STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
DOMINION TEXTILE, (USA) INC., AS SUCCESSOR TO JORIC CORP.	:	DETERMINATION DTA NO. 812248
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Year Ended May 31, 1987.	:	

Petitioner, Dominion Textile, (USA) Inc., as successor to Joric Corp., 120 West 45th Street, New York, New York 10036-4003, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal year ended May 31, 1987.

A hearing was held before Frank W. Barrie, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on June 23, 1994 at 1:15 P.M. Briefs were filed by petitioner and the Division of Taxation. Petitioner's reply brief was received on December 5, 1994, which began the six-month statutory period for issuance of a determination. Petitioner appeared by Peter L. Faber, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Vera R. Johnson, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation's refusal to apply retroactively the current corporation tax regulation which treats stock options as investment capital was improper so that the Division of Taxation incorrectly required petitioner to allocate capital gains received from the sale ofcertain stock options by use of its business allocation percentage of 100% instead of its investment allocation percentage of 4.8540%.

II. Whether, if the Division of Taxation may properly refuse to apply the current regulation retroactively, the former regulatory definition of investment capital which included "other

securities" covered stock options so that the Division of Taxation incorrectly required petitioner to allocate capital gains received from the sale of certain stock options by use of its business allocation percentage of 100% instead of its investment allocation percentage of 4.8540%.

FINDINGS OF FACT

Dominion Textile, Inc. ("Dominion Textile"), which began operations in 1905, was, during the period at issue, the largest Canadian manufacturer of textiles and related products, with worldwide manufacturing and sales activities. In Canada, Dominion Textile designed, produced, finished and marketed a wide range of woven fabrics including: (i) consumer products such as sheets, blankets, towels, knitted sportswear and leisurewear; (ii) spun yarn for knitters and weavers; and (iii) woven and nonwoven industrial products engineered to meet the requirements of many manufacturing and processing industries. In the United States, Dominion Textile, by various subsidiaries, manufactured and sold: (i) denim, polyester/cotton and cotton yarns; (ii) geotechnical products;[1] and (iii) plastic accessories.

Petitioner, Dominion Textile, (USA) Inc. ("Dominion Textile USA"), was the principal United States subsidiary of Dominion Textile, the Canadian parent corporation. In turn, Dominion Textile USA, as a holding company, owned the subsidiary corporations that conducted Dominion Textile's active business operations in the United States.

In the spring of 1986, Dominion Textile decided to expand and diversify its investments in the United States. It targeted Burlington Industries, Inc. ("Burlington"), whose corporate headquarters were located in North Carolina, for takeover. Burlington, one of the world's largest and most broadly diversified textile companies, operated principally in the United States with additional operations in Canada, Mexico, Ireland and Italy.

Burlington's stock, which was publicly held, traded on several United States exchanges.

---

[1]The record does not disclose the nature of "geotechnical" products.

Dominion Textile was inexperienced in the takeover mania that was sweeping Wall Street, and anticipating resistance by Burlington to its takeover, Dominion Textile enlisted the assistance of Asher Edelman, who had participated in other takeovers.

Complex Takeover Creations

Dominion Textile USA created a wholly-owned subsidiary, Joric Corp. ("Joric") on December 6, 1986 for the sole purpose of acquiring the outstanding common stock of Burlington. Joric and Grid Partners, L.P. ("Grid Partners"), which was a limited partnership organized under the laws of Delaware controlled by Asher Edelman, formed Samjens Partners I ("Samjens Partners"), a New York general partnership, for the sole purpose of acquiring the stock of Burlington.

Asher Edelman's takeover organization was remarkably complex. His Grid Partners, which served as the general partner of Samjens Partners, was made up of (1) Grid Management Corp. ("Grid Management"), the sole general partner of Grid Partners (i.e., the general partner of a general partner), and (2) five limited partners consisting of three corporations, Canran Corp., Intelogic Trace, Inc., and United Stockyards Corporation, and two limited partnerships, Plaza Securities Company and Valley Partners, L.P. (i.e., limited partnerships which were limited partners).

The partnership agreement of Samjens Partners stated that its business purposes were (i) to acquire, directly or through its subsidiaries, actively traded marketable securities (or rights or options relating thereto) of a specified issuer, and (ii) to hold, sell, dispose, exchange, transfer, vote or otherwise exercise all rights, powers and privileges and other incidents of ownership with respect to the securities of the specified issuer and other partnership property. Samjens Partners designated Burlington as the specified issuer.

The only activities conducted by Joric and Samjens Partners were activities conducted in connection with the acquisition of Burlington stock. Joric purchased Burlington common stock on the open market over a five-month period, from December 1986 until April 1987. Joric transferred its Burlington stock to Samjens Partners during 1987. Samjens Partners also

purchased Burlington stock.

In addition to the purchase of Burlington stock, Joric purchased Burlington stock options. On March 5, 1987, Joric paid a total of $1,299,318.00 to purchase 1,440 June 40 options of Burlington on the New York Stock Exchange[2] in two[3] transactions: (i) 265 options for $268,843.00 and (ii) 1,175 options for $1,028,125.00. Each June 40 option represented the right to purchase 100 shares of Burlington common stock at $40.00 per share, exercisable in June 1987. In other words, Joric had the option to purchase 144,000 shares of Burlington stock at $40.00 per share in June 1987 for a total price of $5,760,000.00. Since the cost of the options totalled $1,299,317.50, if Joric, in fact, exercised its options in June 1987, it would have paid $7,059,317.50 for the 144,000 shares of Burlington ($5,760,000.00 + $1,299,317.50 = $7,059,317.50), or a per-share cost of $49.02.

On March 5, 1987, Joric also paid $113,558.00 to purchase 243 June 55 options of Burlington. Each June 55 option represented the right to purchase 100 shares of Burlington common stock at $55.00 per share, exercisable in June 1987. If Joric, in fact, exercised these June 55 options, it would have paid $1,450,058.00 for the 24,300 shares of Burlington ($1,336,500.00 + $113,558.00 = $1,450,058.00), or a per-share cost of $59.67.

Joric's purchase of Burlington stock options was part of a strategy to acquire the

---

[2]The taxpayer's expert witness, Professor Stephen Figlewski, noted that the first exchange trading of options occurred in 1973.

[3]The parties stipulated that such purchase was made in three transactions. However, Exhibit "E" to the stipulation, which is a photocopy of confirmation slips for such purchase from Bear, Stearns & Co., Inc., shows two purchases as follows:

Number of June 40 Options	Price per Option	Principal	Net Commission	Amount
265	10-1/8	$ 268,312.50	$ 530.00	$ 268,842.50
1,175	8-3/4	1,028,125.00	2,350.00	1,030,475.00
1,440		$1,296,437.50	$2,880.00	$1,299,317.50

outstanding common stock of Burlington. It is noted

that the Burlington stock options purchased by Joric were traded on the New York Stock Exchange and were not specifically created for the purpose of enabling Joric to acquire Burlington's common stock.

Takeover Attempt Becomes Public

On April 8, 1987, an article in USA Today reported that a group led by Asher Edelman and Dominion Textile USA had acquired 4.9% of the outstanding Burlington stock. A week later, a competing group led by representatives of Morgan Stanley Group, Inc. ("Morgan Stanley Group") contacted Burlington management and, on April 28, 1987, representatives of the Morgan Stanley Group met with Burlington representatives concerning their possible acquisition of Burlington. This competing group was willing to allow Burlington management to acquire an interest in the Morgan Stanley Group entity that would make the acquisition and would prove to be Burlington's so-called white knight against petitioner's hostile tender offer.

Dominion Textile's Hostile Takeover Attempt Fails

Over a period of a few intense weeks in May 1987, Dominion Textile's attempt to take over Burlington would fail:

(a) On May 6, 1987, Samjens Partners extended a tender offer to Burlington shareholders to purchase all of Burlington's stock for $67.00 per share;

(b) On May 11, 1987, Burlington's board of directors met and rejected the tender offer of Samjens Partners, recommending to Burlington shareholders that they not tender their shares and announcing that Burlington would offer to buy back at a price of $80.00 per share up to 25% of its shares;

(c) On May 14, 1987, Burlington made a tender offer to buy back up to 8,000,000 of its shares (approximately 25%) at a price of $80.00 per share at a total buy back cost of $640,000,000.00 (8,000,000 x $80.00 = $640,000,000.00);

(d) On May 15, 1987, Samjens Partners amended its tender offer to increase by $5.00

the price per share in its tender offer, from $67.00 to $72.00, and in a letter to Burlington refused to abandon its tender offer;

(e) On May 20, 1987, Burlington's board of directors and the Morgan Stanley Group reached an agreement on an acquisition of Burlington by the Morgan Stanley Group for a price of $76.00 per share with selected members of Burlington's management invited to participate in the Morgan Stanley Group entities that would effect the acquisition;

(f) On May 26, 1987, the Morgan Stanley Group, through controlled entities, extended a tender offer to Burlington shareholders to purchase their Burlington stock for $76.00 per share;

(g) On May 27, 1987, Samjens Partners amended its tender offer by raising the price in its tender offer another $5.00 per share, from $72.00 to $77.00, $1.00 more per share than the competing group's tender offer;

(h) In a matter of days, it became apparent that the Morgan Stanley Group would increase its offer, while Dominion Textile and Asher Edelman concluded that they would not be able to match an offer in excess of $77.00 per share;

(i) On June 10, 1987, the Morgan Stanley Group increased its offer another $2.00 per share, from $76.00 to $78.00, $1.00 per share more than Dominion Textile's tender offer; and

(j) On June 24, 1987, the Morgan Stanley Group announced that 78% of the Burlington shares had been tendered to it.

Joric Dissolves

As noted in Finding of Fact "13", by late May 1987, Dominion Textile's takeover attempt had failed and, consequently, Joric had no reason to continue holding the Burlington stock options described in Finding of Fact "10". On May 29, 1987, Joric sold 970 of its June 40 options for $3,547,656.00, realizing a gain of $2,660,528.00. On the same day, it also sold 240 of its June 55 options for $517,783.00, realizing a gain of $404,225.00. A comparison of these stock options sold to stock options purchased (described in Finding of Fact "10") shows that

Joric retained 470 June 40 options and 3 June 55 options.

Subsequently, Samjens Partners and its affiliates sold the Burlington common stock that they held (along with Burlington's other shareholders) pursuant to the tender offer of the Morgan Stanley Group.

On August 10, 1989, Joric filed a certificate of dissolution, and its assets and liabilities were transferred to Dominion Textile USA, its sole shareholder, in liquidation.

The Division of Taxation's Assessment

The Division of Taxation ("Division") issued a Notice of Deficiency[4] dated June 12, 1992 against an entity named in the notice

as "Joric Corp. Dominion Textile" asserting additional tax due of $321,379.00, plus penalties[5] and interest, which was allocated as follows:

Tax Period Ended	Additional Corporate Franchise Tax	MCTD Surcharge[6]	Totals
May 31, 1987	$272,922.00	$46,397.00	$319,319.00
May 31, 1989	1,724.00	336.00	2,060.00
Totals	$274,646.00	$46,733.00	$321,379.00

Petitioner has contested only the assertion of additional tax for the

[4]A photocopy of the Notice of Deficiency dated June 12, 1992 was included with the taxpayer's petition, which was marked into evidence as the Division's Exhibit "C". This photocopy of the notice, however, appears to be missing a fourth page which apparently would have shown an additional tax asserted due of $336.00 for the period ended May 31, 1989 representing the surcharge imposed on corporations doing business in the Metropolitan Commuter Transportation District ("MCTD surcharge"). An unsigned Form DO-356, Consent to Field Audit Adjustment, included in the Division's Exhibit "F", the field audit report and attachments, indicated this additional minor amount.

[5]Penalties were imposed under Tax Law § 1085(a)(1); (b)(1), (2) and (k) for failure to file, failure to pay, negligence and substantial underpayment of taxes.

[6]See footnote "4".

period ended May 31, 1987. In the course of the audit, petitioner had argued that New York had no nexus to tax Joric's income for the period at issue, but subsequent to the conciliation conference held in this matter, petitioner withdrew such contention. A Conciliation Order dated June 18, 1993 had upheld the assertion of additional tax of $321,379.00, plus penalties and interest, except the assertion of penalty under Tax Law § 1085(k).[7]

Subsequent to the conciliation conference, petitioner developed its position that gains from the sale of the stock options should be allocated to New York by an investment allocation percentage of 4.8540% and not by a business allocation percentage of 100%. A schedule labeled "Computation of Tax on Allocated Net Income" included in the field audit report (Exhibit "F") shows how the Division computed tax due for the taxpayer's 1987 fiscal year as follows:

Federal taxable income	$3,562,473.00
50% of dividends non-sub	(8,302.00)
Entire net income per audit	$3,554,171.00
Investment income for allocation	548,325.00
Business income for allocation	3,005,846.00[8]
Investment allocation %	4.8540%
Business allocation %	100.0000%
Allocated investment income	26,616.00
Allocated business income	3,005,846.00
Total allocated income	3,032,462.00
Allocated taxable net income	3,032,462.00
Tax rate	9%
Tax on allocated net income	$ 272,922.00

The MCTD surcharge rate of

[7]An auditor's memorandum dated April 2, 1993 (Division's Exhibit "G") shows that the auditor had agreed "with the taxpayer that the 1085(k) penalty should be waived as per recent instructions from Albany" (because penalty for substantial understatement of liability should not be imposed with the negligence penalty).

[8]As noted in Finding of Fact "14", Joric realized gains of $2,660,528.00 and $404,225.00 on its sale of Burlington stock options, for a total gain of $3,064,753.00. The record does not disclose why this amount is $58,907.00 greater than the amount shown above as "business income for allocation" of $3,005,846.00.

9% applied to the tax of $272,922.00 results in a surcharge of $46,397.00. The sum of these amounts is $319,319.00, the amount of tax for the taxpayer's fiscal year which is at issue here as noted in Finding of Fact "17".

The Taxpayer's Expert

In support of its position that the Division should treat income from the sale of stock options as investment income, not business income, because stock options are investment capital, not business capital,

petitioner presented the testimony of Stephen Figlewski, an economist and professor of finance at the New York University Stein School of Business. In Professor Figlewski's opinion, "buying an option is, in terms of financial economics, a capital asset in the same way that stock is a capital asset" (tr., pp. 40-41). Like the stock of which it is a derivative, an option is a form of investment in the business of a corporation. Its value depends on the corporation's success, as does the value of stock. Like stock, the money that is made or lost on the option market changes hands among investors and does not actually return to the underlying company, which does not get fresh money when the transactions occur.

In response to a leading question, Professor Figlewski agreed that stock options provide the buyer with rights in the corporate enterprise. He elaborated:

> "[I]n the sense that the option gives you a right to control the stock, and the stockholder has rights in the corporate enterprise. Then the option essentially is giving you the right to acquire these rights in the corporate enterprise -- I am trying to say 'as a matter of right' . . ." (tr., p. 47).

According to Professor Figlewski, in a hostile takeover attempt, stock options are essentially equivalent to the purchase of the underlying stock:

> "If I were trying to do a hostile takeover, any way I could think of locking in the stock at the price that is fixed today, is the same" (tr., p. 51).

Moreover, the acquisition of stock options is the "cost effective way" of carrying out a hostile takeover because, in Professor Figlewski's words, "[t]he option is the more leveraged

instrument" by which more stock can be controlled "with the same amount of money" (tr., p. 52). In short, Professor Figlewski views stock options as "means of investment" (tr., p. 47).

The Division's auditor testified that, prior to January 1, 1990, the Division always treated income from the sale of stock options as business income and he computed additional tax asserted as due, as detailed in Finding of Fact "19", based upon an automatic application of this established policy. The issue at hand, according to the auditor, did not come up in the course of the audit. Rather, the taxpayer argued that stock options should be treated as investment capital, not business capital, after the conciliation conference. At that point, the auditor analyzed the issue and concluded that the stock options were properly treated as business capital because they "were not designed as means of investment by Joric Corporation", but rather their purpose was "[t]o take over . . . Burlington" (tr., p. 61). The auditor emphasized that the taxpayer "did not invest in any other stocks or options in any other company" (tr., p. 61).

The parties executed a Stipulation of Facts dated June 23, 1994, of which relevant portions have been incorporated into these findings of fact.

SUMMARY OF THE PARTIES' POSITIONS

The Division contends that the current corporation tax regulation which treats stock options as investment capital, 20 NYCRR 3-3.2(c), should not be applied retroactively because the Department of Taxation and Finance has clearly indicated that the current corporation tax regulation should be applied prospectively only. Under the old regulation, 20 NYCRR former 3-4.2(c), stock options were properly treated as business capital and not as "other securities" (or investment capital) because they are not designed as a means of investment and are not used for the purpose of financing a corporate enterprise. According to the Division, in the matter at hand, the purpose for the taxpayer's purchase of stock options was for a hostile takeover, which was a business purpose.

Petitioner maintains that the Division's refusal to apply retroactively the current corporation tax regulation, which explicitly treats stock options as investment capital, to the

period at issue is unreasonable in light of the fact that the statutory provision which the current regulation interprets was unchanged. According to petitioner, "the Department cannot issue regulations interpreting a statute that has not changed and apply those regulations prospectively only . . . if options are investment capital now, they equally were investment capital under the same statute seven years ago" (petitioner's brief p. 3). Petitioner points out that in various jurisdictions (albeit outside New York), courts have recognized that administrative regulations interpreting statutes are generally effective from the effective date of the relevant statute, no matter when the regulation was promulgated. In the alternative, petitioner contends that under the former regulation, stock options should be viewed as "other securities" and therefore deemed investment capital.

Petitioner rejects the Division's central thesis that the purpose for the purchase of the stock option is relevant. Stock acquired pursuant to a takeover attempt is an investment. In the words of petitioner's representative in his closing argument, "Why the purpose can taint a stock option but not stock itself is beyond me" (tr., p. 92). Furthermore, petitioner points to the testimony of its expert witness, Professor Stephen Figliewski, in support of its position that stocks options are a means of investment:

> "The buying of stock options is just another way of investing in corporate equities. Since corporate stock is indisputably investment capital, the right to buy that corporate stock should be treated the same way. Like other instruments that have been found to be 'other securities', the options were traded as an investment and were commonly recognized by investors as securities" (petitioner's brief, p. 31).

In the matter at hand, petitioner maintains that stock and options were interchangeable investments:

> "In addition to being traded on an exchange, an option is similar to stock in several fundamental ways. An option, like the stock of which it is a derivative, is a form of investment in the business of a corporation. [Citations to pages in the hearing transcript are omitted.] Its value depends on the corporation's success, as does the value of stock. Like stock, the money that is made or lost on the option market changes hands among investors and does not actually return to the underlying company. Each of these similarities demonstrate that options are not only 'similar' to stocks, they can be (and in this case, are) the functional equivalent of stock" (petitioner's brief, p. 29).

CONCLUSIONS OF LAW

A. Tax Law § 210(1) provides that the corporation franchise tax is to be computed by whichever of four alternative methods results in the greatest tax. The method at issue here consists of a tax of 9% on the taxpayer's entire net income base. Tax Law § 210(1)(a) provides, in relevant part:

> "The taxpayer's entire net income base shall mean the portion of the taxpayer's entire net income allocated within the state . . ." (emphasis added).

As noted in Finding of Fact "19", petitioner's business income allocation percentage is 100%, while its investment income allocation percentage is 4.854%. As a result, if the Division properly viewed petitioner's gains from the sale of the Burlington stock options as business income, petitioner's corporation tax liability is significantly higher. Therefore, at the heart of this matter are the statutory definitions of "investment income" and "business income".

B. Tax Law § 208 (former [6])[9] as in effect for the period at issue, defines the term "investment income" in relevant part as follows:

> "The 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 . . ." (emphasis added).

Tax Law § 208(8) defines the term "business income" as follows:

> "The term 'business income' means entire net income minus investment income."

Given the above statutory definitions which pivot on the meaning of "investment capital", a close analysis of Tax Law § 208 (former [5])[10] , as in effect during the period at issue, which defines "investment capital", in pertinent part, as follows, is necessary:

> "The 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 . . ." (emphasis added).

---

[9]The current definition of "investment income" under Tax Law § 208(6) is the same except it includes special treatment for income received from certain subsidiary corporations based on acquisition dates (not relevant to the matter at hand).

[10]The current definition of "investment capital" at Tax Law § 208(5) varies from the above but not in any fashion relevant to the matter at hand.

The issue at hand therefore becomes whether the Burlington stock options, which generated the substantial income at issue here, constituted "other securities" so that the Division should have treated the income from their sale as "investment income" and not "business income".

C. In Mobil Intl. Fin. Corp. v. State Tax Commn. (117 AD2d 103, 501 NYS2d 947, 949), the court noted that in determining whether certain loan instruments were "other securities" under Tax Law § 208(5), special

deference should be paid to the Division's[11] determination, which was based upon application of its interpretive regulation at 20 NYCRR former 3-4.2(c), because the question is "one of specific application of a broad statutory term" and not a question of "pure statutory reading and analysis, dependent only on accurate apprehension of legislative intent." The court, citing its earlier decision in Matter of Howard Johnson v. State Tax Commn. (105 AD2d 948, 481 NYS2d 909, revd on other grounds 65 NY2d 726, 492 NYS2d 11), noted that "the term 'other securities' in Tax Law § 208(5) is 'patently ambiguous'" (Mobil Intl. Fin. Corp. v. State Tax Commn., supra, 501 NYS2d at 950). Consequently, so long as the Division's application of its interpretive regulations was rational, it should be confirmed.

D. The current regulation, 20 NYCRR 3-3.2, specifically includes stock options within the definition of "other securities":

---

[11]The respondent in Mobil Intl. Fin. Corp. v. State Tax Commn. was the former State Tax Commission. However, the court noted that:

> "in reviewing administrative determinations, the construction given statutes and regulations by an agency responsible for their administration will, if not irrational or unreasonable, be upheld (citation omitted)" (Mobil Intl. Fin. Corp. v. State Tax Commn., supra, 501 NYS2d at 949; emphasis added).

Since the Division of Taxation is the "agency responsible" for the administration of tax statutes and regulations (other than in relation to the administration of the administrative hearing process), this standard of review, which clearly requires the upholding of a tax regulation if it is "not irrational", is properly applied (cf., Tax Law § 2026).

"(a)(1) The term investment capital means the taxpayer's investments in stocks, bonds and other securities issued by a corporation [exception not relevant to this matter omitted] . . . .

* * *

"(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 publicly 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 . . . ;

"(4) options on any item described in paragraph (1), (2), or (3) of this subdivision [exception not relevant to this matter omitted], or on a stock or bond index, or on a futures contract on such an index, unless the options are purchased primarily to diminish the taxpayer's risk of loss from holding one or more positions in assets which constitute business or subsidiary capital; and

"(5) stock rights and stock warrants not in the possession of the issuer thereof" (emphasis in original except for emphasis added to "options on any item described").

E. However, the Division issued a special memorandum dated July 13, 1990 entitled "Amendments to Article 9-A Regulations Concerning Investment Capital and Investment Income" (TSB-M-90[4]C, 1990 WL 128467) which explicitly limited the application of the current regulation as follows:

"On November 16, 1989, the Commissioner of the Department of Taxation and Finance adopted amendments to the Business Corporation Franchise Tax Regulations to update those provisions concerning the nature and treatment of investment capital and investment income. The amended regulations deal with the treatment of various financial instruments such as futures contracts and forward contracts, repurchase agreements, money market mutual funds and stock options.

"Generally, the amendments made by this regulation apply to taxable years beginning on or after January 1, 1990. However, the amendments which classify options as investment capital, and which classify as investment income the income from certain futures and forward contract transactions, income from certain short sales and premium income from certain unexercised covered call options, apply only to positions taken in taxable years beginning on or after January 1, 1990

[exception not relevant to this matter omitted].[12]

"In general, investment capital is defined as the taxpayer's investments (including items held in book entry form) in stocks, bonds, and OTHER SECURITIES issued by a corporation or by any governmental entity.

"The phrase 'stocks, bonds and OTHER SECURITIES' includes: stocks; and similar corporate equity instruments such as units in certain publicly traded partnerships; debt instruments issued by a governmental entity; qualifying corporate debt instruments; options on the foregoing or on a stock or bond index or on a futures contract on such an index unless the option hedges the taxpayer's business or subsidiary capital; stock rights and stock warrants" (capitalization of the letters of "other securities" in original).

F. As noted in paragraph "23", petitioner argues that the Division's refusal to apply retroactively the current corporation tax regulation, which explicitly treats stock options as "other securities" and therefore "investment capital", is unreasonable in light of the fact that the statutory provision which the current regulation interprets was unchanged. However, the Tax Appeals Tribunal, in its recent decision in Matter of Varrington Corporation (March 23, 1995), set forth a standard for

determining whether a tax regulation should be applied retroactively. The New York State Register for the effective date of the regulations at issue in Varrington specifically noted that the provisions at issue "are being made prospectively because they constitute a change in Departmental policy, as such policy was previously represented by several Advisory Opinions

---

[12] The Division gave "Notice of Adoption" of the current regulation in the New York State Register, December 6, 1989, of which official notice is taken. In the "Regulatory Flexibility Analysis" of such notice, the Division noted two substantive changes in the final rule as adopted including the following:

"The effective date of the proposal provided that the amendments made by the regulation which classify options as investment capital . . . shall apply only to positions taken on or after January 1, 1990. The effective date of the final rule provides that . . . the amendments made by this regulation which classify options as investment capital . . . shall apply only to positions taken in taxable years beginning on or after January 1, 1990." [Emphasis added.] Consequently, for a taxpayer like petitioner who has a fiscal year running June 1 to May 31, the new rule would apply to options obtained commencing June 1, 1990.

on the subject." Consequently, the Tribunal determined that since the regulations effected a policy change, they should not be applied retroactively.

G. Similarly, as noted in Conclusion of Law "E", the current regulation which treats stock options as "investment capital" represented a significant change in Departmental policy because, under the prior regulations, stock options were not considered "other securities", a position which had been sustained by the Appellate Division, Third Department, as discussed below.

H. The prior corporate tax regulations at 20 NYCRR former 3-4.2(c) defined "other securities" as follows:

> "The other securities referred to . . . are 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, 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. Thus other securities include debentures, notes of a type commonly dealt in upon securities exchanges or markets or commonly dealt in as a medium for investment, and certificates of indebtedness which have many of the essential characteristics of bonds, and certificates of interest and other instruments evidencing proprietary rights in corporate enterprises which have many of the essential characteristics of stock. They do not include corporate obligations not commonly known as securities, such as real property bonds and mortgages, chattel bonds and mortgages, contracts of sales, purchase money obligations, short-term notes acquired in the ordinary course of trade or business for services rendered or for sales of property which is primarily held for sale to customers, bills of lading, bills of exchange, bankers' acceptances and other commercial instruments."

I. In Matter of C. Czarnikow, Inc. (Tax Appeals Tribunal, April 25, 1991), the Tribunal described the four requirements under the former regulations as follows:

(1) The instruments at issue are of a like nature as stocks and bonds, customarily sold in the open market or on a recognized exchange;

(2) The instruments are designed as a means of investment from the perspective of the petitioner;

(3) The instruments are issued for the purpose of financing a corporate enterprise; and

(4) The instruments provide a distribution of rights in or obligations of, the corporate enterprise.

J. The treatment of stock options as "business capital" was upheld by the Tax Appeals

Tribunal in Matter of Pohatcong Investors (December 1, 1988, confirmed 156 AD2d 791, 549 NYS2d 211). In Pohatcong Investors, the Tribunal decided that stock options were not "other securities" for two reasons: (1) they did not distribute any rights in or obligations of a corporate enterprise (the fourth element listed in Czarnikow), and (2) in the facts before it, the options were not designed as a means of investment for the taxpayer in Pohatcong Investors, who was the writer of the stock options. The Tribunal elaborated as follows:

> "The next element in dispute is whether petitioner, as writer of the call options, provides the purchasers of the options with a distribution of rights in or obligations of the petitioner corporation. Applying a functional analysis, petitioner as the writer of the options should be compared to a corporation issuing shares of stocks or bonds. As a corporation that issues shares of stock or bonds provides its purchasers with rights in or obligations of its enterprise, so should the writer of a call option provide the purchasers of the options with rights in or obligations of its enterprise if it is to pass a functional analysis. We find that petitioner does not provide the purchasers of its options with rights in or obligations of its enterprise of a like nature to those provided by a corporation issuing shares of stock or bonds. Petitioner provides its purchasers with the potential to exercise an option, which only upon exercise allows for the option to be converted into direct ownership of the stock called for. Such a relationship does not exhibit the essential characteristics of bonds or the proprietary rights in corporate enterprises which are the essential characteristics of stock. The covered call options are only executory contracts which bind petitioner to sell certain underlying stock at a specific price within a specific time if the purchaser chooses to exercise the option (see, Carret & Company, Inc. v. State Tax Commn., Supreme Court, Albany County, Special Term, November 20, 1987, Bradley, J.).[13] The issuer of stock or bonds, however, distributes rights or obligations to its purchasers which require no further action on the part of the purchasers for the essential attributes of ownership to become fixed. The issuer of an option, such as petitioner, parts with no like immediate, fixed rights or obligations in its enterprise as it sells a call option to a purchaser. Rather, the purchaser must choose to act by exercising his option to purchase in order to require the writer of the option to sell the stock that is the subject of the call. Therefore, we find that the writer of call options does not provide purchasers of the options with a distribution of rights in or obligations of its corporate enterprise of a like nature as those provided to purchasers of stocks or bonds.
>
> "The last element in dispute is whether the call options are designed as a means of investment for the writer of the options. While the Division concedes that in general options are designed as a means of investment, the Administrative Law Judge found to the contrary on the facts presented here. Investment income is income that comes from investment capital (Tax Law § 208[6]). Investment capital is 'investments in stocks, bonds and other securities." (Tax Law § 208[5]). Clearly the income that petitioner receives in exchange for the issuance of a call option is

---

[13] Special Term's decision, which held that eight soybean futures contracts were not "other securities", was affirmed in Carret & Co. v. State Tax Commn (148 AD2d 40, 543 NYS2d 216).

not from an investment by petitioner. Petitioner creates the call options and receives income from their sales."

K. Petitioner is correct that the facts in the matter at hand are distinguishable from those in Pohatcong Investors because the capital gains at issue here were received by petitioner from its investment in stock options, while the income to the taxpayer in Pohatcong Investors was from its writing of stock options. However, the stock options here are like the stock options in Pohatcong in that they too "are only executory contracts." Not until the options are exercised are rights in or obligations of a corporate enterprise acquired. Therefore, the fourth element as set forth in Matter of C. Czarnikow, Inc. remains unmet. In Finding of Fact "20", the testimony of petitioner's expert concerning the similarity of stock and stock options is cited at length. However, the ultimate point of fact is that stock and stock options are not the same: a right to acquire a right is simply not the same as having the right.

L. It is also observed that the matter at hand is unlike situations where the Division could base its action on the underlying statute itself, where the regulations promulgated subsequent to the particular audit period at issue simply interpret the statute itself and do not represent a change in the Division's policies or interpretations (see, e.g., Matter of Cortelco, Tax Appeals Tribunal, October 31, 1991). In such situations, the regulations were not viewed as having been applied retroactively. In contrast, the matter at hand involves a change in the Division's interpretation of an underlying ambiguous statute.

It is noted that both the prior interpretation as set forth in the former regulations and the current interpretation cannot be viewed as not rational or unreasonable. Petitioner's argument that it is unreasonable to have two interpretations when the statute has not changed is without merit in this situation, where the underlying statute is "patently ambiguous" (Mobil Intl. Fin. Corp. v. State Tax Commn., supra, 501 NYS2d at 950). In footnote "2", it is noted that the first exchange trading of options occurred only recently, in 1973. It is fair to say that financial instruments have evolved rapidly in the past 20 years, both in nature and quantity (in particular, the explosion in types of derivatives) and, given the "patently ambiguous" statutory language,

petitioner's attempt to tie the Division to one unchanging interpretation of what constitutes "other securities", clearly unspecific statutory language, should be impeded. In short, each of the Division's interpretations is rational and the Division's specification of an effective date of January 1, 1990 for the current interpretation is plainly reasonable given the significant change in policy.

M. The petition of Dominion Textile, (USA) Inc., as successor to Joric Corp., is denied, and the Notice of Deficiency dated June 12, 1992 is sustained.

DATED: Troy, New York
May 25, 1995

/s/ Frank W. Barrie
ADMINISTRATIVE LAW JUDGE