STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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| In the Matter of the Petitions | : | |
| of | : | |
| **C. CZARNIKOW, INC.** | : | DECISION<br>DTA Nos. 802174 and 806000 |
| for Redetermination of Deficiencies or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended September 30, 1981 through September 30, 1985. | : | |

Petitioner C. Czarnikow, Inc., 75 Wall Street, New York, New York 10005 and the Division of Taxation filed exceptions to the determination of the Administrative Law Judge issued on February 22, 1990 with respect to the petitions of C. Czarnikow, Inc. for redetermination of deficiencies or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended September 30, 1981 through September 30, 1985 (File Nos. 802174 and 806000). Petitioner appeared by Burton G. Lipsky, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Anne W. Murphy, Esq., of counsel).

Petitioner and the Division of Taxation filed briefs in support of their respective exceptions. Petitioner submitted a reply memorandum of law to the exception filed by the Division of Taxation. At the request of both parties, oral argument was heard on November 14, 1990.

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

## *ISSUES*

I. Whether income received by petitioner from repurchase agreements is allocated properly by petitioner's investment allocation percentage or business allocation percentage.

II. Whether income received by petitioner from demand notes issued by petitioner's grandparent corporation is allocated properly by petitioner's investment allocation percentage or business allocation percentage.

## *FINDINGS OF FACT*

We find the facts as determined by the Administrative Law Judge except for findings of fact "8" and "9" which have been modified. We have also made additional findings of fact. The Administrative Law Judge's findingsof fact, the modified findings of fact and the additional findings of fact are set forth below.

Petitioner, C. Czarnikow, Inc., and the Division of Taxation entered into a stipulation of facts which is substantially incorporated into this determination. There are no facts in dispute.

Following a field audit of petitioner's books and records, the Division, on March 18, 1985, issued to petitioner two notices of deficiency. The first asserted tax due for the fiscal year ended September 30, 1981 in the amount of $45,109.00 plus interest. The second notice asserted tax due for the fiscal year ended September 30, 1982 in the amount of $32,601.00 plus interest.

A second field audit covering fiscal years 1982, 1983 and 1984 resulted in the Division issuing the following notices of deficiency to petitioner on March 6, 1987:

| Period Ended | Tax Amount | Interest | Total |
|---|---|---|---|
| 9/30/83 | $19,446.00 | $8,117.00 | $27,563.00 |
| 9/30/83 | 3,500.00* | 1,461.00 | 4,961.00 |
| 9/30/84 | 10,203.00 | 2,726.00 | 12,929.00 |
| 9/30/84 | 1,734.00* | 463.00 | 2,197.00 |
| 9/30/85 | 2,457.00 | 315.00 | 2,772.00 |
| 9/30/85 | 418.00* | 54.00 | 472.00 |

*Metropolitan transit tax surcharge

Petitioner, a New York corporation, is a commodities trader and broker, dealing primarily in sugar. It began doing business in 1978 as Christman Trading Corporation. Hanmark Commodity Corporation was a general corporate partner and minority stockholder of Christman Trading Corporation. Hanmark is the financial holding company of C. Czarnikow, Limited

("Limited"), a United Kingdom corporation which is Hanmark's sole shareholder. In October 1980, Hanmark acquired all of the stock of Christman Trading Corporation which then changed its name to C. Czarnikow, Inc.

As a commodities broker, petitioner needed to maintain large amounts of readily available cash, and it was able to project its need for cash on a daily basis. During the fiscal years ended September 30, 1981 and September 30, 1982, it was petitioner's policy to conduct a daily review of its need for cash for the following business day and to place any unneeded funds in repurchase agreements. Petitioner executed its repurchase agreements with Chase Manhattan Bank, N.A. and Morgan Guaranty Trust Company of New York. These transactions were structured in the following manner. Petitioner agreed to purchase certain United States government securities from its bank and simultaneously agreed to sell the same securities to the same party at a specified resale price on an agreed future date. Generally, the agreement was for repurchase on the following business day. The resale price generally exceeded the purchase price by an amount which reflected an agreed upon interest rate for the term of the repurchase agreement. Petitioner submitted several representative repurchase agreements. The samples refer to the dollar amounts placed in the repurchase agreements as either "principle" or "quantity". There is no discernible relationship between the dollar amounts placed in the agreements and the fair market value of the government securities sold or between the stipulated interest rate and the coupon yield on the underlying government securities as shown on the repurchase agreement. The record does not establish whether there was an actual transfer of possession of the underlying securities from the banks to petitioner.

The repurchase agreements entered into by petitioner were similar to repurchase agreements actively traded in the over-the-counter market.

Late in its fiscal year ended September 1981, petitioner changed its policy with regard to funds not immediately needed in its business operations. At that time, petitioner began placing excess funds in demand notes issued by its grandparent corporation, Limited. Limited, like petitioner, was a commodities broker with a need for large amounts of working capital. The

rate of return on the demand notes was negotiated by petitioner and Limited. It was set at a rate that enabled Limited to obtain capital at an interest rate lower than that charged by Limited's banks in the United Kingdom while providing petitioner with a rate of return higher than that which it was earning on the repurchase agreements.

We modify finding of fact "8" to read as follows:

> The demand notes at issue are similar to several different issues of variable interest demand notes which are actively traded in the over-the-counter market.[1]

We modify finding of fact "9" to read as follows:

> The corporation franchise tax report filed by petitioner for the fiscal year ended September 30, 1981 reported total investment capital of $2,830,460.00. This was allocated to cash in the amount of $2,371,830.00, consisting entirely of funds placed in the repurchase agreements, and the fair market value of demand notes held by petitioner and issued by its grandparent corporation, Limited, amounting to $458,630.00. Petitioner reported interest income from the repurchase agreements as investment income in the amount of $714,894.00. Petitioner reported an investment allocation percentage of zero for this period. Petitioner's corporation franchise tax report for the fiscal year ended September 30, 1982 reported investments in stock issued by unrelated companies as well as cash in the form of the repurchase agreements and the demand notes issued by Limited. For the fiscal year ended September 30, 1982, petitioner computed an investment allocation percentage of 0.0134.[2]

We find the following additional findings of fact:

> The corporation franchise tax report filed by petitioner for the period ended September 30, 1982 reported investment income classified as interest on bank accounts in the amount of $160,958.00. Petitioner, by petition filed in this matter, recomputed investment capital, and allocated investment income for both report periods. The recomputations reflect petitioner's position that the repurchase agreements are items of investment capital, and the income earned on the repurchase agreements is investment income. On April 25, 1986

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[1] Finding of fact "8" of the Administrative Law Judge's determination originally read as follows:

> "8. Although petitioner and the Division stipulated that the demand notes at issue are similar to those traded in the over-the-counter market, there is no evidence that the demand notes issued by Limited were ever sold in a private placement market."

We modified this fact to accurately reflect the stipulation of facts entered into by the parties.

[2] We modified finding of fact "9" by inserting the third sentence.

petitioner filed a claim for refund of franchise tax paid for the period ended September 30, 1982. By stipulation entered into by representatives of the parties, it was agreed that income in the amount of $160,958.00 which petitioner reported for the period ended September 30, 1982, was interest income from repurchase agreements.

During the years in issue, petitioner treated income it received from the repurchase agreements and demand notes as investment income. The amounts it received in each category are shown below.

| YEAR | REPURCHASE AGREEMENTS | DEMAND NOTES |
|---|---|---|
| 1981 | $714,894.00 | $ 88,715.00 |
| 1982 | 160,958.00 | 613,850.00 |
| 1983 | | 369,378.00 |
| 1984 | | 340,906.00 |
| 1985 | | 224,920.00 |

On the first audit, the Division reclassified petitioner's income from the repurchase agreements as business income and allocated that income by a business allocation percentage. On both audits, the Division took the position that notes of a related corporation are items of business capital. Consequently, the Division treated the fair market value of Limited's demand notes as business capital, and it treated the interest income on demand notes issued by Limited as business income and allocated it by a business allocation percentage.

On June 2, 1988, a conciliation conference was held covering the first audit period under consideration here. As a result of information submitted by petitioner at this conference, the tax asserted for the fiscal year ended September 30, 1983 was reduced, resulting in a refund due to petitioner in the amount of $2,497.00. The refund was based on the carry back of a net operating loss sustained by petitioner in 1986 to the fiscal year ended September 30, 1983. Petitioner claims a refund for this period in the amount of $12,498.00. Petitioner's calculation of its refund claim is based upon its treatment of the demand notes as investment capital and the interest income from those notes as investment income.

On April 25, 1986, petitioner filed a claim for credit or refund of corporation tax for the fiscal year ended September 30, 1982 in the amount of $84,520.00. Petitioner's claim was based upon the application of a New York net operating loss of $1,747,345.00 sustained by petitioner in the fiscal year ended September 30, 1985 to the fiscal year ended September 30, 1982.

Petitioner and the Division agreed to recalculate petitioner's refund claim for the fiscal year ended September 30, 1982 as if the Division had prevailed on the issues to be determined here. However, if it is determined that petitioner's income from the repurchase agreements and demand notes is properly classified as business income, the parties nevertheless disagree about the correct method of calculating the refund due to petitioner.

A taxpayer with both business income and investment income must apportion a net operating loss between the two before deducting the loss. The method of apportioning the loss differs depending on whether the tax would have been measured by entire net income or by entire net income plus officer's compensation before deducting any net operating loss. It is petitioner's position that the tax here would have been measured by entire net income, and the Division's position that the tax would have been measured by entire net income plus officer's compensation. This disagreement explains the difference in the amount of the refund calculated by each party.

Petitioner calculates a corporation franchise tax liability for the fiscal year ended September 30, 1982 of $32,252.00, entitling petitioner to a refund of $56,340.00. The Division computes a tax due for the same period of $34,957.00, entitling petitioner to a refund due of $53,635.00.

Petitioner also protested assessment number C8505020600 in the amount of $269.25 for the fiscal year ended September 30, 1984. The Division conceded that this tax was paid, and it asserted that the assessment had been or would be canceled.

***OPINION***

In the determination below, the Administrative Law Judge characterized the funds placed by petitioner in the repurchase agreements as cash on deposit. Accordingly, the Administrative Law Judge held that petitioner was entitled to treat its interest in those repurchase agreements as investment capital in accordance with Tax Law § 208(7). In reliance on Matter of Carret & Co. v. State Tax Commn. (148 AD2d 40, 543 NYS2d 216), the Administrative Law Judge further held that the repurchase agreements did not have the essential characteristics of a security and, therefore, could not be deemed "other securities" within the meaning and intent of Tax Law § 208(5). Turning to the classification of the demand notes, the Administrative Law Judge rejected petitioner's assertion that the demand notes constituted "other securities" within the meaning of Tax Law § 208(5) and the relevant regulation. It was concluded that the Division of Taxation (hereinafter the "Division") properly treated the demand notes as intercompany loans made in the regular course of business. Lastly, the Administrative Law Judge directed the Division to recalculate the refund due petitioner for the fiscal years ending September 30, 1982 and September 30, 1983 utilizing the methodology advanced by petitioner, i.e., allocating the net operating loss according to the measure by which petitioner would have paid its tax before deducting the net operating loss.

On exception, petitioner reasserts its position below that the repurchase agreements and the demand notes constitute investment capital within the meaning of Tax Law § 208(5). Petitioner further contends that the regulation defining "other securities" (see, 20 NYCRR 3-4[2][c]) requires the classification of the repurchase agreements and demand notes as investment income. Petitioner also argues that the Administrative Law Judge erroneously characterized the repurchase agreements as "cash on deposit."

The Division contends on exception that the Administrative Law Judge improperly classified the repurchase agreements as "cash on deposit." The Division further submits that the repurchase agreements are in essence collateralized loans and, therefore, cannot constitute investment capital but rather are properly characterized as business capital. The Division

additionally requests that the determination of the Administrative Law Judge be sustained in all other respects and does not except to the determination with respect to the allocation of the net operating loss in the refund calculation.

We modify the determination of the Administrative Law Judge for the reasons stated below.

Section 208(5) of the Tax Law defines the term investment capital as investments in "stocks, bonds and other securities" (Tax Law § 208[5], emphasis added). Since it is clear that the repurchase agreements and demand notes held by petitioner are neither stocks nor bonds of the participating banks, the issue distills to whether these evidences of indebtedness constitute "other securities" as included in the definition of investment capital (see, Tax Law § 208[5]).[3]

The statutory phrase "other securities" is defined by the regulation in effect during the years at issue as:

> ". . . 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 . . ." (20 NYCRR 3-4.2[c]).[4]

In further construing the term "securities" as used in that regulation and in Tax Law § 208(5), it has been stated that an interest qualifies as a security if there is "an investment of money in a common enterprise with profits to come solely from the efforts of others" (Matter of Carret & Co. v. State Tax Commn., supra, 543 NYS2d 216, 217, quoting Securities and Exchange Commn. v. Howey Co., 328 US 293, 90 L Ed 1244; see, Matter of Anametrics, Inc., Tax Appeals Tribunal, December 21, 1989). In applying that test, it is appropriate to look at the function of the security, and search for substance over form with emphasis on economic reality

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[3]On exception, the Division and petitioner each contend that the Administrative Law Judge improperly characterized the repurchase agreements as "cash on deposit." Since we do not have sufficient facts to justify any other conclusion, we accept the parties' contention that the repurchase agreements at issue are not "cash on deposit."

[4]The provisions of 20 NYCRR 3-4.2(c) were recently amended and provide inter alia, that a repurchase agreement may be characterized as investment capital or a collateralized loan depending upon the nature of the agreement (20 NYCRR 3-4.2[f][1]). The parties agree (Oral Arg. Tr., pp. 11 & 17) that this regulation applies to taxable years beginning on or after January 1, 1990 (20 NYCRR 3-4.2; see, TSB-M-90[4]C) and, therefore, is inapplicable here.

(see, Matter of Pohatcong Investors v. Commissioner of Taxation & Fin., 156 AD2d 791, 549 NYS2d 211 [where stock options were held not to have the essential characteristics of securities within the meaning of 20 NYCRR 3-4.2(c)]; Matter of Mobil Intl. Fin. Corp. v. New York State Tax Commn., 117 AD2d 103, 501 NYS2d 947, [where loan instruments issued to corporate taxpayers were found not to constitute "other securities"]; Matter of Avon Prods. v. State Tax Commn., 90 AD2d 393, 458 NYS2d 278 [where banker acceptances found to constitute "other securities" within the meaning of former 20 NYCRR 3.31(c)]; see also, Matter of Carret & Co. v. State Tax Commn., supra, [where commodities future contracts were found not to constitute "other securities"]; Matter of Anametrics, Inc., supra, [where income derived from the trading of precious metals contracts held not to constitute investment income]).

We begin our analysis and application of this regulation by first observing that the Division's argument that the repurchase agreements are not other securities because they are collateralized loans does not assist our analysis. This argument appears to be grounded upon the idea that a loan could never qualify as investment capital, but this concept is inconsistent with the regulation which states that securities of a like nature as bonds can qualify. Since a bond is simply "a certificate or evidence of a debt" (Black's Law Dictionary 224 [4th ed 1957]), the regulation clearly intends that some loans can constitute other securities. In applying the regulation to repurchase agreements, the Division has itself recognized that a repurchase agreement that is a collateralized loan may qualify as investment capital, "[i]f the debt instrument comes within the ambit of investment capital pursuant to section 208(5) of the Tax Law and section 3-4.2 of the Business Corporation Franchise Tax Regulations, such debt instrument will constitute investment capital" (Advisory Opinion TSB-A-89[8]C). Accordingly, the Division's argument ultimately leads only back to the regulation and to application of the conditions of the regulation to determine if its four requirements have been satisfied.

The first requirement of 20 NYCRR 3-4.2(c), that the instruments at issue are "of a like nature as stocks and bonds, customarily sold in the open market or on a recognized exchange," is clearly satisfied here. The plain language of the regulation does not require that the instrument at issue itself be actually traded in the open market or on a recognized exchange before it can qualify as investment capital. Rather, the explicit language in the regulation requires only that the instrument be similar to stocks and bonds customarily traded on such markets (see, 20 NYCRR 3-4.2[c]). In this matter, the stipulated facts provide that both the repurchase agreements and the demand notes were similar to repurchase agreements and demand notes actively traded in the over-the-counter-market[5] (Findings of Fact "6" and "8"). Accordingly, the instruments at issue here satisfy the first condition of 20 NYCRR 3-4.2(c).

We turn next to the question of whether the repurchase agreements and the demand notes were designed as a means of investment. This inquiry is made from the perspective of petitioner, i.e., were the instruments an investment for petitioner? (see, Matter of Avon Prods. v. State Tax Commn, supra; cf., Matter of Pohatcong Investors v. Commissioner of Taxation & Fin., supra [where it was concluded that the petitioner's sale and creation of option were not an investment for the petitioner]). With regard to the repurchase agreements, it is clear they are designed as a means of investment for petitioner. By the contractual terms of the agreements, petitioner agreed to purchase certain governmental securities from the bank and simultaneously agreed to sell the same securities back to the bank at a specified purchase price and interest rate. The clear design of this transaction was to enable petitioner to place excess funds into the repurchase agreements for varying short term periods of time so as to obtain the highest rate of return possible on the short term investment. The fact that petitioner earned interest from this

[5]These stipulated facts make this case indistinguishable from Avon on this point. The facts in Avon were that the bankers' acceptances were of the "type commonly traded by dealers and marketmakers." There was no finding of fact that the specific instruments held by Avon had been traded on the open market or on a recognized exchange (Matter of Avon Prod., State Tax Commn., May 21, 1981, annulled 90 AD2d 393, 458 NYS2d 278). This identity with the facts of Avon distinguishes this case from Matter of Mobil Intl. Fin. Corp. v. State Tax Commn. (117 AD2d 103, 501 NYS2d 947) where the court upheld the State Tax Commission's determination that the petitioner's proof fell far short of that required in Avon to prove that the securities were customarily sold on the open market or on a recognized exchange.

transaction indicates petitioner was lending money to the banks. For petitioner's purpose then, it is clear that the repurchase agreements served as a means of investment.

The demand notes, like the repurchase agreements, were also used by petitioner as a vehicle for short term investment of its excess funds. Petitioner chose to invest its funds in the demand notes rather than in the repurchase agreements specifically because it could obtain a more favorable return from the demand notes than that which petitioner had been able to earn on the repurchase agreements. Viewed in that light, it is clear that the demand notes were also designed as a means of investment for petitioner.

The last requirements which must be met for the repurchase and demand notes to qualify as investment capital is that they must have been issued for the purpose of financing a corporate enterprise and provide a distribution of rights in or obligations of the corporate enterprise. Applying a functional analysis, the proper comparison is to the issuance of stocks and bonds and the rights and obligations which devolve from their issuance (see, Tax Law § 208[5]; Matter of Pohatcong Investors v. Commissioner of Taxation & Fin., supra, 549 NYS2d 211, 213). Thus, this inquiry takes place from the perspective of the issuer.

The repurchase agreements plainly served to finance the corporate enterprise of the issuing banks. Upon the issuance of the repurchase agreement, the bank received funds with which it could carry on its banking activities. Similarly, the issuance of the demand notes served to finance the enterprises of Limited, since they provided Limited with a supply of working capital at lower interest rates than charged by banks.

With respect to whether the repurchase agreements provided petitioner with a distribution of rights in or obligations of the issuing bank, our analysis indicates that the repurchase agreements cannot be meaningfully distinguished on this point from the bankers' acceptances that were held to provide a distribution of rights in or obligations of the issuing bank in Avon (Matter of Avon Prods. v. State Tax Commn., supra). Bankers' acceptances are "essentially post-dated drafts which are certified by a bank" (Matter of Avon Prods., State Tax Commn., May 21, 1981, annulled 90 AD2d 393, 458 NYS2d 278). By accepting the draft, the accepting

bank agrees to honor the draft as presented (see, Uniform Commercial Code § 3-410[1]). Thus, the primary obligation of the bank that was held to be distributed by the court in Avon was the agreement to pay the draft when due. Since the repurchase agreements similarly require the banks to pay over a fixed sum of money on a certain date, we must conclude that the repurchase agreements provide for the distribution of an obligation of the banks within the meaning of the regulation.

Turning to the demand notes, the Administrative Law Judge noted that the regulation explicitly excluded short-term notes from the definition of other securities and concluded that petitioner failed to prove that the demand notes were intended to distribute rights and obligations in the corporate enterprise. The Division has advanced no arguments to support its contention that the demand notes are not "other securities."

We see nothing in the regulation that is intended to exclude all short-term notes. Instead, the complete text of the regulation excludes "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" (20 NYCRR 3-4.2[c]). The intent of this provision is to exclude those notes received in exchange for goods and services and, thus, has no application to short-term notes issued by a corporation to finance its business enterprises, as are the notes at issue. Furthermore, an interpretation that automatically excludes short-term notes only when they are received in payment for goods or services is consistent with the history of this provision of the regulation.[6]

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[6]This history indicates that the regulation was amended to add the words "acquired in the ordinary course of trade or business for services rendered or for the sale of property which is primarily held for sale to customers" so that the regulation comported with the Division's long-standing policy of treating short-term notes as investment capital if they represented an investment by the taxpayer and were not received as a result of the taxpayer's business operations (see, Matter of Howard Johnson Co. v. State Tax Commn., 105 AD2d 948, 481 NYS2d 909, 913-914 Mikoll, J. dissenting [citing letter of June 6, 1962 from Joseph H. Murphy, Commr. of the Dept. of Taxation & Fin. and Matter of International Harvester Co. v. State Tax Commn., 58 AD2d 125, 396 NYS2d 82], revd 65 NY2d 727, 492 NYS2d 11).

It is noteworthy that the short-term notes described in Commissioner Murphy's letter were very similar to those at issue here, i.e., they were notes evidencing loans between affiliated corporations. Further, the fact of Commissioner Murphy's letter and the policy expressed in it led the Court of Appeals to reverse the majority opinion of the Appellate Division in Howard Johnson on the basis that the Division had a long-standing policy to treat certain

Concluding that the demand notes are not within the explicit exclusion of the regulation, we must decide then whether petitioner did establish that the notes provided a distribution in the right of the corporation so that the last requirement of the regulation is satisfied. The stipulated fact is that these notes were "similar to several different issues of variable interest demand notes which are actively traded in the over-the-counter market." The fact that these were notes means that they evidenced the issuer's promise to pay a certain sum of money (see, Uniform Commercial Code § 3-104). This is sufficient under Avon to conclude that the instruments provided a distribution of the obligations of the issuer (Matter of Avon Prods. v. State Tax Commn., supra).

Since both the repurchase agreements and the demand notes satisfy all of the requirements of the definition of "other security" set forth at section 3-4.2(c) of the regulations, we conclude that on the facts presented here, these instruments are to be treated as investment capital.

Accordingly, it is ORDERED, ADJUDGED, and DECREED that:

1. The exception of petitioner C. Czarnikow, Inc. is granted;

2. The exception of the Division of Taxation is granted in part and denied in part;

3. The determination of the Administrative Law Judge is modified to the extent that the repurchase agreements and demand notes are to be treated as other securities (not as cash) and classified as investment capital, and in all other respects, the determination is affirmed;

4. The petitions of C. Czarnikow, Inc. are granted to the extent consistent with paragraph "3" above and to the extent consistent with conclusions of law "F" and "G" of the determination of the Administrative Law Judge; and

5. The notices of deficiency issued on March 18, 1985 and March 6, 1987 are modified to the extent consistent with paragraphs "3" and "4" above; assessment number C8505020600 is

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short-term notes as investment capital notwithstanding the language of the regulation prior to its amendment (Matter of Howard Johnson Co. v. State Tax Commn., supra, 492 NYS2d 11).

cancelled in accordance with finding of fact "17" of the determination of the Administrative Law Judge.

DATED: Troy, New York
April 25, 1991

/s/John P. Dugan
John P. Dugan
President

/s/Maria T. Jones
Maria T. Jones
Commissioner