and other securities that it holds are all investment capital because they are all considered "stocks, bonds or other securities" for purposes of Tax Law § 208.5 and none of these assets are held for sale to customers in the regular course of business. According to Petitioner, The Company has no customers for purposes of Regulation section 3-3.2(a)(2) and instead is trading for its own account.

Neither the Tax Law nor the regulations promulgated thereunder define the phrase "held for sale to customers in the regular course of business." However, very similar wording appears in the capital asset definition in IRC §1221(a), which provides that all property is considered a capital asset except for several specifically enumerated types of assets. The exception at issue here is for property "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" (IRC § 1221(a)(1)). In view of the similarity of the federal and State provisions, authorities construing the Code provision are helpful in the interpretation of the Article 9-A regulation.[4] In Mirro-Dynamics Corp. v. United States (374 F.2d 14, 15-16 (1967), Cert. denied, 389 US 896, 88 S.Ct. 215) the Ninth Circuit Court of Appeals noted "that the phrase 'to customers' was added to the predecessor of §1221(1) to exclude from the definition of capital assets only those securities bought and sold by dealers, and not those traded by investors on their own account."[5]

The United States Tax Court agrees with this analysis. In King v. Commissioner, 89 T.C. 445 (1987), the Tax Court provided a comprehensive legislative history of the predecessor of section 1221 and concluded as follows:

> As a result, a primary distinction for Federal tax purposes between a trader and a dealer in securities or commodities is that a dealer does not hold securities or commodities as capital assets if held in connection with his trade or business, whereas a trader holds securities or commodities as capital assets whether or not such assets are held in connection with his trade or business. A dealer falls within an exception to capital asset treatment because he deals in property held primarily for sale to customers in the ordinary course of his trade or business. A trader, on the other hand, does not have customers and is therefore not considered to fall within an exception to capital asset treatment.

The Tax Court has also provided guidance to options specialists and market makers. In Laureys v. Commissioner, 92 T.C. 101 (1989), the Tax Court considered whether an individual taxpayer should treat his losses from securities transactions as capital or ordinary losses. The taxpayer was a market-maker on the CBOE and engaged in a wide range of transactions, including ones that were unrelated to the requirements imposed on a market maker by the CBOE. The Tax Court stated:

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[4] Consideration of federal interpretations of this provision is also appropriate since it is the legislative and judicial policy of the State that local taxes should be administered in a way generally consistent with the Federal taxes on which they are patterned (Rockefeller Cent. Luncheon. v. Schwartz, 43 Misc.2d 865, 866 [1964]).

[5] A taxpayer who trades securities solely on his own account does not sell "to customers" within the meaning of section 1221(1) (United States v. Diamond (4th Cir. 1986) 788 F.2d 1025, 1028; Faroll v. Jarecki (7th Cir. 1956) 231 F.2d 281; Davidson Partners, TSB-A-88(11)I; Christopher Doyle, TSB-A-98(13)I).

> Petitioner's explanation of the reasons for the trades in which he engaged persuaded us that those trades were conducted with a profit objective. The extent and nature of them suggests that he was a 'trader' rather than an 'investor' in options. His explanations, however, all related to his personal profit strategy. None of the trades were justified by reference to CBOE requirements imposed on him as a market maker. He acknowledged that he did not recall any of the trades being attributable to a 'call to the post' in which he was required to make a market in a particular stock or option. None of the trades were explained in relation to a customer of the CBOE, except to the extent that petitioner himself was a customer. The transactions in issue, therefore, cannot be treated as dealer transactions. See Brown v. United States, 426 F.2d 355, 363-365 (Ct. Cl. 1970). The options granted for petitioner's own account cannot be said to be in the ordinary course of market maker activity because they were not written for the purpose of meeting demands for a market or even for creating liquidity. Thus, petitioner is not entitled to ordinary loss treatment for those transactions.
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> Laureys v. Commissioner, 92 T.C. at 137

Thus, it appears that for federal purposes a market maker who holds securities in order to carry out its responsibilities as a market maker may not treat those securities as capital assets, but rather must treat them as dealer property that is held for sale to customers. This treatment for a market-maker is consistent with the view that dealers are "comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost." (Kemon v. Commissioner, 16 T.C. 1026, 1032-33 (1951).

The Department has also considered the effect of market-making activities under the Tax Law. In *Kenneth S. Davidson Partners*, Adv Op Comm T&F, June 28, 1988, TSB-A-88(11)I, the Department advised that a partnership will not be considered to be purchasing and selling solely for its own account if the partnership engages in other activities such as market making activities. Such partnership would be deemed to be carrying on a trade or business within the state. (See also, *Bryan Sullivan*, Adv Op Comm T&F, May 31, 1990, TSB-A-90(7)I).

Moreover, in *Wedbush*, *Noble, Cook, Inc.*, Adv Op St Tax Comm, July 23, 1981, TSB-A-81(3)C, the Commissioner advised that the receipts from a taxpayer's market-making activities in the over-the-counter market and as a specialist on the American Stock exchange were receipts from the sale of intangible personal property included in business capital, held by the taxpayer as a dealer for sale to customers in the regular course of business. They were therefore entirely allocable to New York because the sales were made in New York State or through a regular place of business of the taxpayer in New State.

Thus, a "customer" of an options market maker/specialist for Regulation section 3-3.2(a)(2) purposes is not a specific party but rather all of the parties with whom the market maker/specialist buys and sells securities in the ordinary course of business as part of the dealer's market-making activity. The Company's capital used for specialist/market-making purposes, including capital used to position the market maker's inventory for anticipated order flow or for hedging activities, is business capital. The Company may, however, hold stocks, bonds, or other securities that would qualify as "investment capital," if those securities were acquired for investment activities beyond the scope of The Company's bona fide market making/specialist activity. All the

facts and circumstances will be considered, including whether The Company designated the securities as capital assets under IRC §1236; whether The Company properly elected to treat the securities as held for investment under IRC§475(b); and the application of the inventory designation rules of the given options exchange.

Accordingly, we conclude that Petitioner's flow-through income derived from specialist/market making activities of The Company should be treated as income derived from business capital for corporate franchise tax purposes.

DATED: February 27, 2009

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NOTE: An Advisory Opinion is issued at the request of a person or entity. It is limited to the facts set forth therein and is binding on the Department only with respect to the person or entity to whom it is issued and only if the person or entity fully and accurately describes all relevant facts. An Advisory Opinion is based on the law, regulations, and Department policies in effect as of the date the Opinion is issued or for the specific time period at issue in the Opinion.