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

TSB-A-89(8)C
Corporation Tax
July 12, 1989

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C890321A

On February 18, 1982, a Petition for Advisory Opinion was received from First Albany Corporation, 41 State Street, Albany, New York 12207.

The issue raised is whether an investment in a repurchase agreement by a corporation subject to tax under Article 9-A is considered investment capital pursuant to section 208.5 of the Tax Law.

Facts

Petitioner, a New York corporation and a member of the New York Stock Exchange, regularly invests customer monies in repurchase agreements.

Petitioner is required by the Securities and Exchange Commission to deposit excess customer-related credit balances in a "Special Reserve Account for the exclusive benefit of customers". The funds in this account may be invested only in debt securities guaranteed fully by the U.S. Government (Treasury bills, bonds, notes or repurchase agreements secured by the same.)

The customer is paid interest at a rate determined at the end of each month, but his credit balance is not evidenced by any specific security. Petitioner invests these monies in repurchase agreements with various New York banking institutions. The repurchase agreement indicates that the investment is made in U.S. treasury notes or other U.S. government security. The interest earned is directly deposited into Petitioner's checking account or added to the next repurchase agreement by the banking institution. Petitioner pays the customer a rate of interest anywhere from one-half to two and one quarter percent below the amounts received on the repurchase agreement.

Additional factors are (1) Petitioner reports these investments on its books and in its financial statements as "Segregated Securities" and (2) the repurchase agreements may be for a period of anywhere between twenty-four hours and five days depending on the rate of interest at the time of purchase.

Petitioner contends that the investments mentioned above constitute "investment capital" for New York State franchise tax purposes and therefore, interest received on such investments is "investment income" under Article 9-A.

Discussion

Section 208.5 of the Tax Law states that "[t]he 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.... "

Section 208.6 of the Tax Law states that "[t]he term 'investment income' means income, including capital gains in excess of capital losses, from investment capital, to the extent included in computing entire net income .... "

Technical Services Bureau Memorandum TSB-M-88(5)I reprinted, in its entirety, an Opinion of Counsel dated May 4, 1988. In such opinion, Counsel discussed whether repos are secured loans or, rather, are more properly treated as distinct purchases and (re)sales. Even though the Opinion of Counsel pertained to a regulated investment company for personal income tax purposes, the rationale used to characterize repurchase agreements is applicable to taxpayers under Article 9-A of the Tax Law.

Such Opinion of Counsel states, in pertinent part:

> Very recently, authorities in both Illinois and Virginia have considered sets of facts and issues indistinguishable from those which you now present: the state taxation of shareholders of a RIC that invests assets in Federal paper repos, first "buying" the Federal obligations and then "reselling" them to the same party. See, Andras v. Illinois Department of Revenue, 154 Ill. App. 3d 37, 106 Ill. Dec. 732, 506 N.E. 2d 439 (2d District 1987), lv. app. den., No. 63703 (Oct. 7, 1987, Illinois Supreme Court), cert. den., 108 S. Ct. 1223 (Mar. 21, 1988); Illinois Department of Revenue Information Bulletin, FY 87-25 (May 1987); Virginia Department of Taxation, Ruling of the Commissioner (P.D. 87-186, July 7, 1987). See also, Virginia Tax Bulletin 82-3 (April 1982).
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> The reasoning of the Illinois court in Andras is particularly instructive and bears repeating here:
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> > "Plaintiffs next argue that the Department incorrectly classified the Trust's repurchase agreements as secured loans rather than sales. The transactions are arranged as follows. The Trust [a RIC] agrees to purchase certain U.S. Government securities from a bank or other seller and simultaneously agrees to resell the same securities to the same party on a certain, fixed date, which is generally within a few days of the original sale date. The seller agrees to pay the Trust interest at a fixed rate for the period between the original sale and the repurchase. The record contains some representative repurchase agreements supplied by the Trust. Some of the agreements refer to the original purchase price as 'principal' and to the government securities as 'collateral' ....
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> > "In reviewing similar transactions involving municipal bonds, Federal courts have consistently held that the Federal income tax exemption provided for income received from State or municipal obligations (26 U.S.C. sec. 103(a)(1954)) is available only to the taxpayer who actually owns the securities -- i.e., the taxpayer who has

the right to dispose of them and who bears the risk of a profit or loss. (See American National Bank v. United States (5th Cir. 1970), 421 F. 2d 442, 451, and cases cited therein.). . . If the Trust is not the true owner of these securities, but is merely loaning the sellers the securities, purchase price and there by earning otherwise taxable interest income, we conclude that it may not shelter that income from State taxation by allowing the borrowers to secure the loans with tax-exempt Federal securities.

"In determining whether or not a repurchase transaction is actually a loan, Federal courts consider the entire transaction, and look to the following specific factors, which, if present, tend to indicate that the transaction is a loan: (1) whether the seller could require the purchaser to resell the securities; (2) whether the purchaser could require the seller to repurchase them;(3) whether the agreement provides either party a specific remedy in the event that the other defaults; (4) whether the seller agreed to pay interest at a stipulated rate between the sale and resale; and (5) whether the amount advanced does not necessarily equal the fair market value of the securities sold. (See Citizens National Bank v. United States (1977), 551 F. 2d 832, 842, 213 Ct. Cl. 236.) Other indications of a loan are: (6) whether the identical securities are bought and sold, and (7) whether the purchaser may sell the securities for the seller's account in the event of a default. See I.R.S. Rev. Rul. 74-27 1974-1 C.B. 24). See also, I.R.S. Rev. rul. 82-144 (1982-2 C.B. 34) (transaction held to be purchase where the purchaser could sell the securities at will); I.R.S. Rev. Rul. 77-59 (1977-1 C.B. 196) (transaction was found to be loan only and the purchaser's assets were found not to be the securities themselves, but the seller's obligation to repay the funds loaned). Here the Trust and the sellers affirmatively agreed to a repurchase transaction involving the same securities at the time of the sale, and either could therefore properly require the other to perform. And while the agreements do not expressly provide mutual remedies in the event of a default, plaintiffs have stated that the Trust is authorized to sell the securities if the seller defaults. There is no indication that a default sale would relieve the seller of the obligation to pay the agreed amount, and we therefore perceive that such a default sale would only act as a credit against any amount still owed by the seller under the original agreement. In addition, all of the sample agreements clearly set a specific rate of interest.

"The Department has not argued that the sale amounts do not accurately reflect the value of the securities, and we will therefore assume that they do. The evidence nevertheless clearly indicates that the Trust accepted none of the risks of ownership, and we therefore conclude that the transactions were secured loans rather than sales. See American National Bank v. United States (5th Cir. 1970), 421 F. 2d 442, 451 ..... We therefore affirm the circuit court's conclusion that income derived by the Trust from these repurchase agreements is not tax-exempt.

"The decision of the circuit court is. . . remanded with directions to permit taxpayers to deduct from their gross income that proportion of the dividends they received from the Trust that is attributable to U.S. Government securities, but not the amount attributable to income from repurchase agreements."

Andras v. Illinois Department of Revenue, supra, 506 N.E. 2d at 443-444.

It is my opinion that both the rationale and conclusion reached in Andras, concerning the repo issue, are sound and should be followed for the matter at hand.

Note, also, that the Virginia Department of Taxation has taken a position which accords with that expressed in Andras. Responding to inquiries from several mutual funds, a recent Ruling of the Commissioner (P.D. 87-186, July 7, 1987) stated, in relevant part:

"You also requested a ruling regarding the taxability, for Virginia individual income tax purposes, of the interest and dividends paid to Virginia residents from [a] mutual fund. This fund may invest only in marketable securities issued or guaranteed by the United States Government, by various agencies of the United States Government and by various instrumentalities which have been established or sponsored by the United States Government ('U.S. Government Securities'). It is the present policy of this fund to invest 100% of its assets in overnight repurchase agreements with government securities dealers recognized by the Federal Reserve Board or with member banks of the Federal Reserve System. The agreements are collateralized by U.S. Government Securities.

"Section 630-2-322(C)(2)(d) of the Virginia Individual Income Tax Regulations provides:

'Repurchase agreements are usually obligations issued by financial institutions which are secured by U.S. obligations exempt from Virginia income taxation . . . . In such cases the interest paid by the financial institutions to purchasers of repurchase agreements does not qualify for the

> subtraction. Repurchase agreements issued following current commercial practice will invariably be regarded as obligations of the issuing financial institution. However, if the purchaser is regarded as- the true owner of the underlying exempt obligation, the interest will qualify for the subtraction even though collected by the seller and distributed to the purchaser. Any claim of such ownership must be substantiated, by a taxpayer claiming a subtraction.'

"Based upon the information that you have provided and upon the above regulation section, such dividends paid by this fund would currently be subject to the Virginia individual income tax."

I am aware of two state tax cases which, at first glance, might seem to hold contrary to the Illinois and Virginia view. See, Matz v. Michigan Department of Treasury, 155 Mich. App. 778, 401 N.W. 2d 62 (1986); In re Thomas C. Sawyer Estate, No. S101-84 (Chittenden County, Vermont, Superior Court, Feb. 20, 1986), aff'd, No. 86-177 (Dec. 11, 1987, Vermont Supreme Court). However, the concern in Matz was with whether -- absent a statute on point -- dividends from a mutual fund which admittedly owned Federal securities would retain their character attribute as Federally exempt interest, essentially passed through from the mutual fund. Although repos were involved, and the facts seem akin to those considered by the above Illinois and Virginia authorities, Matz never considered the present issue of whether the mutual fund indeed owned the Federal securities. The loan versus sale issue was passed over without mention. Instead Matz took it for granted that the mutual fund was, as stipulated, the true owner of the Federal securities. The same is true of Sawyer. Thus, neither Matz nor Sawyer addressed the instant issue and do not, in reality, hold contrary to either Andras or the Ruling of the Virginia Tax Commissioner.

. . .I believe that the loan versus sale issue turns on whether the purchaser/lender becomes endowed with the economic benefits and burdens of ownership of the (Federal) securities. The chief indicia of such endowment, as alluded to in Andras, are (1) the right freely to dispose of or pledge the securities to a third party, and (2) the accrual to such party of the opportunity for profit and loss deriving from changes in the market value of the securities ....

Conclusion

Herein, depending on the nature of the repurchase agreement, in some instances Petitioner will have in fact purchased the securities, whereas in other instances the transfer of funds to Petitioner will in fact constitute a loan which is collateralized by the securities. If, Petitioner, as a result of the repurchase agreement, owns the securities, and if the securities qualify as securities pursuant to the definition of investment capital contained in section 208.5 of the Tax Law, such securities will constitute investment capital. If Petitioner, as a result of the repurchase agreement, has not acquired ownership of the securities, then it is a lender of funds and has acquired a debt instrument collateralized by the securities. If such 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. Otherwise, the purchased security or debt instrument will constitute either business capital or subsidiary capital.

In conclusion, the determination of whether Petitioner's investment in a repurchase agreement constitutes investment capital and, therefore, income from such agreement is investment income, is a question of fact not susceptible of determination in an advisory opinion. An advisory opinion merely sets forth the applicability of pertinent statutory and regulatory provisions to "a specified set of facts." Tax Law, § 171, subd. twenty-fourth; 20 NYCRR 901.1(a). In as much as the question presented herein arises within the context of an audit, the necessary factual determination will be made within such context, in accordance with the principles outlined above.

DATED: July 12, 1989

s/FRANK J. PUCCIA
Director
Technical Services Bureau

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