New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-92 (3) C
Corporation Tax
February 25, 1992

STATE OF NEW YORK

COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C910315A

On March 15, 1991, a Petition for Advisory Opinion was received from Morrison & Foerster, 1290 Avenue of the Americas, New York, New York 10104.

The issue raised by Petitioner, Morrison & Foerster, is whether for taxable years 1985 through 1987, the funds held by Corporation A for eventual payment to federal, state and local taxing authorities, gives rise to investment income under section 208 of the Tax Law.

Corporation A is a Delaware corporation with its headquarters in State X, outside New York State. It is engaged, directly and through subsidiaries, in performing a variety of data processing services for clients throughout the United States and in foreign countries. It maintains central computing facilities and regional offices in over forty locations, including New York State.

Among the services provided by Corporation A are payroll services, which include the preparation of virtually all of the paperwork associated with employer salary payments to employees. Corporation A performs computations and prepares the checks and other documentation for each payroll. For many of its payroll service clients, Corporation A also performs a tax filing service, in which it makes the necessary payroll tax withholding deposits for income taxes, employer and employee social security and unemployment taxes and disability insurance, to the appropriate federal, state and local taxing authorities. Funds are supplied to Corporation A for this purpose by the clients. Corporation A also prepares and files the associated returns. Most of the data used to perform the tax filing services is generated by Corporation A as part of its payroll service, and Corporation A does not provide tax filing services for clients for whom it does not provide payroll services.

Corporation A receives a separate arms' length fee for both its payroll processing service and its tax filing service. Corporation A does not enter into a formal written contract with its clients for either its payroll processing service or its tax filing service. Instead, Corporation A commits to perform certain services and meet certain obligations by means of a written proposal provided to its clients. The proposal sets forth price quotes, among other things, for each of the various services rendered by Corporation A. The amount of Corporation A's fee for its payroll services varies for each payroll that it processes depending primarily on the volume and the complexity of the work done. The fee does not depend on the dollar amount of a client's payroll. Corporation A's fee for the tax filing service has no relationship to the amounts that will eventually have to be paid to federal, state and local authorities. These requirements vary significantly from state to state, but Corporation A's fee does not.

Corporation A's fee for the tax filing service, like its fee for the payroll service, is based instead on competitive considerations, and the volume and complexity of work done for a client for each payroll, not on the state in which the client operates or on the dollar amounts of the payroll involved.

Under Federal, state and local tax law, it is compulsory that payroll taxes be deposited in a timely manner by, or on behalf of, each of Corporation A's clients. It is not compulsory that the funds be deposited directly by the client and, in fact, that Internal Revenue Service authorizes deposits by third parties.

Corporation A agrees with its clients to make the necessary payments on time, and agrees to reimburse clients for any penalties and interest attributable to a late payment of tax. Corporation A does not compute the amount, if any, of funds attributable to each particular client that are on hand at any particular time, nor the time for which such funds may be held. It cannot attribute any investments to any particular client deposit, nor can it ascertain whether particular funds are invested, if at all, in taxable obligations or in obligations that are exempt from federal tax.

To protect itself from transmitting funds to various tax authorities for a client before funds are available to Corporation A, Corporation A collects funds from its clients before payment is due to the tax authorities. These funds are commingled and money is not set aside for any particular obligation. Corporation A accumulates a pool of money out of which current obligations to various taxing authorities can be paid as they come due.

Before each client's payroll date, Corporation A computes the amounts of withholding taxes that will be due with respect to that client's payroll, and prepares a "pre-authorized draft" in such amount, drawn on a bank account of the client. Usually on the day before the payroll date, Corporation A deposits this draft in a regional collection bank account for the region in which the client is located. Such regional collection accounts are maintained by Corporation A in various banks for this purpose.

The day after the funds are collected, the balance deposited in each of the regional accounts is electronically transferred to a "concentration account", maintained by Corporation A at a bank in California. This concentration account, which includes all of the funds that have been forwarded to Corporation A, is swept each day. First, to the extent funds are needed immediately to satisfy payments to federal, state and local taxing authorities, these amounts are transferred to another account, out of which the tax liabilities are paid. Any such amounts due would not bear any relationship to the funds actually collected on that day, and would usually not be payments on behalf of clients whose funds had been transferred to Corporation A's concentration account on that day. Any remaining balance in the concentration account is automatically deposited into an interest-bearing account at that same California bank and, except for overnight balances, is promptly transferred to a payroll tax deposit account (hereinafter "tax account") maintained by Corporation A at a bank in New York. The overnight balances retained in California result largely from funds that arrive at the California bank too late in the day to be transferred and invested in New York.

A large pool of funds accumulates in Corporation A's tax account. These funds are invested in short and long term securities, including municipal securities, bank time deposits and certificates of deposit. Funds are wire transferred back to the California bank when needed to cover amounts to be disbursed on a given day. The deadline for federal payroll taxes is usually within three to six days after the client's payroll date; the deadlines for state and local payroll taxes vary and are frequently longer. Some state and local unemployment taxes need only be paid on a quarterly basis.

Corporation A maintains a separate portfolio of investments, attributable to the total amount of collected funds on hand, purely for administrative convenience. There is no requirement, either by contract with the clients or under any rule of law, that the funds be maintained in a separate account. There are no regulations restricting Corporation A's use of the funds or the type of investments that may be made with the funds in the tax account. Corporation A does not have any written contractural agreements with clients that restrict its use of the funds or even refer to the funds in any way.

Petitioner treats the funds collected from clients as an owned asset of Corporation A offset by an equal liability to pay the tax deposits. The liability is considered a "contra-account" and since it is exactly equal to the amount of the asset at any point in time, it does not appear on the audited balance sheet for financial reporting purposes. Furthermore, since the balance in the portfolio attributable to funds collected from clients is significantly large, the reporting of those assets and liabilities would materially distort the balance sheet.

Since the balance sheet reported on the Federal income tax return is a "book" balance sheet, the assets and liabilities are not separately stated on the tax return either. However, the income generated from the investment assets is reported in both book income and federal taxable income. Petitioner states that Corporation A could not report the income from municipal securities as tax-exempt income if the funds were in fact owned by the clients. In addition, if Corporation A declared bankruptcy, the clients would be liable to the government for unpaid taxes. The clients would then have recourse against Corporation A in bankruptcy proceedings.

Corporation A also has an arrangement with X Management Co. under which a portion of its funds are managed by X Management for a fee. From time to time, funds are deposited into the X Management Co. account. The funds in this account are generally invested in bank time deposits, treasury securities and municipal securities with maturities of up to three years, the parameters set by Corporation A. Each security is in the name of Corporation A. The income earned from these funds is generally reinvested. The source of withdrawals from this account is the individual investments, not X Management Co. funds.

Section 208.5 of the Tax Law states that "[t]he term 'investment capital' means 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.... "

For the taxable years at issue, section 208.6 of the Tax Law states that "[t]he term 'investment income' means income, including capital gains in excess of capital losses, from investment capital, to the extent included in computing entire net income .... "

Section 208.7 of the Tax Law states, in part, that "cash on hand and on deposit shall be treated as investment capital or as business capital as the taxpayer may elect".

Section 3-4.2(d) of the Business Corporation Franchise Tax Regulations (hereinafter "Regulations") in effect for the taxable years at issue, provides, in part, that "Certificates of deposit are deemed to be cash. An election may not be made to treat part of such cash as investment capital and part as business capital. No election to treat cash as investment capital may be made where the taxpayer has no other investment capital."

The term "cash on deposit" as used in section 208.7 of the Tax Law is not defined by statute or regulation. Where this occurs, the words used in the statute "may be given their ordinary meaning, with any ambiguity to be construed most strongly in favor of the taxpayer and against the government" (Manhattan Cable TV Services v Freyberg, 49 NY2d 868, 869). To the ordinary reader, cash on deposit must mean nothing more than cash deposited in a bank or similar institution, both for safekeeping and to earn income.

The case law interpreting section 208.5 of the Tax Law, and the regulations thereunder, provides that whether an asset is investment capital, as an "other security," with respect to a specific taxpayer depends upon that taxpayer's particular relationship to the asset (see, Pohatcong Investors v. Commissioner of Taxation and Fin., 156 AD2d 791, 549 NYS2d 211; Avon Products v. State Tax Commn., 90 AD2d 393, 458 NYS2d 278). Similarly, the determination of whether income is investment income to a specific taxpayer must depend upon that taxpayer's particular relationship to the asset. Thus, the question is whether the income at issue is traceable to assets that were investment capital with respect to Corporation A. (see, Matter of Custom Shop Fifth Avenue Corp, Dec Tax App Trib, August 1, 1991, TSB-D-91(12)C)

Section 7501(a) of the Internal Revenue Code (hereinafter "IRC") provides that "Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United states. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose."

Even though section 7501 of the IRC provides that "the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States", there is no general requirement that the withheld sums be segregated from the employer's general funds, however, or that they be deposited in a separate bank account until required to be paid to the Treasury. (See Slodov v United States, 436 US 238, 243.)

However, if an employer fails to pay taxes that have been withheld from its employees' wages, and it is determined that the employer is inexcusably delinquent, the employer may be required pursuant to section 7512 of the IRC to deposit withheld taxes in a special bank trust account within two banking days after collection and that the funds be retained there until required to be paid to the Treasury.

Section 7512 of the Internal Revenue Code provides that:

> Whenever any person who is required to collect, account for, and pay over any tax imposed by subtitle C, or chapter 33--
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> > (1) at the time and in the manner prescribed by law or regulations (A) fails to collect, truthfully account for, or pay over such tax, or (B) fails to make deposits, payments, or returns of such tax, and
> >
> > (2) is notified, by notice delivered in hand to such person, of any such failure,
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> such person...shall collect the taxes imposed by subtitle C, or chapter 33 which become collectible after delivery of such notice, shall (not later than the end of the second banking day after any amount of such taxes is collected) deposit such amount in a separate account in a bank (as defined in section 581), and shall keep the amount of such taxes in such account until payment over to the United States. Any such account shall be designated as a special fund in trust for the United States, payable to the United States by such person as trustee ....

Section 3504 of the IRC provides that:

> In case a fiduciary, agent, or other person has the control, receipt, custody, or disposal of, or pays the wages of an employee or group of employees, employed by one or more employers, the Secretary, under regulations prescribed by him, is authorized to designate such fiduciary, agent, or other person to perform such acts as are required of employers under this title and as the Secretary may specify. Except as may be otherwise prescribed by the Secretary, all provisions of law (including penalties) applicable in respect of an employer shall be applicable to a fiduciary, agent, or other person so designated but, except as so provided, the employer for whom such fiduciary, agent, or other person acts shall remain subject to the provisions of law (including penalties) applicable in respect of employers.

Section 3505(a) of the IRC provides that:

> For purposes of sections 3102 [relating to Federal Insurance Contributions Act], 3202 [relating to Railroad Retirement Tax Act], 3402 [relating to income tax withholding] and 3403 [relating to income tax withholding], if a lender, surety,

> or other person, who is not an employer under such sections with respect to an employee or group of employees, pays wages directly to such an employee or group of employees, employed by one or more employers, or to an agent on behalf of such employee or employees, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) required to be deducted and withheld from such wages by such employer.

Section 31.3505-1(c) of the Treasury Regulations provides that for purposes of section 3505 of the IRC "the term 'other person' means any person who directly pays the wages or supplies funds for the specific purpose of paying the wages of an employee or group of employees of another employer. It does not include a person acting only as agent of the employer or as agent of the employees." Example 2 of such section 31.3505-1(c) of the Treasury Regulations illustrates this provision:

> Example (2). N, a construction company, maintains a payroll account with the O Bank in which N deposits its own funds. Pursuant to an automated payroll service agreement between N and O, O prepares payroll checks and earnings statements for each of N's employees reflecting the net pay due each such employee. These checks are delivered to N for signature. After the checks are signed, O distributes them directly to N's employees on the regularly scheduled pay day. O, acting only in the capacity of a disbursing agent of N's funds, would incur no liability under section 3505 with respect to these payroll distributions. However, O may incur liability under section 3505 in the capacity of a lender if it supplies the funds for the payment of wages.

Herein, Corporation A performs a tax filing service for its clients in which it makes the necessary payroll tax withholding deposits and prepares and files associated returns for income taxes, employer and employee social security and unemployment taxes and disability insurance, to the appropriate federal, state and local taxing authorities. The funds or these tax deposits are supplied by the clients.

Pursuant to sections 7501, 7512, 3504 and 3505 of the IRC and the regulations promulgated thereunder, Corporation A is acting as an agent of its clients, but it is Corporation A's clients who are ultimately liable for the payment of the employment taxes including income tax withholding to the Internal Revenue Service. These same principles would apply to the taxes required to be paid to state and local taxing authorities.

After the funds are collected, Corporation A transfers excess funds from its concentration account to its tax account. The funds in the tax account are invested by Corporation A until the funds are needed. Withdrawals from the tax account are made when the tax deposits required to be made on a given day exceed the funds in the concentration account and the tax account funds are needed to cover the amounts to be disbursed on such day.

Except with respect to funds that Corporation A must deposit in an account designated as a "special fund in trust for the United States" pursuant to section 7512 of the IRC or a similar type account required by a state or local taxing authority, the tax account funds are not in a "special" trust or fiduciary type account. Corporation A can invest the funds until moneys from the tax account are needed to make the required tax deposits to the various taxing authorities.

Therefore, the funds that are in Corporation A's tax account will constitute investment capital if the funds meet the criteria contained in section 208.5 of the Tax Law and section 3-4.2 of the Regulations. In addition, funds in the tax account that constitute cash on hand and on deposit, pursuant to section 208.7 of the Tax Law, may be investment capital if there are other items of investment capital and Corporation A elects to treat cash as investment capital. If such election is made, Corporation A must include in such amount all cash on hand and on deposit.

Any funds that Corporation A must deposit in an account designated as a "special fund in trust for the United States" pursuant to section 7512 of the Internal Revenue Code or a similar type account required by a state or local taxing authority are not considered Corporation A's funds and such funds do not constitute investment capital or cash. Therefore, any income earned on such funds is business income.

With respect to the funds deposited into the X Management Co. account, the determination of whether such funds will constitute investment capital and the income therefrom be investment income is the same as for the tax account. Where X Management Co. invests Corporation A's funds within the parameters set by Corporation A (i.e. bank time deposits, treasury securities and municipal securities with maturities up to three years) and such investments are in the name of Corporation A and the withdrawals are from the source of the investment not from X Management Co. funds, such funds in the X Management Co. account will constitute investment capital if the investments meet the criteria contained in section 208.5 of the Tax Law and section 3-4.2 of the Regulations.

Accordingly, where the tax account funds of Corporation A and the funds in the X Management Co. account constitute investment capital the income earned on such securities is investment income, and if Corporation A elected to treat all of its cash on hand and on deposit as investment capital, the tax account funds and the funds in the X Management Co. account invested in bank time deposits and certificates of deposit constitute investment capital and the interest earned on such funds is investment income.

DATED: February 25, 1992

s/PAUL B. COBURN
Deputy Director
Taxpayer Services Division

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.