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EXTERNAL ALERT

New York Appellate Court Rules that a Financing Agreement with a Governmental Obligor is not Investment Capital

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Overview

In *Matter of Xerox Corporation v. N.Y. State Tax Appeals Tribunal et al.*,[1] the Supreme Court of New York, Appellate Division (3rd Department) (the "Appellate Division") upheld a determination by New York's Tax Appeals Tribunal that denied Xerox Corporation's ("Xerox") request for a refund of corporate franchise tax. Xerox had requested a refund for years 1997, 1998 and 1999 based on its classifying financing agreements provided to governmental customers as investment capital. In this Tax Alert we summarize the Appellate Division's decision concluding that the financing agreements at issue, which were executed by governmental entities in connection with the purchase of goods and services, did not constitute "investment capital" under New York Tax Law § 208.5, but instead constituted items of "business capital" under New York Tax Law § 208.7. This determination in turn dictated the applicable allocation method.[2] Under the facts of this specific case, a classification of the financing agreements as investment capital would have been advantageous to Xerox for the periods at issue.

Background

Xerox manufactures and sells office equipment and related services. It offers financing agreements to both its governmental and its nongovernmental customers.[3] Xerox filed corporate franchise tax returns that treated the subject finance agreements as "business capital" and the related interest income as "business income" for the periods at issue. In a later year, Xerox filed amended franchise tax returns, classifying the subject finance agreements as "other securities" for purposes of the definition of "investment capital,"[4] thus reclassifying the interest income that it received under the finance agreements as "investment income."[5] Based upon these changes, Xerox requested refunds from the Department of Taxation and Finance (the "Department") for the periods at issue. The refunds were denied and Xerox appealed the decision to the Division of Tax Appeals where an Administrative Law Judge ("ALJ") granted the refunds, determining that the interest income qualified as investment income. The Department appealed the ALJ's ruling to the Tax Appeals Tribunal, where the ALJ's ruling was reversed and the refunds were again denied. Xerox appealed the matter to the Appellate Division.

The Appellate Division Decision

The disputed issue was whether Xerox's interest income from the subject finance agreements constituted business income or investment income. Business income is defined as "entire net income minus investment income;"[6] investment income, as relevant here, is defined as "income . . . [derived] from investment capital."[7] Investment capital is defined as "investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business . . . ."[8] The corporate franchise tax statutes do not provide a definition of the term security or the phrase "other securities." The Department's regulations provide that the phrase

[1] 2013 NY Slip Op 06899 (Oct. 24, 2013); 2013 N.Y. App. Div. LEXIS 6873. A copy of the court's decision is accessible at: **http://www.courts.state.ny.us/reporter/3dseries/2013/2013_06899.htm#2FN**.

[2] As explained by the Appellate Division, "Business income is allocated to New York based upon the amount of the *taxpayer's* (i.e., petitioner's) property, receipts and payroll in this state, whereas investment income is allocated to New York according to the extent of the presence in New York of the *obligor or issuer* of the stock, bond or other security that the taxpayer invests in and derives income from (*see Tax Law § 210 [3] [a], [b]*). For a corporation such as petitioner that has a substantial presence in New York, it is often advantageous to classify income as investment income rather than as business income because a smaller portion of its income may be allocated to New York." 2013 NY Slip Op 06899 at 2, footnote 2. The receipts factor constitutes 100% of the business allocation percentage for taxable years beginning on or after January 1, 2007. New York Tax Law § 210.3.(a)(10)(A)(ii).

[3] There were two types of financing agreements at issue, fixed purchase option leases, in which Xerox owned the equipment during the term of the agreement and installment sales, in which title is transferred to the customer at the beginning of the contract term. In its analysis, the court did not appear to distinguish between the two types of agreements.

[4] New York Tax Law § 208.5.

[5] New York Tax Law § 208.6.

[6] New York Tax Law § 208.8.

[7] New York Tax Law § 208.6.

[8] New York Tax Law § 208.5.

"stocks, bonds and other securities," among other things, means "debt instruments issued by . . . government[s]."[9] Xerox argued that the finance agreements at issue constituted such debt instruments and, thus, the interest income derived therefrom was investment income.

The Appellate Division accorded deference to the Department's interpretation of the applicable statutory definitions and concluded that the Tax Appeals Tribunal had rationally determined that the financing agreements in question did not constitute "other securities."[10] The Tax Appeals Tribunal had determined that the financing agreements were not securities, and therefore not an item of investment capital. The Tribunal had looked to New York and federal securities case law to determine whether an economic interest constitutes a security.[11]

The Appellate Division noted that under statutory principles of construction, where the scope of general statutory language is unclear (as in the term "other securities"), the meaning of such language "is limited by specific terms or phrases that precede it, where the preceding terms/phrases are themselves of a similar nature."[12] Therefore, the phrase "other securities" is limited to security instruments similar to "stocks" and "bonds" (i.e., the terms that precede it).

Moreover, the Appellate Division noted that Xerox "did not demonstrate that the financing agreements were 'issued by' any governmental entity . . . [, as required by] 20 NYCRR Sec. 3-3.2(c)(2), or should be considered debts of the governmental customers within the meaning of the state restrictions on the assumption of debt by governments . . ." under New York's Constitution.[13] Finally, the Appellate Division noted that Xerox was unable to advance an argument as to why the finance agreements should qualify as "debt instruments" and, thus, "investment capital" under the statute and regulation when the lessee/purchaser of the equipment was a governmental entity, but not "investment capital" when the lessee/purchaser was a nongovernmental entity.[14] Since the finance agreements were not of a similar nature to stocks or bonds and did not fit within any recognized test or "well settled legal meaning" for securities, the Appellate Division affirmed that the financing agreements did not qualify as investment capital under N.Y. Tax Law § 208.5.[15]

As the period for appeal of this decision remains open as of the date of issuance of this Tax Alert, this decision is not yet final.

Considerations

Although this court decision is not yet final, taxpayers that offer financing arrangements in conjunction with the sale of goods and services to governmental entities and have characterized such financing arrangements as investment capital may wish to consider whether the analysis in this case affects such characterization. Moreover, this decision highlights that in order to qualify as an item of investment capital under the tax regulations, the financial instrument in question must, as a threshold matter, constitute a "security" under well-established legal precedent.

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[9] 20 NYCRR Sec. 3-3.2(c)(2).
[10] 2013 NY Slip Op 06899 at 3-5.
[11] The Tribunal had relied on a Supreme Court case determining that an "investment contract" was an investment of money in a common enterprise with profits to come solely (or substantially) from the efforts of others. See *Securities & Exchange Commn. v. W.J. Howey Co,* 328 U.S. 293, 298-299 (1946) (the so called "*Howey*" test). The Tribunal had also determined that the financing agreements could not qualify as securities under another securities law test recognized in New York, under *Matter of Waldstein,* 160 Misc 763, 767 (N.Y. Sup. Ct. 1936).
[12] 2013 NY Slip Op 06899 at 4.
[13] 2013 NY Slip Op 06899 at 5.
[14] *Id*.
[15] *Id*.