STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

XEROX CORPORATION : DETERMINATION
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.

Petitioner, Xerox Corporation, 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 period January 1, 1997 through December 31, 1999.

On August 10, 2009 and August 11, 2009, respectively, petitioner, appearing by Hodgson Russ, LLP (Christopher L. Doyle, Esq., and Mark S. Klein, Esq., of counsel), and the Division of Taxation, appearing by Daniel Smirlock, Esq. (Clifford M. Peterson, Esq., of counsel) waived a hearing and submitted this matter for determination based on documents and briefs to be submitted by January 29, 2010, which date commenced the six-month period for issuance of this determination. By a letter dated July 22, 2010, this six-month period was extended for an additional three months (Tax Law § 2010[3]). After review of the evidence and arguments submitted, Dennis M. Galliher, Administrative Law Judge, renders the following determination.

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[1]

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

2. 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%.

3. 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.

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[1] The parties entered into a Stipulation of Facts setting forth some 26 individually numbered facts. These stipulated facts are included in the Findings of Fact with the exception of those stipulated facts numbered 15 through 17, which set forth procedural matters, 18 which sets forth the issue in this case, and 22 through 26, which specify those documents (including the stipulation) which comprise the parties' entire submission of evidence in this matter. In addition, petitioner submitted 47 proposed findings of fact and the Division submitted 19 proposed findings of fact. Rulings with regard to the parties' proposed findings of fact are set forth in Findings of Fact 43 and 44.

4. Petitioner maintained accounting records that allocated and tracked the different 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.

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

6. 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.

7. 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

8. 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. Petitioners'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.

9. 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).

10. 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.

11. 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

12. XEEP's, 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.

13. 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).

14. 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

15. 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.

16. 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).

17. 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

18. 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.

19. 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.

20. 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

21. 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.

22. 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.

23. 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

24. 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.

25. 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), applicable Treasury Regulations and official announcements, as well as existing case law.

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

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

28. 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.

29. 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).

30. 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.

31. 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.

32. 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).

33. 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.

34. 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.

35. 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

36. 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.

37. 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.

38. 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

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

40. 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.

41. 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 governmental or nongovernmental 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."

42. 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

43. Petitioner submitted proposed findings of fact numbered 1 through 47, with respect to which the following rulings are made:

a) proposed facts 1, 4 through 41, and 43 through 47 are accepted as accurate and have been incorporated in the Findings of Fact.

b) proposed facts 2 and 3 recite portions of the undisputed procedural history of this matter and have been excluded as unnecessary.

c) proposed fact 42 essentially repeats proposed fact 1 and has been excluded as repetitive.

44. The Division submitted proposed findings of fact numbered 1 through 19, with respect to which the following rulings are made:

a) proposed facts 1 through 3, 5 through 9, and 11 through 15 are accepted as accurate and have been incorporated in the Findings of Fact.

b) proposed facts 16 through 18 recite portions of the undisputed procedural history of this matter and have been excluded as unnecessary.

c) proposed facts 4 and 19, while accurate and accepted, have been expanded to provide additional detail and clarity with respect to revenues and profit percentages (***see*** Finding of Fact 2) and to clarify that a portion of the income in dispute consisted of IRC § 103 exempt income derived from transactions with state and local governmental entities, and that the balance of the income in dispute consisted of income from transactions with other governmental entities (***see e.g.*** Finding of Fact 38).

d) proposed fact 10 is rejected as incomplete and misleading to the extent it identifies the "income in dispute" as consisting only of that income reported

> by petitioner as exempt from federal taxation pursuant to IRC § 103, and to the extent it characterizes such IRC § 103 income as "claimed" exempt income. Petitioner's proposed facts 36, 37, 40, 43 and 44, adopted and set forth herein as Findings of Fact 31, 32, 35, 37 and 38, fairly and accurately reflect the facts in this matter.

CONCLUSIONS OF LAW

A. New York State imposes an annual franchise tax on corporations for the privilege of exercising a corporate franchise, doing business, employing capital, owning or leasing property or maintaining an office in the state (Tax Law § 209[1]). The tax is imposed upon the highest of four different bases, and is usually calculated upon a taxpayer's "entire net income" (ENI). ENI is, generally, the same as the taxpayer's federal taxable income with certain modifications, less income from investments in subsidiary corporations (Tax Law § 210[1][a]; § 208[9]; § 209[1]). Once ENI is determined, it is separated into two components, to wit, "investment income" and "business income" (Tax Law § 208[9]; § 210[3]). "Investment income" is defined as income from "investment capital" (Tax Law § 208[6]). The other component, "business income", is ENI less investment income (Tax Law § 208[8]).

B. "Investment capital," from which "investment income" is derived, is defined as "investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business . . ." (Tax Law § 208[5]). For years prior to, during, and after those in issue, the Division's regulations further defined the term "investment capital," in relevant part, as follows :

> The term *investment capital* means the taxpayer's investments in stocks, bonds and other securities issued by a corporation or 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. (20 NYCRR 3-3.2[a][1]; formerly 20 NYCRR 3-4.2[a].)

C. The pay-over-time installment sales (the XEEPs) and the finance leases that received installment sale treatment (some of the FPOs), between petitioner and its governmental customers (as described in Findings of Fact 12, 18, 27, 28 and 37), from which the income in dispute arose and which have been generically referred to herein as "financing arrangements," are clearly not "stocks" or "bonds." Thus, these financing arrangements can be treated as investment capital only if they constitute "other securities." While the relevant statute (Tax Law § 208[5]) does not specifically define "other securities," the Division's regulations do provide such a definition. In this case, the Division raises arguments that rely, in part, on the definition of "other securities" as set forth in its regulations that were in effect for years *prior* to those in question (20 NYCRR former 3-4.2[c]). The Division also raises arguments that rely upon such regulations as amended and in effect *during* the years in question (20 NYCRR 3-3.2[c]). Thus, both the prior and the current versions of such regulations are set forth below.

D. Prior to December 7, 1989, the Division's regulation at 20 NYCRR 3-4.2(c) defined "other securities," for purposes of inclusion in investment capital, as follows:

> The *other securities* referred to in the subdivision (a) of this section 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 charactistics 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 sale, 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. (20 NYCRR former 3-4.2[c].)

E. Effective December 7, 1989, 20 NYCRR former 3-4.2(c), as above, was amended so as to define "stocks, bonds and other securities" for purposes of inclusion in investment capital, as follows:

> 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);
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> (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[2] (emphasis original in part, added in part).

By amendment filed October 7, 1993, the foregoing regulation was renumbered as 20 NYCRR 3-3.2(c), but was not otherwise changed as to content, and thus the foregoing language

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[2]The language of 20 NYCRR 3-3.2(c)(2) lists with specificity the various governmental entities whose debt instruments constitute, as relevant here, "other securities." Rather than repeatedly list each of such entities, the same will be referred to hereafter, generically, as "governmental entities."

reflects the Division's definition of "stocks, bonds and other securities" for purposes of inclusion in "investment capital" as in effect for the years in issue.[3]

F. From the foregoing, it is clear that during the years in issue the term "other securities" specifically encompassed "debt instruments issued by governmental entities" (20 NYCRR 3-3.2[c][2]). The Division's regulations do not further define "debt instruments." However, the same is clearly a broad phrase encompassing items (instruments) other than and in addition to securities such as stocks (which are not issued by governmental entities), bonds, and similar corporate equity instruments (***compare*** 20 NYCRR former 3-4.2[c] ***with*** 20 NYCRR 3-3.2[c]). The regulation previously in effect (20 NYCRR former 3-4.2[c]), which reflected a more limited definition of "other securities," may well have barred inclusion of the items at issue herein as "other securities" insofar as the same do not appear to be of a type "customarily sold in the open market or on a recognized exchange" (20 NYCRR former 3-4.2[c]). By contrast, the applicable regulation, i.e., the regulation in effect during the years in issue, specifically delineated "debt instruments issued by [governmental entities]" as "other securities," and thus amended the prior regulation and its definition of "other securities" in a substantive manner.

G. Narrowing the focus in this matter, the Division does not dispute that the financing arrangements in question are debt instruments issued by governmental entities. This is consistent with the nature and function of the instruments themselves, the tax and financial accounting (GAAP) treatment thereof, and the manner in which petitioner has treated and reported such instruments. Under the substance of these instruments, the various governmental entities are obligated to pay the financed portion of the cost of the equipment acquired (i.e., principal amount) over time, and in so doing are obligated to pay finance charges (i.e., interest)

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[3] Other amendments to 20 NYCRR 3-3.2 were made after the years in issue, but did not impact the sections of such regulation pertinent to the question presented in this case.

on such financed principal amount. The instruments clearly indicate the rate and amount of such interest, and include provisions whereby the governmental entity can prepay the principal balance at any point and thereby eliminate its obligation to pay future finance charges (interest). The terms of the financing arrangements contain credit review provisions and retain credit revocation rights to petitioner upon a determination that a particular entity is not creditworthy. Petitioner also makes provision, in its financial accounts, for credit losses and uncollectible amounts. To mitigate the risk of loss to petitioner due to casualty, petitioner's customers are required to maintain insurance on the equipment and to name petitioner as an additional insured under such coverage. Thus, the financing arrangements set forth obligations of governmental entities to pay, over a specified period of time, principal (i.e., the cost of the equipment) and interest (the stated finance charge) representing the time value of the money that would otherwise be due for the equipment but which petitioner agrees not to collect at the time the equipment is acquired by the governmental entity. In substance, the governmental entity receives use of the equipment in exchange for its debt obligation embodied in the financing arrangement. Like other governmental obligations (e.g., bonds), the governmental entity is obliged to pay principal and interest over the term of the obligation it has issued. Under these facts, the financing arrangements in question are clearly debt instruments issued by governmental entities, and thus constitute "other securities" per 20 NYCRR 3-3.2(c).

H. As noted, the Division does not dispute that the financing arrangements in question are debt instruments issued by governmental entities, and thus constitute "other securities" per 20 NYCRR 3-3.2(c)(2). Instead, the Division maintains that the same may not be included in "investment capital" because they do not "qualify" as such. The Division bases its position on two primary, and somewhat intertwined, arguments. The Division first maintains that the financing arrangements do not qualify as "other securities" as the same were defined under the

Division's former regulation (20 NYCRR former 3-4.2[c]). In making this argument, the Division relies specifically upon the following limiting language found in its former regulation:

> other securities . . . 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* . . . (20 NYCRR former 3-4.2[c]; emphasis added).

The Division maintains that this provision is relevant because the Division did not "disavow" the italicized language when it amended its regulation effective December 7, 1989, and because the language of Tax Law § 208(5) defining "investment capital" has not been amended in any relevant manner since such date. Thus, the Division posits that the italicized language precludes the subject financing arrangements from qualifying as investment capital because the same were not designed to be "sold in the open market" and were not "designed as a means of investment and issued for the purpose of financing corporate enterprises." This argument is rejected. While the Division may not have explicitly or affirmatively "disavowed" the italicized language found in 20 NYCRR former 3-4.2(c) upon amendment thereto, it remains that such language is not found in the regulation as amended and thus may not be relied upon. Instead, it is the regulation in effect during the years in issue (20 NYCRR 3-3.2[c]), which must be applied to the facts of this case (***see e.g. Matter of C. Czarnikow, Inc.***, Tax Appeals Tribunal, April 28, 1991).

I. As its second argument, the Division asserts that the instruments in question do not constitute "qualifying" debt instruments under subdivision (d) of the applicable regulation (20 NYCRR 3-3.2), which specifically eliminates certain types of *corporate* debt instruments from inclusion in investment capital. The Division points out, in this regard, that the relevant regulation, (20 NYCRR 3-3.2[c]) does not address whether income from a debt instrument, acquired in connection with the sale of equipment, constitutes income from *investment* in such debt instrument where the obligor is a governmental entity. The Division maintains that this lack of specificity or guidance in the regulation should lead one to the subsequent portion of the regulation which defines *"qualifying" corporate* debt instruments. In turn, such subsequent portion (20 NYCRR 3-3.2[d][iii]) specifies that income earned from *corporate* debt instruments will not be considered "income from investments in stocks, bonds and other securities" (i.e., will not be considered income from investment capital) where such debt instruments are "acquired by the taxpayer for services rendered or for the sale, rental or other transfer of property, where the obligor is the recipient of the services or property . . . ." (20 NYCRR 3-3.2[d][iii].) The Division seeks to apply this same limitation to interest income earned on debt instruments issued by governmental entities. The Division maintains that since governmental debt obligations and corporate debt obligations are governed by the same statutory definition of investment capital (Tax Law § 208[5]), then this definition must be interpreted in the same manner for both types of obligations and must result in consistent treatment regardless of whether they involve governmental or non-governmental (i.e., corporate) entities.

J. This line of reasoning, which essentially represents the Division's attempt to ignore the specificity set forth in its own regulation, is rejected. Contrary to the Division's argument, it is clear that the Division's manner of amending the regulation (effective December 7, 1989), specifically with regard to "stocks, bonds and other securities," served to carve a distinction between debt instruments issued by governmental entities (20 NYCRR3-3.2[c][2]) and corporate debt instruments (20 NYCRR 3-3.2[d]), with the latter subject to the distinguishing requirement that they must be *qualified* corporate debt instruments in order to be treated as investment capital.[4] As is relevant here, the latter portion of the regulation goes on to provide specific limitations on what types of *corporate* debt instruments do not qualify as "investment capital" including, at subdivision (d)(iii) thereof, the situation where the corporate debt instrument is "acquired by the taxpayer for services rendered or for the sale, rental or other transfer of property, where the obligor is the recipient of the services or property . . . ."[5] Contrary to the Division's position that the qualifying conditions for *corporate* debt instruments must be equally applied to *governmental* debt instruments, the regulation segregates the two and imposes no such qualifying limitations on governmental debt instruments. The applicable regulation draws a clear distinction between debt instruments of governmental entities, for which no such limiting or qualifying criteria are set forth, and the more limited realm of what is encompassed within *qualifying* corporate debt instruments. Whether as the result of intent or oversight, the regulation as written simply does not support "reading in" such qualifying limitations and imposing the same on governmental debt instruments so as to preclude the debt instruments in issue here from

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[4] The regulation *qualifies* such instruments by exclusion, stating that "[t]he term *qualifying* corporate debt instruments means all debt instruments issued by a corporation *other than the following* [listing of *excluded* items]." (20 NYCRR 3-3.2[d][iii]; emphasis added.)

[5] To the extent one might argue that the income in dispute in this case was earned in the regular course of petitioner's business of selling its equipment, and thus constitutes business income rather than investment income, it must be recognized that it is not simply the fact that a business sale of equipment generated revenue (i.e., profit on the sale) but rather how the sale was consummated and how the income in issue was earned. While the revenue from the sales resulted in business income, which was treated as such by petitioner, the manner of financing the sales resulted in the creation of debt instruments (in this case debt instruments that were obligations of governmental entities), the interest income from which constitutes investment income to petitioner (invested capital extended in return for the payment of interest thereon over the term of such investment). Thus, while petitioner's profit on the sale of the equipment (by finance lease) was gained in the regular course and conduct of its business, the interest income was generated by petitioner's extension of financing credit and reflects sums earned by petitioner for the time value of the investment of its money.

constituting "investment capital" thereunder. Simply put, where the Division would equate governmental and corporate debt instruments, its own regulation distinguishes the two.[6]

K. Finally, the result reached herein is entirely consistent with IRC § 103, which excludes interest earned on state and local bonds from federal income taxation. Under IRC § 103, a "state or local bond" is broadly defined to include "an obligation of a state or political subdivision thereof" (IRC § 103[c][1]). This language similarity between "an obligation of a State or political subdivision thereof," per IRC § 103(c)(1), and "debt instruments issued by any state . . . or political subdivision thereof," per 20 NYCRR 3-3.2(c)(2), is consistent and further supports the petitioner's position and the result arrived at herein.

L. The petition of Xerox Corporation is hereby granted, the Division's August 23, 2005 Notice of Disallowance of petitioner's claim for refund is cancelled, and the Division is directed to refund to petitioner the sum of $1,211,807.00 together with applicable interest thereon.

DATED: Troy, New York
October 7, 2010

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE

[6] To clarify any confusion, it is critical to understand and remember that the obligations in question are not corporate debt obligations issued by petitioner, but rather are governmental debt obligations issued by the governmental entities in exchange for the equipment received from petitioner. Thus, the obligations in question are not corporate debt and the question of whether the same represent "qualified" corporate debt, per 20 NYCRR 3-3.2(d) becomes irrelevant.