

New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-H-81(35)C
Corporation Tax
June 18, 1981

STATE OF NEW YORK
STATE TAX COMMISSION

ADVISORY OPINION

PETITION NO. C800710A

On July 9, 1980 a Petition for Advisory Opinion was received from South-Western Publishing Company, 5101 Madison Road, Cincinnati, Ohio 45227.

The issue raised is the proper classification of certain written evidences of indebtedness for purposes of the Franchise Tax on Business Corporations imposed under Article 9-A of the Tax Law.

Petitioner is a corporate subsidiary. Loans from Petitioner to its parent are generated when, at the end of each month, Petitioner's excess cash is transferred to the parent. The parent issues to Petitioner a written evidence of indebtedness (the nature of which is at issue herein but which will hereinafter be denominated a "note") for the amount of such transferred funds to date. That is, each month the previously issued note is cancelled and a new note is issued in the amount of funds currently owed by the parent to Petitioner. These notes, over a period of time, represent a constantly increasing debt. The notes formalize a cash flow process whereby the parent gains the use of excess funds generated by its subsidiary and puts such funds to various uses, such as purchasing new acquisitions, reloaning money to other subsidiaries or financing its own business functions. Through this cash flow process the parent reduces its need for borrowing from outside sources.

The note issued by the parent is denominated on its face a "Floating Rate Note" and is stated, also on its face, to be unsecured. It states the sum due and sets forth a promise to pay the same on December 31, 1999, as well as "...to pay interest monthly from date hereof, on the Balance or Principal remaining from time to time unpaid, at a rate equal to the average rate earned on short term investments or the average rate paid on short term borrowings." A sample note submitted by Petitioner, dated April 30, 1977, states a sum due of \$16,778,810. The notes bear the signatures of the President and other officers of the parent corporation, as well as the corporate seal of the parent corporation. The notes have never been acquired in the open market and have never been sold by Petitioner to its customers. The notes were not acquired for services rendered or for the sale of property primarily held for sale to customers. Petitioner contends that the notes constitute "bonds," within the meaning of section 208.5 of the Tax Law, and are thus "investment capital" for purposes of Article 9-A of the Tax Law.

Article 9-A of the Tax Law divides a taxpayer's capital into three categories, subsidiary capital, investment capital and business capital. Such terms are defined in section 208, subdivisions 4, 5, and 7 of the Tax Law, respectively. Petitioner asserts that the notes at issue represent investment capital rather than business capital. The term "investment capital" is defined as follows:

"The term 'investment capital' means investment 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 tax commission, there shall be deducted from investment capital any liabilities payable by their terms on demand or within one year from the date incurred, other than loans or advances outstanding for more than a year as of any date during the year covered by the report, which are attributable to investment capital "Tax Law, §208.5

While narrower definitions may be applicable within certain restricted spheres of activity, taken in its broadest sense the term "bond" includes any written instrument acknowledging a debt. The term "corporate bond" is defined in Black's Law Dictionary (revised fourth edition) as "A written promise by a corporation under seal to pay a fixed sum of money at some future time named, with stated interest payable at some fixed time or intervals, given in return for money or its equivalent received by the corporation, sometimes secured, and sometimes not." So, too, it has been said that the "...distinguishing feature of a bond is that it is an obligation to pay a fixed sum, with stated interest...[which] may or may not be secured." Cass v. Realty Securities Co., 148 App. Div. 96, aff'd 206 NY 649. While each of the notes at issue herein may thus fairly be denominated a "bond", such determination does not conclude this inquiry, for it is still necessary to determine whether these "bonds" are such within the meaning and intent of section 208.5 of the Tax Law.

The Tax Law includes under the rubric of investment capital "...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" Tax Law, §208.5. The use of the phrase "stocks, bonds and other securities" indicates an intention to include as investment capital only those "bonds" which are "securities."

The Franchise Tax Regulations contain no definitions for the terms "bonds" and "securities". However, at 20 NYCRR 3-4.2(c) there is a description of the types of securities which are includible as "other securities," within the meaning of section 208.5 of the Tax Law. It is there provided, thus, in relevant part, that such "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 . . . They do not include corporate obligations not commonly known as securities"

This description of the types of securities which are includible in investment capital as "other securities" is equally applicable in determining which "bonds," assuming the same to be securities, are also so includible. An examination of the notes at issue herein reveals that they do not satisfy the applicable criteria and consequently do not constitute investment capital within the meaning of section 208.5 of the Tax Law. Thus, bonds commonly sold in the open market or on a recognized exchange and commonly used as a means of investment are typically stated to represent a specified and unchanging debt; are in denominations, such as \$1,000, designed to enhance marketability; are supported by an indenture (trust agreement), with a trustee to safeguard bondholders' interests; are sold in the form of a series rather than a single instrument; and, finally, are negotiable. The notes at issue are not only not themselves sold in the open market or on a recognized exchange, they do not bear any of the foregoing characteristics of bonds and other securities which are so sold or commonly used as a means of investment. Thus, although on its face each note states a specific sum due the holder, in actuality this represents a transitory state of indebtedness from its parent corporation to Petitioner, modified at the end of each month; the notes are in amounts (e.g., \$16,778,810) wholly atypical of bonds commonly traded; the notes, unlike such bonds, are not supported by an indenture; the notes are not issued as part of a series but, rather, appear only singly, the issuance of each note requiring the retirement of its predecessor; and, finally, the notes are not negotiable. The notes are not negotiable because, contrary to Section 3-104(1) of the Uniform Commercial Code, the notes are not payable "to order or to bearer," and because they do not constitute promises to pay "a sum certain," this last in that the interest is

stated on the face of the instrument to be payable "...at a rate equal to the average rate earned on short-term investments or the average rate paid on short-term borrowings." Further, the notes are not negotiable as "securities," within the meaning of Article 8 of the Uniform Commercial Code, because they do not meet the requirements set forth in section 8-102 thereof. Thus, for example, each note is not "either one of a class or series or by its terms...divisible into a class or series of instruments...", nor is it "of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment." The notes in question, therefore, do not bear the quality of negotiability, which is characteristic of the "bonds and other securities" treated in section 208.5 of the Tax Law.

The notes in question, thus, are not of a type commonly traded in the open market or on a recognized exchange and, furthermore, are not of a type commonly dealt in as a means of investment. Accordingly, the notes in question do not constitute "bonds or other securities," within the meaning of section 208.5 of the Tax Law, and are therefore properly classifiable as business capital rather than investment capital under Article 9-A of the Tax Law.

DATED: June 16, 1981

s/LOUIS ETLINGER
Deputy Director
Technical Services Bureau