STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
XEROX CORPORATION	:	DECISION DTA NO. 822620
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax Under Article 9-A of the Tax Law for the Period January 1, 1997 through December 31, 1999.	: : :	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on October 7, 2010. The Division of Taxation appeared by Mark Volk, Esq. (Clifford M. Peterson, Esq., of counsel). Petitioner appeared by Hodgson Russ, LLP (Mark S. Klein, Esq. and Christopher L. Doyle, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioner filed a brief in opposition. The Division of Taxation filed a reply brief. Oral argument, at the Division of Taxation's request, was heard on July 13, 2011 in New York, New York.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether certain equipment financing agreements between Xerox Corporation and various governmental entities qualify as "investment capital," the income from which constitutes investment income as opposed to business income for purposes of Tax Law Article 9-A (Franchise Tax on Business Corporations) and the regulations thereunder.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge.[1] These facts are set forth below.

Petitioner, Xerox Corporation, manufactures and sells photocopiers, printers, fax machines, scanners, desktop software, digital printing and publishing systems, supplies and comprehensive document-management services.

During the years at issue, on average, 75 to 80 percent of equipment sales were financed through petitioner, and a significant portion of petitioner's profits arose from financing its customers' purchases of petitioner's equipment. While petitioner's revenue from equipment sales was much greater (approximately four times greater) than its revenue from financing, the latter did enjoy a higher profit margin. Thus, for example, petitioner's 1999 revenue from equipment sales totaled $5.7 billion, while its 1999 revenue from financing totaled $1.2 billion. However, petitioner's gross margin on equipment sales was 37.2%, while its gross margin on financing was 63%.

Petitioner sells most of its products and services under bundled lease arrangements, which contain multiple deliverable elements. These multiple element arrangements typically include separate equipment, service, supplies and financing components for which a customer pays a single fixed negotiated price on a monthly basis, as well as variable amounts for page volumes in excess of stated minimums.

Petitioner maintained accounting records that allocated and tracked the different

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[1] On exception neither the Division nor petitioner requested any changes to the Administrative Law Judge's findings of fact.

components that made up the set monthly payments. Petitioner separately accounted for the portions of the monthly payments attributable to the equipment, supplies, services and financing. In this way, petitioner was able to determine how much interest was paid with respect to each transaction.

From January 1, 1997 through December 31, 1999, petitioner marketed its document processing equipment to both governmental and non-governmental customers as part of its general business operations. Petitioner's governmental customers included foreign governments, the U.S. federal government, various state and local governments, and agencies and instrumentalities of these governments.

The income in dispute arises from petitioner's lease transactions for document processing equipment sold to governmental entities, and is that portion of the income generated by those transactions that petitioner earned from financing the sales of the equipment.

Petitioner files its federal income tax and New York State franchise tax returns on a calendar year basis. Petitioner files combined New York State returns with certain of its subsidiary entities. When petitioner initially filed its New York State franchise tax returns for 1997, 1998 and 1999, it characterized the income in dispute as business income. The income in dispute was included in the calculation of the receipts factor of petitioner's combined business allocation percentage.

GAAP Accounting for Pay-Over-Time Transactions

During the 1997 through 1999 time period, petitioner recorded interest income on its financial books and records with respect to certain pay-over-time transactions that were frequently referred to as leases. Petitioner's finance transactions generally stay outstanding on average for 36 to 56 months. As a result, some of the recorded interest was reflective of transactions entered into in the three years preceding 1997.

During the period in issue, petitioner engaged in three different types of pay-over-time arrangements with governmental customers: a) the fixed purchase option lease (FPO Lease); b) the installment sale contract (XEEP); and c) the fair market value purchase option lease (FMV Lease).

For financial accounting purposes and its requirement to report said information in its SEC Forms 10-K, petitioner treated its governmental lease transactions as sales-type leases as required by Statement of Financial Accounting Standards No. 13 “Accounting for Leases” (FAS 13). Under FAS 13, a pay-over-time transaction, which generically may be called a “lease,” is classified by Generally Accepted Accounting Principles (GAAP) as either (a) an operating lease, where the lessor maintains the adjusted cost of the equipment on its books and reports rental income therefrom, or (b) a capital lease, which is treated as a current sale of the underlying equipment with installment payments. Capital leases can include leases containing both fixed and fair market value purchase options.

For GAAP purposes, petitioner, in its capacity as a lessor, has consistently reported the payments received from its customers for equipment provided under operating leases as rental revenue for the year of payment or accrual. For GAAP purposes, petitioner has consistently reported the payments received from its customers for equipment provided under capital leases in a manner that yields the same results as an installment sale. Under this treatment, in the first year when the equipment is installed, the gross profit from the transaction is recognized and a receivable for the principal balance to be financed by future monthly payments is also established. In subsequent periods, as the invoices for such monthly payments are issued and the income is accrued, petitioner treats the portion of the invoice related to the customers' financed acquisition of the equipment as principal and interest components. Of these two components, only the interest is treated as interest income for the year of payment or accrual. This accounting treatment, which is applicable to both capital leases and installment sales, is referred to below as the "Installment Sale Method."

XEEP Transactions

XEEPs, which stands for "Xerox Equipment Equity Plans," are installment sale agreements in which title to and possession of the equipment is transferred to the customer at the beginning of the transaction. The customer pays the purchase price by agreeing to make periodic scheduled payments over a term of months according to an amortization schedule. Sometimes a XEEP may also provide for a down payment. The down payment would reduce the amount of the receivable established by petitioner and the amount of interest earned thereon in subsequent periods. However, the gross profit element for the sale of the equipment would not be affected. A XEEP would not include service or supply elements.

Under GAAP, a XEEP is an installment sale. As such, upon installation of the equipment transferred under a XEEP, petitioner booked as equipment sales revenue the entire purchase price, which was equal to the Net Present Value (NPV) of the equipment portion of the monthly installment sale payment stream. Any financing charge or interest was not reflected in the equipment sales revenue. If there was a down payment, that amount was booked as an addition to cash. The entire purchase price net of any down payment was booked as a receivable. As monthly invoices were generated over the life of the XEEP transaction, the equipment (or principal) component of the invoices reduced the receivable and increased cash (as it was received), and the financing component was booked as interest income, also increasing cash (as it was received).

Although petitioner was the subject of a thorough investigation by the Securities and Exchange Commission that included the 1997 through 1999 years, petitioner's financial accounting treatment (i.e., the installment sales method) of the XEEPs as installment sales has not been challenged.

FMV Leases

FMV Leases are agreements in which petitioner maintains title to the equipment, but possession and use of the equipment is enjoyed by the customer for the term of the lease. The customer makes fixed monthly payments to compensate petitioner for the customer's possession and use of the equipment. The fixed monthly payments may also compensate petitioner for the provision of services and supplies and for a predetermined number of copies. There may also be a variable monthly payment for page volumes in excess of stated minimums as a separate incremental charge. The term of the FMV Lease is fixed and the payment obligation is non-cancellable. At the end of the lease term, the customer has the option to purchase the equipment for its fair market value at that time.

Under GAAP, certain FMV Leases are capital leases to which the installment sales method applies. Before 2001, petitioner treated all of the FMV Leases as capital leases for financial accounting purposes. As such, at the time the equipment transferred under an FMV Lease was installed, petitioner booked as equipment sales revenue the entire purchase price of the equipment sold under the FMV Lease, which was equal to the NPV of the equipment portion of the monthly payment stream. Any financing charge or interest was not reflected in the equipment sales revenue. If there was a down payment, that amount was booked as an addition to cash. The entire purchase price net of the down payment was booked as a receivable. As monthly invoices were generated over the life of the FMV Lease, invoiced amounts were segregated into their various components: supplies, service, excess copy charges, principal (equipment), finance (interest), etc. The principal component of the monthly invoices reduced the receivable and increased the cash (again, as it was received).

Petitioner was the subject of a thorough investigation by the Securities and Exchange Commission that included the 1997 to 1999 period, and although certain FMV Leases were challenged and reclassified for GAAP purposes as operating leases, such reclassification did not impact the tax treatment for federal income tax purposes because such leases continued to be characterized under the federal income tax rules as true tax leases and not as installment sales.

FPO Leases

The FPO Leases are contracts in which petitioner maintains title to the equipment, but possession and use of the equipment is enjoyed by the customer for the term of the lease. The customer makes fixed monthly payments to compensate petitioner for the customer's possession and use of the equipment. The fixed monthly payment may also compensate petitioner for the provision of services and supplies for a predetermined number of copies. There may also be a variable monthly payment for page volumes in excess of stated minimums as a separate incremental charge. The term of the FPO Lease is fixed and noncancellable. At the end of the lease term, the customer has the option to purchase the equipment for a negotiated amount that is fixed before the FPO Lease is executed by the parties.

Under GAAP, an FPO Lease is a capital lease to which the installment sale method applies. As such, at the time the equipment transferred under an FPO Lease was installed, petitioner booked as equipment sales revenue the entire purchase price of the equipment sold under the FPO Lease, which was equal to the sum of the NPV of the equipment portion of the monthly payment stream and the NPV of the fixed purchase option amount. Any financing charge or interest was not reflected in the equipment sales revenue. If there was a down payment, that amount was booked as an addition to cash. The entire purchase price including the NPV of the monthly payment stream and of the fixed purchase option amount, but net of the down payment, was booked as a receivable. As monthly invoices were generated over the life of the FPO Lease, the invoice amounts were segregated into their various components: supplies, service, excess copy charges, principal (equipment), finance, etc. The principal (equipment) component of the monthly invoices reduced the receivable and increased cash (as it was received), and the finance component was booked as interest revenue, also increasing the cash (again, as it was received). If one ignores the supply, service and excess page aspects of the FPO Leases, the installment sales method used for the XEEPs and FPO Leases produced the same GAAP results.

Petitioner was the subject of a thorough investigation by the Securities and Exchange Commission that included the 1997 through 1999 period. Petitioner's financial accounting treatment of the FPO Leases as capital leases subject to the installment sales method has not been challenged.

Transactions with Governmental Entities

Petitioner maintained a segmented sales force, one segment of which was primarily responsible for transactions with governmental entities. This part of petitioner's sales force was specially trained and supplied with appropriate and customized marketing and pricing materials to better serve prospective governmental customers.

Petitioner maintained unique financing rates for its state and local governmental customers, and these rates reflected the tax advantages available for certain transactions with state and local governments commensurate with the anticipated tax exemptions.

The type of pay-over-time arrangements to be used was determined by each governmental customer based on the customer's cash flow and other considerations. Each different type of pay-over-time transaction had its particular strengths, weaknesses and pricing.

Federal Income Tax Treatment of the Pay-Over-Time Transactions

The financial accounting rules for classifying leases are not the same as the income tax rules for classifying leases. Thus, the financial accounting classification and income tax classification may differ.

For federal income tax purposes, petitioner classified each FPO and FMV Lease as either a finance lease treated as an installment sale or a true lease in accordance with the Internal Revenue Code (IRC or the Code), applicable Treasury Regulations and official announcements, as well as existing case law.

Petitioner classified its FMV Leases as true leases for federal income tax purposes.

Petitioner classified its XEEPs as installment sales for federal income tax purposes.

Petitioner classified a portion of its FPO Leases as true leases and the remainder as finance leases (receiving installment sale treatment) for federal income tax purposes.

During the tax years at issue, the decision to treat an FPO Lease as either a true lease or a finance lease was governed by the terms of a closing agreement issued to petitioner by the Appellate Division of the IRS as part of petitioner's 1987 - 1989 IRS tax audit. Petitioner has followed this guidance on all subsequent federal tax returns, including the federal returns filed for the 1997, 1998 and 1999 tax years. As mentioned above, FPO Leases allowed customers to purchase property at the end of the lease term for a fixed purchase price. In accordance with the terms of the closing agreement, if the fixed purchase price was 15% or greater of the equipment's original value at the outset of the lease on a four year lease, or 20% or greater of the equipment's original value at the outset of the lease on a three-year lease, then such a lease was to be classified as a true lease. If, however, the fixed purchase price was less than the aforementioned percentages of the equipment's original value at the outset of the lease, then the lease was to be classified as a finance lease (receiving installment sale treatment).

Petitioner maintained records that separately accounted for both the FPO Leases classified for federal income tax purposes as true leases and the FPO Leases classified for federal income tax purposes as finance leases.

On its 1997, 1998 and 1999 federal tax returns, petitioner excluded from federal taxable income the interest portion of the monthly payments it received pursuant to the finance leases when the acquirer of the equipment was a state or local governmental entity. Petitioner made this exclusion pursuant to IRC § 103. Petitioner listed this amount on the Schedule M attached to each of its federal income tax returns filed for the years at issue.

The total amount of petitioner's excluded IRC § 103 income during the 1997, 1998 and 1999 tax years was $181,463,703.00 (Section 103 Income).

For income tax purposes, petitioner treated the sum of the principal and interest portions of the monthly payments received on its FMV Leases as rental revenue.

The FMV Leases did not give rise to any of the interest revenue at issue in this matter. Petitioner did not treat any portion of the income received from the FMV Leases as exempt from federal income taxation under IRC § 103 or as investment income for New York State Article 9-A franchise tax purposes.

During federal audits of petitioner's 1997, 1998 and 1999 tax returns, the IRS upheld petitioner's characterizations of its pay-over-time transactions as either finance leases or true leases. Consequently, the IRS upheld the exclusion of petitioner's Section 103 Income.

New York State Franchise Tax Treatment of the Pay-Over-Time Transactions

When petitioner originally filed its New York State Article 9-A franchise tax returns for the 1997, 1998 and 1999 tax years, it treated all of the leases as business capital. Petitioner added the Section 103 Income back into its federal taxable income to compute New York entire net income and it characterized the Section 103 Income as income from business capital.

On February 14, 2001, petitioner timely submitted refund claims and amended returns for 1997, 1998 and 1999. Petitioner amended these returns in order to reclassify certain business income as investment income (income in dispute). Petitioner reclassified as investment income the sum of: (1) its Section 103 Income and (2) the interest income that arose from its finance leases, including all XEEPs and certain of the FPO Leases in which the lessee was the federal government, or its agencies or instrumentalities. In its amended returns, petitioner recharacterized the income in dispute as investment income rather than business income, but did not amend its earlier characterization of the balance of the income generated by its lease transactions with government entities and did not amend its characterization of the income received pursuant to its non-governmental lease transactions.

The amounts reclassified as investment income on petitioner's amended returns are:

	1997	1998	1999	Total
State and Local Governmental Customers (Section 103 Income)	$61,681,821.00	$63,878,445.00	$55,903,437.00	$181,463,703.00
Other Governmental Customers	$10,689,394.00	$12,433,943.00	$14,868,536.00	$37,991,873.00
Total "Income in Dispute"	$72,371,215.00	$76,312,388.00	$70,771,973.00	$219,455,576.00

Petitioner did not amend its characterization of income received pursuant to non-governmental pay-over-time transactions.

Petitioner restated its earnings in 2001 to reflect changes to the financial accounting treatment of certain of its transactions. As a result of the restatement, the financial accounting treatment of certain of the pay-over-time arrangements was changed. As a result of these changes, petitioner's reported equipment sales revenue was reduced for certain years prior to 2001, including but not limited to 1997 through 1999. On the other hand, financing revenue (interest) for those same transactions was increased.

The Division of Taxation (Division) audited petitioner's amended returns and, by a Notice of Disallowance dated August 23, 2005, disallowed petitioner's refund claims because the "leases" did not qualify as "investment capital" but rather were "agreements between the parties arising out of normal trade and therefore constituted business capital." By a memorandum dated December 7, 2004, the Division expanded upon its basis for this position by concluding that qualifying corporate debt instruments do not include instruments acquired by the taxpayer for services rendered or for sales, rentals or other transfers of property where the obligor is the recipient of the services or property. The Division stated that since both corporate and governmental debt obligations are governed by the same statutory definition of "investment capital," then the same types of transactions giving rise to such instruments should be treated in the same manner, whether such transactions involved government or non-government customers. Thus, the Division concluded that "financing arrangements between taxpayers and corporations and taxpayers and municipalities for the sale of goods should be treated consistently and excluded from the definition of investment capital."

The parties have agreed that if petitioner's governmental lease transactions do not qualify as investment capital, then the denial of petitioner's claim for refund should be sustained. In contrast, if petitioner's governmental lease transactions qualify as investment capital, then petitioner is entitled to a refund of tax (plus applicable interest) in the following amounts:

Year	Franchise Tax	MTA Tax Surcharge	Total Tax Refund
1997	$407,893.00	$20,596.00	$428,489.00
1998	$379,103.00	$17,802.00	$396,905.00
1999	$368,037.00	$18,376.00	$386,413.00
TOTAL	$1,155,033.00	$56,774.00	$1,211,807.00

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge found the foregoing facts and determined that the question of whether the subject revenue constituted investment income under Tax Law § 208(6) turned on whether petitioner's equipment leases and installment sales[2] were investment capital under Tax Law § 208(5). The Administrative Law Judge found that these instruments were clearly neither stocks nor bonds. As such, the Administrative Law Judge narrowed the question to whether the "other securities" language within Tax Law § 208(5) included equipment leases and installment sales.[3] In reviewing the cases interpreting the term, *other securities*, the Administrative Law Judge found that the New York courts have historically deferred to the interpretation provided by the Division in its regulations.

Turning to the regulations, the Administrative Law Judge noted that the current regulations were updated on December 7, 1989. As stated in the determination, the former regulations contain a test for investments in *other securities*, whereas the current regulation only provides a list of generic instruments that may fall into this category of investment capital. The Administrative Law Judge determined that the resolution of this case required construing the meaning of the current regulation, in particular 20 NYCRR 3-3.2(c). This section provides that *other securities* may include debt instruments issued by government entities.

Before the Administrative Law Judge, petitioner argued that a plain reading of 20 NYCRR 3-3.2(c) supports its position that the subject equipment leases and installment sales were investment capital. Petitioner argued that the lease/sale constitute debt instruments because its customers provided a debt obligation in exchange for petitioner's extension of credit that enabled the underlying equipment purchases. As the subject leases and installment sales involved government customers, petitioner argued that these financing agreements qualify as

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[2] Herein, the decision may refer to the subject transactions as "lease/sale financing agreements" or "leases and installment sales."

[3] When referred to as a term within Tax Law § 208(5), "other securities" shall appear italicized.

other securities under 20 NYCRR 3-3.2(c) because they constitute debt instruments issued by the government.

The Division argued that the denial of refund should be sustained because the financing agreements were not investments under Tax Law § 208(5). In support of its position, the Division cited to the legislative history of the franchise tax, as well as the text of and cases under the former applicable regulations. The Division also disagreed with petitioner's interpretation of current 20 NYCRR 3-3.2(c) because, as the Division asserted, this reading required imputing the term "all" as the first word of the section and produced an unnatural meaning of Tax Law § 208(5).

In reviewing the Division's argument, the Administrative Law Judge concluded that the Division did not dispute that the subject lease/sale financing agreements were debt instruments under 20 NYCRR 3-3.2(c). The Administrative Law Judge found no merit to the Division's arguments because they, in large part, relied upon interpretation under former 20 NYCRR 3-3.2(c), which provided a test for *other securities*.

The Administrative Law Judge agreed with petitioner's construction of 20 NYCRR 3-3.2(c) and concluded that the lease/sale financing agreements were *other securities* under the current regulations. The Administrative Law Judge arrived at this conclusion by finding that petitioner's extension of credit, which enabled the equipment purchases, created debt obligations issued by petitioner's government customers and, as such, was one of the enumerated devices that could be characterized as an *other security* under the regulations. By finding that the equipment financing agreements were investment capital under the *other securities* language of the regulations, the Administrative Law Judge further concluded that the revenue from these instruments could properly be classified as investment income under Tax Law § 208(6).

The Administrative Law Judge noted that this interpretation of investment income was consistent with Internal Revenue Code (IRC) § 103, which concerns interest on state and municipal bonds. The Administrative Law Judge made this conclusion based on the broad language within the federal statute and the Division's applicable regulation (***compare*** IRC § 103[c][1] ***and*** 20 NYCRR 3-3.2[c][2]). The Administrative Law Judge also found this interpretation to be consistent with treatment provided by the New York City Department of Finance.[4]

Accordingly, the Administrative Law Judge concluded that the revenue generated by the equipment financing agreements was investment income under Tax Law § 208(6) because the instruments were investment capital under the *other securities* language of 20 NYCRR 3-3.2(c).

ARGUMENTS ON EXCEPTION

On exception, the Division substantially modified its arguments from those made before the Administrative Law Judge below. The Division asserts that petitioner's equipment leases and installment sales agreements do not qualify as "investments" under 20 NYCRR 3-3.2(c) and former 20 NYCRR 3-4.2(c). The Division also argues that the Administrative Law Judge's interpretation of Tax Law § 208(5) runs counter to the history and expressed intent of the Legislature. It argues that the purpose of the subject section is to segregate income by its source, whether it is business or investment income. The Division submits that the Administrative Law Judge's reading defeats this purpose by allowing revenue from contracts, generated by petitioner in its ordinary course of business, to qualify as investment income. As such, the Division asserts

[4] ***see*** New York City Finance Letter Ruling No. 96-4691 (1997).

that the Administrative Law Judge's interpretation of *other securities,* as provided in the regulations, thwarts the legislative intent.

The Division also now argues that equipment leases and installment sales agreements do not qualify as investment capital because petitioner's leases and installment sales agreements are not debt instruments "issued by" government entities. Furthermore, the Division also now asserts that the subject agreements are not "securities" and thus capable of qualifying as investment capital under the relevant statutes and regulations.

Petitioner argues that the Administrative Law Judge arrived at the correct interpretation of Tax Law § 208(5) based on the Division's regulations at 20 NYCRR 3-3.2(c). Petitioner contends that the subject lease/sale financing agreements rely upon the extension of retail credit to its government clients, which then provide petitioner with an obligation to pay. In petitioner's view, it is of no relevance that the subject transactions were equipment sales and that petitioner was and remains in the business of selling such equipment. Rather, petitioner argues that the language of the regulation is determinative and that these financing agreements meet the clear, plain-language of 20 NYCRR 3-3.2(c)(2), which include "debt instruments" with the government within *other securities*. Petitioner argues that it is entitled to rely on the language of the regulation, particularly because the courts have deferred to the Division's interpretation of the *other securities* language within Tax Law § 208(5).

OPINION

This matter presents the question of whether the revenue from petitioner's leases and installment sales agreements constitute either investment income or business income.

In order to resolve this matter, we must interpret statutorily defined terms, including "investment capital" and "investment income" (***see*** Tax Law § 205[5], [6]). "Investment income" is derived from "investment capital" (Tax Law § 208[6]). Tax Law § 208(5) defines "investment capital" as,

> [I]nvestments 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 . . . .

The record establishes and no party disputes that the subject lease/sale financing agreements do not constitute either stocks or bonds. As such, the subject contracts may only be treated as investment capital if they constitute investments in *other securities* as meant by Tax Law § 208(5).

The courts and this Tribunal have historically deferred to the Division's regulations for the interpretation of what constitutes *other securities* (***see e.g. Matter of Pohatcong Investors***, Tax Appeals Tribunal, December 1, 1988 ***confirmed*** 156 AD2d 791 [1989]). Prior to December 7, 1989, the regulations at 20 NYCRR former 3-4.2[c] incorporated the statutory language by limiting *other securities* to instruments bearing certain attributes.[5] The former regulation went on to provide examples of instruments that did and did not constitute *other securities* under Tax Law § 208(5) (***see*** 20 NYCRR former 3-4.2[c] [specifically excluding notes acquired in the ordinary course of business for services rendered or for sales of property]).

Effective December 7, 1989, the Division amended the relevant regulation to define "stocks, bonds and other securities" for the purposes of inclusion in investment capital as follows:

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[5] In relevant part, the regulation provided that *other securities* in the Tax Law are "designed as a means of investment, and issued for the purpose of financing corporate enterprises and providing a distribution of rights in, or obligations of, such enterprises" (20 NYCRR former 3-4.2[c]).

> For purposes of paragraph (1) of subdivision (a) of this section, the phrase *stocks, bonds and other securities* means:
>
> (1) stocks and similar corporate equity instruments, such as business trust certificates, and units in a publically traded partnership included in the definition of "corporation" contained in section 208.1 of the Tax Law;
>
> (2) *debt 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;*
>
> (3) qualifying corporate debt instruments (see subdivision [d] of this section);
>
> (4) options on any item described in paragraph (1), (2), or (3) of this subdivision and not described in paragraph (2) of subdivision (a) of this section, or on a stock or bond index, or on a futures contract on such an index, unless the options are purchases primarily to diminish the taxpayer's risk of loss from holding one or more positions in assets which constitute business or subsidiary capital; and
>
> (5) stock rights and stock warrants not in the possession of the issuer thereof.
>
> Provided, however, debt instruments described in paragraph (2) or (3) of this subdivision which are deemed to be cash pursuant to paragraph (1) of subdivision (a) of this section do not constitute stocks, bonds or other securities (20 NYCRR 3-3.2[c]) (emphasis original in part, added in part).[6]

This regulation, which was in effect during the years at issue, lacks a test to determine what a security is but, instead, delineates generic instruments that may be included in *other securities*.

In essence, petitioner asserts that 20 NYCRR 3-3.2(c) should be interpreted to mean that the term *other securities* under Tax Law § 208(5) includes any and all agreements that create an obligation to pay money by government entities. Applied herein, the Administrative Law Judge found that the agreements at issue were *other securities* under 20 NYCRR 3-3.2(c) because petitioner's government customers did in fact provide debt obligations to petitioner through the

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[6] While this section was renumbered from 20 NYCRR former 3-4.2(c) to 20 NYCRR 3-3.2(c), the content of the regulation remains unchanged.

terms of the lease/sale financing agreements. Accordingly, the Administrative Law Judge concluded that the revenue from the lease/sale financing agreements was investment income because the sources were investment capital (Tax Law § 208[8]).

In cases of statutory interpretation, our goal is to "effectuate the intent of the Legislature" (***Majewski v. Broadalbin-Perth Cent. School Dist.***, 91 NY2d 577, 583 [1998] [internal quotation marks and citations omitted]). "The courts will not construe statutes, or rules and regulations of a government agency in such a manner as to thwart the obvious legislative intent and reach absurd and unexpected consequences" (***Matter of Friedman-Kien v. City of New York***, 92 AD2d 827, 828 [1983] ***affd*** 61 NY2d 923 [1984]). Where a statute fails to define a term, the term must "be given its precise and well settled legal meaning in the jurisprudence of this state" (***Matter of Moran Towing v. New York State Tax Commn.***, 72 NY2d 166, 167 [1988] [internal quotations and citation omitted]).

As noted, the instant dispute revolves around the class of investment capital known as *other securities* (Tax Law § 208[5]). While this class of investment capital does not include any specific instruments or agreements (***Matter of Howard Johnson Co. v. State Tax Commn.***, 105 AD2d 948 [1984] ***revd on other grounds*** 65 NY2d 726 [1985]), by definition, the includable items must be "securities" as defined by New York law.

We reject the Administrative Law Judge's reading of the regulation because it would permit the regulation to redefine limiting terms in a governing statute. This reading is prohibited (***see e.g. Kurcsics v. Merchants Mut. Ins. Co.***, 49 NY2d 451 [1980] [disregarding regulation of Superintendent of Insurance, limiting recovery for lost earnings to $800 per month, where it conflicted with clear wording of the relevant provisions of the Insurance Law]). The

Administrative Law Judge's reading of 20 NYCRR 3-3.2(c)(2) would define a security as something that is not a security under New York decisional law. As such, this violates the maxim that "'new language cannot be imported into a statute to give it a meaning not otherwise found therein'" (***Matter of Chemical Specialties Mfrs. Assn. v. Jorling***, 85 NY2d 382, 394 [1995], ***quoting*** McKinney's Cons Laws of NY, Book 1, Statutes § 94, at 190).

We also cannot accept the Administrative Law Judge's interpretation because it runs counter to the expressed intent of the Legislature. "The primary consideration of courts in interpreting a statute is to 'ascertain and give effect to the intention of the Legislature'" (***Riley v. County of Broome***, 95 NY2d 455, 463 [2000] [citations omitted]). Further, the history of an enactment may not be ignored when construing and interpreting statutory terms (***supra***).

In 1944, the Legislature combined the separate franchise taxes on business corporations, holding companies, and investment trusts under Article 9-A of the Tax Law (L 1944, ch 415). Among the purposes of the reform were to "[u]nscramble business income and investment income, and allocate each separately" (L 1944, ch 415, p. 26). Business income is currently defined by what does not constitute investment income (Tax Law § 208[8]), while investment income is, as described above, defined as revenue from investment capital (Tax Law § 208[8]).

We review the case *de novo* and reverse the determination of the Administrative Law Judge for the following reasons. Initially, we note that the determination of whether a revenue stream constitutes investment income or business income depends on the taxpayer's relationship to the specific item (***Matter of Custom Shop Fifth Ave. v. Tax Appeals Trib.***, 195 AD2d 702, [1993]). While the term *other securities* is "patently ambiguous" as to the specific instruments included in that category (***Matter of Howard Johnson Co. v. State Tax Commn.***, ***supra*** at 949), we find that the statutory language clearly limits *other securities* to instruments that constitute securities. Accordingly, we conclude that, in order to qualify as investment capital under Tax Law § 208(5) as *other securities*, an instrument must be a security as defined in New York jurisprudence.

Although the Tax Law does not specifically define what a "security" is, the language of the relevant statute is clearly intended to mimic the language utilized under the State securities laws (compare Tax Law § 208[5] reference to "investments in stocks, bonds and other securities" with the language utilized in the Martin Act [General Business Law Article 23-A]). In fact, in the past, New York courts have used a securities law analysis to help determine the outcome of tax law cases (***see reference to Securities & Exch. Commn. v. W.J. Howey Co.***, 328 US 293 [1946] utilized in ***Matter of Carret & Co. v. State Tax Commn.***, 148 AD2d 40 [1989] and ***reference to Matter of Waldstein***, 160 Misc 763 [1936] utilized in ***Matter of Howard Johnson Co. v. State Tax Commn.***, ***supra***).

The New York courts have previously applied two tests to determine whether an interest constitutes a security (***People v. First Meridian Planning Corp***, 201 AD2d 145 [1994], ***affd*** 86 NY2d 608 [1995]). These are the tests announced in ***Securities & Exch. Commn. v. W.J. Howey Co.*** (***supra***) and ***Matter of Waldstein*** (***supra***), referred to as the *Howey* and *Waldstein* tests, respectively. We find it appropriate to consider these tests to determine whether the subject lease/sale financing agreements constitute investments in *other securities* as meant by Tax Law § 208(5).

We first consider the test established by the Supreme Court in ***Securities & Exch.***

Commn. v. W.J. Howey Co.[7] The *Howey* test disregards form for substance (***Tcherepnin v. Knight***, 389 US 332 [1967]), and asks whether the transaction involved "an investment of money in a common enterprise with profits to come solely from the efforts of others" (***All Seasons Resorts v. Abrams***, 68 NY2d 81, 92 [1986] [internal quotations and citations omitted]).

The New York courts have divided the *Howey* test into three elements: (1) is there an *investment of money*; (2) is the investment in a *common enterprise*; and (3) are profits expected to result solely from *the efforts of others* (emphasis added) (***see e.g Gardner v. Lefkowitz***, 97 Misc2d 806 [1978]; ***People v. First Meridian Planning Corp.***, ***supra***; ***All Seasons Resorts v. Abrams***, ***supra***). We note, in particular, that the Appellate Division has previously considered the *Howey* test in determining whether an interest constitutes "other securities" under Tax Law § 208(5) (***Matter of Carret & Co. v. State Tax Commn., supra*** at 41).

In applying the *Howey* test, we must conclude that petitioner's leases and installment sale agreements do not constitute "securities" because the subject instruments meet neither the second nor the third elements of this test.

The second element of the *Howey* test requires a showing of commonality between the investment and the return. "A common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties" (***Securities & Exch. Commn. v. Glen W. Turner Enters.***, 474 F2d 476, 482 [1973] ***cert denied*** 414 US 821 [1973]). Put alternatively, the commonality element is present where "the fortunes of all investors are inextricably tied to the efficacy [of those seeking the

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[7] "The most often cited test for determining whether a given interest is a security, and one that has been adopted in New York (internal citations omitted), is that enunciated by the [US] Supreme Court in the seminal case of ***Securities & Exch. Commn. v. W.J. Howey Co.*** (internal citations omitted);" ***see All Seasons Resorts v. Abrams***, ***supra***.

investment or a third party]" (***People v. First Meridan Planning Corp.***, 86 NY2d at 620, ***quoting Securities & Exch. Commn. v Koscot Interplanetary***, 497 F2d 473 [1974]).

The federal and state courts have adopted three approaches to this element of *Howey*, sometimes termed "horizontal commonality," "vertical commonality," and "broad vertical commonality" (***People v. First Meridian Planning Corp.***, 201 AD2d at 152). Horizontal commonality refers to the pooling of investment funds and the sharing of profits and losses (***see Mount Lucas Assoc. v. MG Ref. & Mktg.***, 250 AD2d 245 [1998]). Narrow vertical commonality requires only a showing that the investor's fortunes are tied to those of the promoter or third party, but does not require the pooling of funds (***Revak v. SEC Realty Corp.***, 18 F3d 81 [1994]). Under the broad vertical commonality approach, there need only be "a direct nexus between the efforts of the promoter and the return on the investor's investment" (***People v. First Meridian Planning Corp.***, 201 AD2d at 152, ***citing Securities & Exch. Commn. v. Koscot Interplanetary, supra***).

Herein, the income from petitioner's lease/sale financing agreements comes primarily from the sales and leasing of equipment to government clients. The terms of the agreements set the rates of return, which are fixed to amortization tables, monthly payments, or on set per-usage bases. As such, the subject lease/sale financing agreements generate revenue on their own accord (intrinsic terms of the contract), and not on the basis of any promotion or venture by its government clients (***see People v. Fleishman***, 163 AD2d 148 [1990] ***appeal denied*** 76 NY2d 939 [1990]; ***see also All Seasons Resorts v. Abrams***, ***supra***).

We find that the lease/sale financing agreements do not fall within any cognizable test for commonality under *Howey*. There is no pooling of assets or funds such that profits or losses are shared. The returns from either contract type are not dependent upon third party promotion. Nor is there a nexus between the returns and the efforts of petitioner's government clients. Therefore, we conclude that the second element of *Howey* has not been met because the subject lease/sale financing agreements were not investments in a common enterprise.

The third element of *Howey* requires an expectation of profits solely from the work of others (***Securities & Exch. Commn. v. W. J. Howey Co.***, ***supra***). In applying this element, the courts have construed it realistically (***People v. First Merdian Planning Corp., supra***). To meet this element, the investor must have an expectation of profit (***All Seasons Resorts v. Abrams, supra***), and must show that the third party or promoter's efforts "are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise" (***Securities & Exch. Commn. v. Glen W. Turner Enters., supra*** at 482).

We first address whether petitioner had a reasonable expectation of financial profit from the lease/sale financing agreements. The Supreme court has defined profit as "either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds" (***United Housing Found. v. Forman***, 421 US 837, 852 [1975]). It is undisputable that the subject agreements provided petitioner with revenue; however, the question before us is whether this revenue is properly construed as investment profit.

Neither revenue stream meets the foregoing definition of profit under *Howey*. Income from leases represents rental charges imposed by petitioner for use of its equipment, which is neither capital appreciation nor shared earnings from the use of funds. Similarly, periodic payments under an installment sale represent the time-price differential (i.e. a finance charge imposed for the privilege of purchasing on credit) (***see Hogg v. Ruffner***, 66 US 115 [1861]), not appreciation or use of earnings (***see Zachary v. Macy & Co.***, 31 NY2d 443 [1972]). We, therefore, find that petitioner had no reasonable expectation of investment profit, as meant by *Howey*, from its equipment leases and installment sales to its government customers.

As to the question of whether profits rely upon the efforts of others, we also find that such did not occur. The revenue from the leases and installment sales was generated by the inherent terms of the contracts. As a party to the contract, petitioner selects the terms and decides whether to enter into the lease/sale financing agreement. The agreed-upon lease/sale financing agreement then generated a set rate of return based upon the contracted terms. As discussed above, the income from the contracts was fixed and did not relate to exerted effort of any party (***cf. Tcherepnin v. Knight***, ***supra*** [profits dependent upon the skill of managers]). Under these facts, we must conclude that the third element of *Howey* has not been met because the revenue streams from the subject agreements did not arise from the efforts of any third party or promoter.

We find that the leases and installment sales do not constitute securities under the *Howey* test because the agreements were neither investments in common enterprises, nor were their profits expected solely from the work of others. Under *Howey*, the subject instruments cannot be construed as *other securities* under Tax Law § 208(5) because they do not constitute securities.

Although application of the *Howey* test is sufficiently dispositive of the issue, we also consider whether the equipment leases and installment sales agreements constitute a security under the test established under ***Matter of Waldstein*** (***supra***). The *Waldstein* test provides that securities are instruments "used for the purpose of financing enterprises and promoting a distribution of rights in or obligations of such enterprises, *and* which are designed as a means of investment" (***Matter of Waldstein, supra*** at 767) (emphasis added).

We find that the subject equipment leases and installment sales do not possess the foregoing attributes of securities. These instruments neither finance corporate enterprises nor do they promote distributions of rights in such an enterprise. Rather, the subject lease/sale financing agreements were designed as product leases and sales, conveying possession and/or title to customers who, in turn, agreed to pay petitioner. The instruments do not possess the attributes of investments (***see All Seasons Resorts v. Abrams***, ***supra***), but those of contracts to rent or purchase equipment at a fixed rate or price. As such, we conclude that the instruments do not constitute securities under the *Waldstein* test.[8]

We conclude that petitioner's lease/sale financing agreements do not constitute securities under New York jurisprudence. As such, petitioner may not construe these instruments as investment capital because they are not *other securities* under Tax Law § 208(5).

In so holding, we also find that petitioner's relationship to the leases and installment sales is of assistance in determining whether the instruments constitute business income or investment income (***see Matter of Burrell v. Lynch***, 274 AD 347 [1948] [discussing what constitutes business under the franchise tax]). Petitioner was and remains in the business of selling, servicing, and leasing office equipment. Upon reviewing the leases and installment sales in the record, we find that the purposes of these instruments were to affect equipment leases and sales. We also find that these instruments were created in petitioner's ordinary course of business. The business nature of these transactions did not change because the sales involved extensions of

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[8] Inasmuch the relevant lease/sale financing agreements are deemed notes, the instruments would still fail to qualify as securities under the relevant securities law analysis (***see Reves v. Ernst & Young***, 494 US 56 [1990], applying the "family resemblance" test and also expressly indicating that a note delivered in a consumer financing transaction is not a security).

retail credit to customers. Nor did it change because the purchasers were government entities. Focusing on petitioner's relationship to and the substance of these transactions (***Matter of Avon Prods. v. State Tax Commn.***, 90 AD2d 393 [1982]), we conclude that the revenue streams from petitioner's leases and installment sales are properly construed as business income.[9]

We have considered petitioner's remaining arguments, including those based upon the Internal Revenue Code. Petitioner's arguments based on IRC § 103 are insufficiently persuasive because that section addresses the federal government's classification of interest from certain instruments, whereas the issue herein is whether the financing charges from the lease/sale financing agreements constitute investment income under Tax Law § 208; although the Internal Revenue Services position on IRC § 103 is somewhat helpful, it does not usurp the necessary analysis performed above. Furthermore, the ruling of the New York City Department of Finance is also insufficiently persuasive because such is not precedential or otherwise binding upon any court or the Division; moreover, we are unpersuaded that the analysis provided therein sufficiently accounts for all the factors analyzed above. In considering petitioner's remaining arguments, we find them either lacking in merit or insufficiently persuasive.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is granted;

2. The determination of the Administrative Law Judge is reversed;

3. The petition of Xerox Corporation is denied; and

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[9] The Division fails to provide sufficient legal analysis or authority to support its new found assertion that the relevant lease/sale financing agreements were not "issued by" government entities and thus we do not opine thereon.

4. The Notice of Disallowance dated August 23, 2005 is sustained.

DATED:Troy, New York
January 12, 2012

/s/ James H. Tully, Jr.
James H. Tully, Jr.
President

/s/ Charles H. Nesbitt
Charles H. Nesbitt
Commissioner