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Leases Receive Favorable Investment Capital Treatment

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Probably the most unusual aspect of the New York State Corporate Franchise Tax[1] ("Franchise Tax" or "Article 9-A") and the New York City General Corporation Tax[2] ("GCT") is the distinction in both taxes between "business capital"[3] and "investment capital."[4] Many states (particularly those states that follow UDIPTA[5]), distinguish between income from a corporation's business[6] and non-business income,[7] and only apportion business income.[8] New York, however, has a unique approach in which all assets (other than investments in subsidiaries) are categorized as investment capital or business capital and the income is apportioned to the State in dramatically different ways.[9] The principal benefit of classification as investment capital is that, in computing the portion of corporate investment income taxable by New York, the income from investment capital is allocated by reference to the business activities of the corporations in which the taxpayer has invested, rather than by reference to the activities of the corporation doing the investing. Corporations with a large presence in New York therefore tend (or at least are motivated to) invest in the stocks and bonds o corporations with very little New York presence. This reduces the New York tax on income and gain from such investments.

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Since income from investment capital is almost always apportioned to New York at a very low percentage, there is a strong incentive among corporate taxpayers to characterize assets as investment capital rather than business capital. Over the years, the State (and City) has amended its regulation defining investment capital to interpret a statute that has been held on numerous occasions to be "patently ambiguous."[10] A recent determination by a State Administrative Law Judge ("ALJ") demonstrates the uncertainties in this area.

The Leases

The recent case of *Xerox Corporation*[11] involves various leases of equipment. The taxpayer, Xerox Corporation ("Xerox") manufactures various types of office equipment including photocopiers, printers, fax machines etc. During the years at issue, Xerox financed 75-80 percent of its equipment sales. Most of these transactions are in the forms of leases of the relevant equipment under which the customer obtains the equipment and pays rent sufficient to cover the sales price of the equipment plus an additional amount reflecting an interest charge for the period the transaction is financed.

Over the years, Xerox entered into various forms of leases to address the varying needs of its customers. Many of the leases are what is generally described as "true" leases or "operating leases". In these situations, the equipment is returned to Xerox at the end of the term or the lessee has an option to renew the lease or purchase the equipment for its fair market value or a fixed price that represents a substantial percentage of its initial value. An operating lease is generally treated for both GAAP and tax purposes in accordance with its form, i.e. the lessor is treated as the owner of the property and the lessee is treated as simply paying rent for the use of the property during the term of the lease.

In other cases, the economic terms of the lease more accurately may be described as an installment sale of the equipment. For example, in many cases, the lease term will cover virtually the entire useful life of the equipment or the lessee may be able to purchase the equipment at the end of the lease term for a nominal payment. Such leases are generally referred to as "capital leases". For GAAP purposes and income tax purposes, the lessee is treated as having purchased the property on the effective date of the lease. The payments by the lessee to the lessor are treated as purchase price payments with a portion of such amounts representing payments of "interest".

A number of the capital leases entered into by Xerox were made with state and local government entities. In those cases, the interest was excluded

from federal gross income under Internal Revenue Code section 103.[12]

Xerox's Refund Claims

When Xerox initially filed its Franchise Tax returns it treated all of the income from its leases as derived from business capital. Subsequently it filed amended returns for the years 1997 through 1999 in which it claimed that the interest component of the capital leases with federal, state, and local government entities constituted income from investment capital. As such the percentage of the income apportionable to New York was substantially smaller than the amount that was originally apportioned to New York when the income was characterized as attributable to business capital. (Rental income received by Xerox from its operating leases and the gain from the sale of equipment were clearly business income.) Xerox did not seek to recharacterize the income from its capital leases with respect to non-government customers. The amended returns requested refunds totaling approximately $1,200,000.

Presumably to no one's surprise, the New York State Department of Taxation and Finance (the "Division") audited the amended returns and disallowed the refund claims. The Division's Notice of Disallowance took the position that the "leases" did not qualify as "investment capital" because they were "agreements . . . arising out of normal trade and therefore constituted business capital."[13] The Division explained in a separate memorandum issued to Xerox that, in its view, "qualifying corporate debt instruments do not include instruments acquired by the taxpayer for services or for sales, rentals or other transfers of property [to the recipient of such sales, etc.]."[14] The parties agreed that the only issue in the case was whether the governmental capital leases qualified as investment capital.

ALJ Decision

The ALJ began its analysis by quoting the statutory definition of investment capital, "investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business . . ."[15] Noting that the capital leases at issue were clearly not "stocks" or "bonds," the issue in the case was whether they constitute "other securities." This term is not defined in the statute but is defined in the Division's regulations.

Curiously, the Division primarily relied on its regulation that was in effect many years prior to the years at issue. As the ALJ explained, prior to December 7, 1989, the Division's Regulation 3-4.2(c) expressly defined the term "other securities" as "limited to securities issued by governmental bodies and securities issued by corporations of a like nature as stocks and bonds, which are customarily sold in the open market or on a recognized exchange . . . . *They do not include corporate obligations not commonly known as securities, such as real property, bonds . . . short-term notes acquired in the ordinary course of trade or business for services rendered or for sales of property* . . . and other commercial instruments"[16] (emphasis added).

Effective December 7, 1989, Regulation 3-4.2(c) was amended (and subsequently renumbered in October 1993 as Regulation 3-3.2(c)). Under the newly promulgated regulation, the term "other securities" is not expressly defined. Instead, the phrase "stocks, bonds and other securities" is defined to include governmental debt obligations, in subparagraph (2) of Regulation 3-3.2(c), as follows:

> [D]ebt instruments issued by the United States, any state, territory or possession of the United States, the District of Columbia, or any foreign country, or any political subdivision or governmental instrumentality of any of the foregoing;[17]

The term is also defined to include, in a separate subparagraph, subparagraph (3) of Regulation 3-3.2(c), certain qualifying corporate debt instruments:

> [Q]*ualifying* corporate debt instruments (see subdivision (d) of this section);[18]

In contrast to the governmental debt provision (subparagraph 2), the corporate debt provision (subparagraph 3), expressly provides that subsection (d) applies. Subsection (d) of Regulation 3-3.2 sets forth a variety of tests and limitations to determine whether corporate debt constitutes a "qualifying corporate debt instrument" eligible for classification as investment capital.[19] Subsection (d) states that such instruments may not be "acquired by the taxpayer for services rendered or for the sale, rental or other transfer of property, where the obligor is the recipient of the services or property." As discussed below, this limitation is similar to the limitation set forth in Division's prior Regulation (see italicized language set forth above in Regulation 3-4.2(c), which previously applied to both governmental and corporate debt instruments.

As the ALJ noted, the Division did not dispute that the capital leases were debt instruments issued by governmental entities. Instead, the Division argued that the leases could not be included in "investment capital" because they did not "qualify" as such.[20] As the ALJ explained, the Division made two intertwined arguments. First, the Division argued that these instruments did not qualify under the prior regulation because they are not of a type customarily sold on the open market, the Division did not "disavow" its prior regulation, and the statute had not been amended. The ALJ noted that the prior regulation, which reflected a more limited definition of the term "other securities," may have excluded the capital leases from the definition since they are not of a type customarily sold in the open market or on a recognized exchange. However, the ALJ found that the Division failed to include the same limitation in the revised regulation, which clearly provides that "debt instruments issued by government entities" constitute "other securities." Thus, the ALJ ruled that the language relied on by the Division is no longer in the regulation and whether or not the Division affirmatively "disavowed" that language, the

Division could not rely on language that was no longer in the regulation.

The Division next argued that the limitations set forth in subparagraph (d) of Regulation 3-3.2 (cited above), which specifically eliminates certain types of corporate debt instruments from investment capital, should be applied to the governmental debt at issue in this case. The Division noted that the regulation does not address whether income from a debt instrument acquired in connection with the sale of equipment constitutes income from investment in such debt instrument where the obligor is a governmental entity. Thus, the Division argued that the limitation governing corporate debt instruments should be relied on since the relevant statute deals with both governmental and corporate debt obligations.

The ALJ refused to accept the Division's argument characterizing it as an "attempt to ignore the specificity set forth in its own regulation."[21] The 1989 amendment "served to carve a distinction between debt instruments issued by governmental entities [section 3-3.2(c)(2)] and corporate debt instruments [section 3-3.2(c(3)]" and the requirement that they must be qualified debt instruments.[22] The ALJ concluded that "whether as the result of intent or oversight, the regulation as written simply does not support 'reading in' such qualifying limitations on government debt."[23]

Observations

From purely anecdotal experience, there is nothing like a seven figure refund claim to cause officials at the Division (as well as other tax departments) to fall over themselves in search of any conceivable argument to avoid having to pay money, no matter how implausible. The case also points out the power discrepancy between the Division and taxpayers since any taxpayer who failed to pay tax in a situation where the language of a regulation was as clearly applicable as in this case would certainly be charged with penalties.

It is also worth noting that the Division has been considering for the last couple of years whole-scale revisions to the Franchise Tax and the State Bank Tax (Article 32). Such revisions would merge the two Articles. As part of the proposed revision the entire concept of investment capital would be eliminated. Certain types of income would be characterized as derived from investments and taxed on a more favorable basis but the distinctions that currently exist would be eliminated.

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1 N.Y. Tax Law §§208 through 219 (Article 9-A of the Tax Law).

2 N.Y.C. Admin. Code §11-602 through 11-610.

3 "Business capital" is a catch-all category that includes everything that is neither subsidiary capital nor investment capital. N.Y. Tax Law §208.7.

4 "Investment capital" is essentially a corporation's investments in stocks, bonds and other securities of corporate and governmental issuers, not held for sale to customers in the regular course of business. N.Y. Tax Law §208.5.

5 The Uniform Division of Income for Tax Purposes Act ("UDIPTA") was initially drafted in 1957 by the National Conference of Commissioners on Uniform State Laws to provide for a uniform method of allocating income between states.

6 Business income is defined as income from the regular trade or business of the corporation and is apportioned by a formula based upon the ratio of receipts (or receipts, property and payroll) in the state to total receipts (or receipts, property and payroll).

7 Nonbusiness income, is defined as all other income (i.e. all income other than business income) including dividends and interest. Income from intangible property may constitute business income, and be apportioned to among the states in which the taxpayer does business, if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business. When income from intangible property constitutes nonbusiness income it is typically allocated 100% to the state of commercial domicile.

8 Under UDIPTA, certain items of income may be allocated 100% to the State, such as the sale of real property located in the State.

9 Article 9-A and GCT corporations divide their assets and income into three classes: subsidiary, investment, and business.

10 *Matter of Dominion Textile (USA) Inc.,* DTA No. 812248, N.Y.S. Tax App. Trib., April 10, 1997 (citing *Matter of Mobil Intl. Fin. Corp. v. New York State Tax Commn.*, 117 AD2d 103 and *Matter of Howard Johnson Co. v. State Tax Commn.*, 105 AD2d 948, *rev'd on other grounds* 65 NY2d 726).

11 *Matter of Xerox Corporation*, DTA No. 822620, N.Y.S. Div. of Tax App., ALJ Determination, Oct. 7, 2010.

12 I.R.C. §103 excludes from gross income interest on any obligation of a State or a political subdivision of a State.

13 *Xerox Corporation*, *supra* note 10, at 12 (internal citation omitted).

14 *Id*.

15 N.Y. Tax Law §208.5.

16 20 NYCRR former §3-4.2(c).

17 20 NYCRR §3-3.2(c)(2).

18 20 NYCRR 3-3.2(c)(3).

19 20 NYCRR 3-3.2(d).

20 *Xerox Corporation*, *supra* note 11, at 18.

21 *Id*. at 20.

22 *Id*.

23 *Id*. at 21.