New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division

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Corporation Tax
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STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C000927A

On September 27, 2000, a Petition for Advisory Opinion was received from Deloitte & Touche LLP, Two World Trade Center, New York, New York 10281.

The issue raised by Petitioner, Deloitte & Touche LLP, is whether a trade acceptance draft constitutes investment capital under section 208.5 of the Tax Law when purchased by the company designated as "C" below.

Petitioner submits the following facts as the basis for this Advisory Opinion.

H company is incorporated in Delaware and is publicly traded. H owns 100 percent of the stock of a first-tier company, C, that owns 100 percent of the stock of two second-tier companies, F and O. C, F and O are incorporated in Delaware. C is registered and doing business in New York, New Jersey and Florida. F is registered and doing business in New York. O is registered and doing business in New York.

H, working through C, F and O has developed and patented a proprietary financing program (the "Program") to allow participating buyers and suppliers to create between them an alternative means of financing commercial purchases. The Program allows suppliers to offer credit terms to their commercial customers through the use of pre-authorized debit drafts. Each draft specifies the amount due, the due date, and the buyer's bank account information. Acceptance of the draft confirms that: (i) the goods or services have been delivered by the seller; (ii) the goods or services were checked and accepted by the buyer; and (iii) establishes a specific payment date. The draft itself constitutes the payment instrument for the transaction according to its terms, and is called a "trade acceptance." The draft is negotiable so that the seller may endorse it and transfer it to another party.

There are three major steps involved in the Program.

(1) Enrollment of the buyer. This involves the buyer providing customary credit and business information to allow O to evaluate the buyer's credit worthiness. In addition, each buyer must execute appropriate Buyer Agreements that set forth the basic terms and conditions of the Program.

(2) Enrollment of the seller. This involves the execution of a basic Letter of Understanding between O and each seller that sets forth the basic terms of the Program. For the most part, this step is purely administrative since the Program depends upon the credit worthiness of the buyer (being

the party obligated to pay the drafts) rather than the seller who will sell the drafts to either C or a third party.

(3) After both parties have enrolled in the Program, the seller will prepare the drafts applicable to the particular commercial transaction and forward them to the buyer. If the merchandise or services are acceptable, the buyer signs the draft and returns it to the seller in payment for the goods or services. The draft cannot be used as payment for purchases by any of the buyer's subsidiaries, parent company, affiliates or employees. The drafts are negotiable instruments as defined by the Uniform Commercial Code and can be transferred by the endorsement of the seller or any subsequent holder of the drafts.

As a participant in this program, a seller has the option of either holding the draft until its due date and collecting cash from the buyer or selling the draft as a negotiable security at the time of issuance by the buyer to an unrelated third party. If the supplier chooses, it may sell the draft to C, although C is not obligated to purchase such draft. If C chooses to purchase the draft, specific terms are provided to suppliers in writing in a bill of sale for each purchase transaction. Terms are either accepted in full, or may be rejected by the supplier for any reason. C becomes a holder in due course.

Generally, C will pay the seller the full-face amount of the draft purchased, less C's fees, charges and agreed upon discounts. In certain cases, valuation and related payments may be less than the full face value of the purchased draft depending upon the evaluation of the seller's customer, the industry in which the seller or buyer operate, the product or service sold and any other factors that may have an impact on the value of the draft. Drafts offered for sale must have been issued and delivered to the seller by the buyer as payment for the actual sale of goods and/or services in a bona fide contemporaneous commercial transaction entered into in the ordinary course of business between two unrelated parties at arm's length. The drafts cannot represent sales of goods and/or services to any of the supplier's subsidiaries, parent company, affiliates or employees. None of the drafts represent payment for products or services purchased from H, C, F or O.

After the purchase of the draft by C, C either holds the draft to maturity and collects cash from the issuing buyer, or resells the draft to other investors. One purchaser of the drafts is F, a 100 percent owned subsidiary of C. C sells the drafts to F and unrelated purchasers at an arm's length discounted net asset value and earns a one percent investment transaction fee. In the case of F, the purchased drafts are then bundled and used as collateral for third party financing. The funds received from the third party lenders are used by F to purchase the drafts from C.

Petitioner states that C is not in the business of lending funds for purposes of section 3-3.2(d)(1)(iv) of the Business Corporation Franchise Tax Regulations ("Article 9-A Regulations").

Discussion

Section 208.7(a) of the Tax Law provides that the term "business capital" means all assets, other than subsidiary capital, investment capital and stock issued by the taxpayer, less liabilities not deducted from subsidiary or investment capital except that cash on hand and on deposit shall be treated as investment capital or as business capital as the taxpayer may elect.

Section 208.4(a) of the Tax Law provides that the term "subsidiary capital" means investments in the stock of subsidiaries and any indebtedness from subsidiaries, exclusive of accounts receivable acquired in the ordinary course of trade or business for services rendered or for sales of property held primarily for sale to customers, whether or not evidenced by written instrument, on which interest is not claimed and deducted by the subsidiary for purposes of taxation under Article 9-A, 32 or 33 of the Tax Law, provided, however, that, in the discretion of the Commissioner of Taxation and Finance, there shall be deducted from subsidiary capital any liabilities which are directly or indirectly attributable to subsidiary capital.

Section 208.5 of the Tax Law provides that 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, exclusive of subsidiary capital and stock issued by the taxpayer, provided, however, that, in the discretion of the Commissioner, there shall be deducted from investment capital any liabilities which are directly or indirectly attributable to investment capital.

Section 3-3.2(c) of the Article 9-A Regulations provides that the phrase "stocks, bonds and other securities" means, among other things, "qualifying corporate debt instruments."

Section 3-3.2(d)(1) of the Article 9-A Regulations provides:

> [t]he term "qualifying corporate debt instruments" means all debt instruments issued by a corporation other than the following:
>
> (i) instruments issued by the taxpayer or a DISC;
>
> (ii) instruments which constitute subsidiary capital in the hands of the taxpayer;
>
> (iii) instruments 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; however, where a taxpayer sells or otherwise transfers property which is investment capital in the hands of such taxpayer (e.g., stock) and receives in return a corporate obligation issued by the recipient of such property, such corporate

obligation, if it is not otherwise excluded from the category of investment capital, would constitute investment capital in the hands of the taxpayer;

(iv) instruments acquired for funds if:

(a) the obligor is the recipient of such funds;

(b) the taxpayer is principally engaged in the business of lending funds; and

(*c*) the obligation is acquired in the regular course of the taxpayer's business of lending funds;

(v) accepted drafts (such as banker's acceptances and trade acceptances) where the taxpayer is the drawer of the draft;

(vi) instruments issued by a corporation which is a member of an affiliated group which includes the taxpayer; and

(vii) accounts receivable, including those held by a factor.

Section 3-3.2(d)(2)(ii) of the Article 9-A Regulations states that:

[a] taxpayer is *principally engaged in the business of lending funds*, for purposes of this subdivision, if during the taxable year more than 50 percent of its gross receipts consist of interest from loans or net gain from the sale or redemption of notes or other evidences of indebtedness arising from loans made by the taxpayer. For purposes of the preceding sentence, receipts do not include return of principal or nonrecurring, extraordinary items.

In this case, the trade acceptance draft, when purchased by C, is a qualifying corporate debt instrument under section 3-3.2(d)(1) of the Article 9-A Regulations if the buyer of the goods or services which signs the draft as the drawee is a corporation because:

(i) The draft is not issued by C.

(ii) The draft does not constitute subsidiary capital in the hands of C.

(iii) The draft is not acquired by C for services rendered or for the sale, rental or other transfer of property.

(iv) C is the purchaser of the draft from the seller of the goods or services. C has not originated a loan with the buyer, the obligor of the draft. Petitioner states that C is not principally engaged in the lending of funds.

(v) The drawer of the draft is the seller of the goods or services, not C.

(vi) A buyer of the goods or services is not a member of the affiliated group of H, C, O and F.

(vii) The draft is not an account receivable.

Accordingly, the trade acceptance draft at issue, when purchased by C, is investment capital if the draft is not held by C for sale to customers in the regular course of its business. If such draft is held by C for sale to customers in the regular course of its business, such draft would constitute business capital. The determination of whether C holds the trade acceptance drafts for sale to customers in the regular course of its business is a question of fact not susceptible of determination in an Advisory Opinion. (§171.Twenty-fourth; 20 NYCRR 2376.1(a).)

DATED: January 22, 2001

/s/
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NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.