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

TSB-A-98(11)C
Corporation Tax
July 29, 1998

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C980423A

On April 23, 1998, a Petition for Advisory Opinion was received from New York State Electric & Gas Corporation, P.O. Box 3287, Ithaca, New York 14852-3287.

The issue raised by Petitioner, New York State Electric & Gas Corporation, pertains to the tax ramifications, under sections 186 and 186-a of the Tax Law, resulting from the proposed corporate restructuring of Petitioner implemented in fulfillment of the New York Public Service Commission's mandate under its Competitive Opportunities proceeding.

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

Background

Petitioner is a publicly-held utility corporation that is subject to the supervision of the New York State Department of Public Service ("PSC"). Its primary business activity is the generation of electricity and the purchase, transmission and distribution of electricity and natural gas. Therefore, Petitioner is required to pay taxes pursuant to sections 186 and 186-a of the Tax Law.

In August, 1994, the PSC began hearings with respect to restructuring the New York electric industry to usher the New York electric industry into a new era where it would be subject to competition, and customers would be able to select their own suppliers. On May 20, 1996, the PSC issued its order[1] (the "Generic Order") in that proceeding. The Generic Order set forth the PSC's vision and goals for the future of the New York electric industry. The PSC directed that Petitioner file a rate and restructuring plan that was consistent with the PSC's vision and goals. The PSC desired that the plan provide for the divestiture of the utility's generation assets.

On September 18, 1996, Petitioner, four other utilities, the Energy Association of New York State (the trade association of New York electric utilities) and certain other parties brought an Article 78 proceeding against the PSC in which they asserted, among other things, that the PSC had no authority to force them to divest their generation assets. On November 26, 1996, the court denied the utilities' petition. On December 24, 1996, the utilities appealed this decision to the Appellate Division, Third Department, where it is pending.

On September 27, 1996, in response to the Generic Order, Petitioner

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[1]Opinion and Order Regarding Competitive Opportunities for Electric Service, Opinion No. 96-12, Issued and Effective May 20, 1996.

submitted a proposed rate and restructuring plan. Subsequently, on October 9, 1997, after extensive negotiation with numerous parties, a revised plan was agreed to by Petitioner, the staff of the PSC and a number of other parties (hereinafter this revised plan is referred to as the "Restructuring Agreement"). The Restructuring Agreement, inter alia, provided for the mechanism by which Petitioner was to dispose of its seven coal-fired generating stations and certain associated assets and liabilities (the "Assets"). One of the terms of the Restructuring Agreement was that Petitioner would withdraw its appeal of the November 26, 1996, court decision. The administrative law judge issued a recommended decision in which he held that the Restructuring Agreement basically was acceptable but that the parties should renegotiate certain matters.

On January 27, 1998, the PSC issued an order in which, subject to certain modifications and conditions (which modifications and conditions are not relevant to the issues discussed herein), it adopted the Restructuring Agreement.[2] On February 4, 1998, Petitioner accepted the PSC's order. On March 5, 1998, the PSC issued a confirming order.[3] As a result, Petitioner will be changing its corporate structure and has commenced disposing of the Assets.

The Restructuring

Petitioner currently is the parent corporation of an affiliated group of corporations as defined by section 1504 of the Internal Revenue Code. Petitioner's affiliated group of corporations files a consolidated return for federal income tax purposes. Two members of Petitioner's affiliated group of corporations will be used to effectuate the terms of the Restructuring Agreement. For purposes of this Advisory Opinion, these two corporations will be referred to as HoldCo and GenSub. On September 23, 1997, after Petitioner had reached an agreement in principle with the staff of the PSC, both of these corporations were incorporated as wholly-owned subsidiaries of Petitioner. Prior to the transactions described herein, both of these corporations had nominal assets. As a result of the mandate of the PSC, the following transactions have taken, or will, take place.

On February 11, 1998, Petitioner and GenSub entered into an agreement (the "Agreement") which provided that the Assets would be transferred to GenSub in exchange for 50 shares of GenSub's common stock and a contingent promissory note (the "Note"). On the same day, substantially all of the Assets were transferred to GenSub, and GenSub issued 50 shares of its common stock and the Note to

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[2] Order Adopting Terms of Settlement Subject to Modifications and Conditions, Issued and Effective January 27, 1998.

[3] Opinion and Order Adopting Terms of Settlement Subject to Modifications and Conditions, Opinion No. 98-6, Issued and Effective March 5, 1998.

Petitioner. The Note was in the principal amount of $92,370,000. Pursuant to the Agreement, the principal amount of the Note will be adjusted, retroactively to February 11, 1998, based upon the ultimate amount that GenSub realizes upon the sale of the Assets. After the transfer, Petitioner owned 150 shares of GenSub's common stock, which was all of GenSub's outstanding stock.[4]

The Agreement further provided that a tax sharing agreement will be entered into among the various members of Petitioner's affiliated group and that this tax sharing agreement will provide that Petitioner will bear the burden of any federal income tax liability that is attributable to the activities of GenSub.

Petitioner's original cost, unreduced by depreciation, for the Assets is substantially in excess of the amount that GenSub is expected to realize upon the sale of the Assets.

On February 19, 1998, Petitioner transferred its 150 shares of GenSub common stock to HoldCo in exchange for 50 shares of common stock of HoldCo. As a result of this transfer, Petitioner currently owns 150 shares of common stock of HoldCo, which is all of the outstanding stock of HoldCo.[5]

Petitioner will request its common stockholders to approve a binding share exchange pursuant to which Petitioner's common stockholders will become the holders of all of HoldCo's outstanding common stock[6], and HoldCo will become the sole holder of Petitioner's outstanding common stock. The holders of Petitioner's common stock will consider this request at the next annual meeting of shareholders which was scheduled for April 29, 1998.

The binding share exchange will take place after it is approved by the holders of Petitioner's common stock. As soon as practicable after the binding share exchange is consummated, the remaining Assets will be transferred to GenSub pursuant to the Agreement.

Also, as soon as practicable after the binding share exchange is consummated, GenSub will conduct an auction for the sale of all of the Assets. On April 8, 1998, the PSC approved the rules pursuant to which the auction will be conducted. Petitioner states that the PSC desired that the rules would maximize the proceeds of the auction since the financial results of the auction will inure to the benefit of Petitioner's customers. All of the Assets might not be sold to a single purchaser. There will be two or more bundles of generating stations and related assets.

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[4]Prior to the exchange, Petitioner owned 100 shares of GenSub's common stock.

[5]Prior to the exchange, Petitioner owned 100 shares of HoldCo's common stock.

[6]The 150 shares of HoldCo common stock that currently are owned by Petitioner will be canceled as part of the binding share exchange.

As soon as practicable after the auction has been conducted, the Assets will be transferred to the winning bidder or bidders. Any substantial delay in the consummation of the transfers will be attributable to obtaining the required approvals for the transfers from the Federal Energy Regulatory Commission ("FERC"), the PSC and other regulatory agencies having jurisdiction over the sale of the Assets.

During the time period between the transfer of the Assets to GenSub and the transfer of the Assets by GenSub to the winning bidders, GenSub will sell most of the electricity that it generates to Petitioner, which will then resell it to the public. Petitioner will pay GenSub a FERC authorized rate for that electricity. Additionally, during that time period, Petitioner will from time to time render services to GenSub. GenSub will pay Petitioner for those services an amount that is equal to Petitioner's cost of providing those services. For regulatory purposes, GenSub's earnings for this period will be combined with Petitioner's earnings.

Shortly after the sales proceeds have been received by GenSub, GenSub will discharge the Note.

Applicable Law -- sections 186 and 186-a

Section 209.1 of Article 9-A of the Tax Law imposes an annual franchise tax on domestic or foreign corporations for the privilege of exercising a corporate franchise, doing business, employing capital, owning or leasing property in a corporate or organized capacity, or maintaining an office in New York State. Section 209.4 of the Tax Law, provides that a corporation liable for tax under section 186 of Article 9 of the Tax Law is not subject to tax under Article 9-A of the Tax Law.

To determine the classification and proper taxability of a corporation under either Article 9-A or section 186 of Article 9, an examination of the nature of the corporation's activities is necessary, regardless of the purposes for which the corporation was organized. See Matter of McAllister Bros., Inc. v Bates, 272 AD 511, 517. Ordinarily, a corporation is deemed to be principally engaged in the activity from which more than 50 percent of its receipts are derived. See, e.g., Re Joseph Bucciero Contracting Inc., Adv Op St Tax Commn, July 23, 1981, TSB-A-81(5)C.

Section 186 of the Tax Law imposes a franchise tax upon every corporation, joint-stock company or association formed for or principally engaged in the business of supplying gas, when delivered through mains or pipes, or electricity, "for the privilege of exercising its corporate franchise or carrying on its business in such corporate or organized capacity in this state". The tax is three-quarters of one percent on the taxpayer's gross earnings from all sources within New York State, and four and one-half percent on the amount of dividends paid during each year ending on the thirty-first day of December in excess of four percent on the actual amount of paid-in capital employed in New York State by the taxpayer.

When section 186 of the Tax Law was enacted in 1896, it provided for a franchise tax measured by "gross earnings from all sources within this state". In 1907, the Legislature amended section 186 by providing a statutory definition of gross earnings. Gross earnings is defined as "all receipts from the employment of capital without any deduction."

The definition of gross earnings was added to address a 1906 New York State Appellate Division decision holding that in order to arrive at taxable “gross earnings”, the cost of raw materials used in producing the utility service had to be deducted from the company’s gross receipts. (See People ex rel Brooklyn Union Gas Co. v Morgan, 114 App Div 266, affd 195 NY 616).

In 1969, the New York State Court of Appeals stated that "the 1907 amendment [of section 186] did not contemplate a substitution of 'capital' or 'gross receipts' for 'gross earnings' as the basis for taxation. It merely sought to include that portion of capital which the Brooklyn Union Gas Co. case [supra] required to be deducted from 'gross earnings' to arrive at the proper basis. This is only that portion of 'gross earnings' which represents the 'employment of capital' to manufacture, distribute and sell various public utility services." (Matter of Consolidated Edison Co. of NY v State Tax Commission, 24 NY2d 114, 119). In the Con Ed case, the court determined that the proceeds received by the company for property damage and insurance claims and from the sale of capital assets no longer employed in its business, consisting of real property, scrap and used machinery, are amounts realized from the destruction or confiscation of capital, not from the employment of capital.

Section 186-a of the Tax Law imposes a tax on the furnishing of utility services that is equal to three and one-half percent of the gross income of a utility that is subject to the supervision of the PSC or the gross operating income of every other utility doing business in New York State. For purposes of section 186-a, a "utility" includes a person subject to the supervision of the PSC and every person (whether or not such person is subject to such supervision) who sells or furnishes gas or electricity, by means of mains, pipes, or wires; regardless of whether such activities are the main business of such person or are only incidental thereto. The word "person" is defined in section 186-a.2(b) of the Tax Law and includes corporations, companies, associations, joint-stock companies or associations, partnerships and LLCs.

Gross income, as defined in section 186-a.2(c) of the Tax Law, consists of the following elements:

1. receipts from any sale made or service rendered for ultimate consumption or use by the purchaser in New York State;

2. profits from the sale of securities;

3. profits from the sale of real property;

4. profits from the sale of personal property (other than inventory);

5. receipts from interest, dividends, and royalties, derived from sources within New York State; and

6. profits from any transaction (except sales for resale and rentals) within New York State whatsoever.

Gross operating income, as defined in section 186-a.2(d) of the Tax Law, means and includes receipts received in or by reason of any sale made for ultimate consumption or use by the purchaser of gas or electricity, or in or by reason of the furnishing for such consumption or use of gas or electric service in New York State, without any deductions.

In Consolidated Edison Company of New York, Inc., Adv Op St Tax Commn, December 1, 1986, TSB-A-86(22)C, ("Con Ed-II") one of the issues involved whether transactions from an agreement whereby Con Ed used its distribution system to facilitate the distribution and sale of preference power by the New York City Public Utility Service resulted in gross income under section 186-a of the Tax Law. The opinion stated that for purposes of section 186-a, "sales made and services rendered" has been defined to include sales and services which are the principal business of the taxpayer and which are made to customers. It also stated that "[i]n order to be included under the heading 'profit from any other transaction whatsoever, except the profit on sales for resale and rentals,' the profits must be from labor not performed in the conduct of the taxpayer's principal business and from the sales of materials and supplies, other than such as are purchased for resale. Isolated transactions also come under this item such as when a water company, which does not make a practice of furnishing this service, lays pipes and mains for a customer with title vesting in such customer." The opinion held that the services Con Ed performed under the agreement in its use of its distribution system were not services "for ultimate consumption or use by the purchaser" within the meaning intended under the law. The services rendered were incidental to the conduct of Con Ed's principal business. As such, the services rendered were transactions taxable on the profits derived therefrom, and to the extent that the services were rendered on behalf of New York State consumers, the profits would be subject to tax in their entirety.

Accordingly, under section 186-a of the Tax Law, a utility subject to the supervision of the PSC includes in gross income the profits from the sale of real property and the profits from the sale of personal property, other than inventory. For purposes of section 186-a, the basis for computing the profit from the sale of real or personal property, other than inventory, is the original cost of the property, without the deduction for depreciation attributable to such property. If the sale of the real or personal property results in a loss, rather than a profit, such loss may not be deducted from the taxpayer’s other gross income.

In an Advisory Opinion of the Commissioner of Taxation and Finance to Long Island Lighting Company, dated May 19, 1995, TSB-A-95(9)C,("LILCO-I") it was determined that in the sale-leaseback transactions presented, the gain, rather than the entire proceeds, on the sale of equipment (machinery and equipment used in the production, transmission and distribution of electricity and natural gas,

such as an undivided interest in one of LILCO's electricity generating plants, or certain diesel generators manufactured by Colt Industries, together with associated spare parts, accessories and related equipment and structures) was a receipt from the employment of capital and as such, the gain constituted gross earnings under section 186 of the Tax Law. The gain from the sale of the equipment, for purposes of section 186, was determined by subtracting from the receipts from the sale of the property, the original cost of the property. Depreciation and other expenses attributable to the equipment were not deducted from the original cost. If the sale resulted in a loss, rather than a gain, the loss could not be deducted from other gross earnings. It was also determined that the profit from the sale of LILCO's equipment was required to be included in gross income for purposes of section 186-a of the Tax Law. When determining whether there was a profit or loss on the sale of the equipment, for purposes of section 186-a, depreciation attributable to the equipment was not deducted from the original cost. The profit was determined by subtracting from the receipts from the sale of the equipment, the original cost of the equipment along with the expenses incurred in making the sale. If the sale of such equipment resulted in a loss, the loss could not be deducted from LILCO's other gross income.

Petitioner is one of several utilities in New York State being compelled by the PSC to reorganize its corporate structure and possibly sell off some of its business to unrelated third parties. With respect to such mandated restructuring, the Commissioner of Taxation and Finance has issued an Advisory Opinion to Long Island Lighting Company, Adv Op Comm T&F, February 27, 1998, TSB-A-98(3)C, TSB-A-98(1)R ("LILCO-II"). LILCO, in restructuring its corporate organization, is entering into a series of transactions under a threat of condemnation by the Long Island Power Authority ("LIPA"). The first transaction involves the acquisition of the stock of LILCO by the LIPA and the transfer of certain of LILCO's assets to a new corporation that will be owned by LILCO's former shareholders. The Opinion reached several conclusions, including the following:

1. That the gas and generation asset exchange is part of such series of transactions that LILCO is entering into under a threat of condemnation by the LIPA, and like Con Ed, supra, LILCO does not employ its capital within the meaning of section 186 of the Tax Law for the purpose of being forced to dispose of such capital under threat of condemnation. Therefore, the consideration received by LILCO for the assets does not constitute "receipts from the employment of capital" and is not taxable under the gross earnings tax imposed by section 186 of the Tax Law.

2. With respect to the gas and generation asset exchange for purposes of section 186-a of the Tax Law, LILCO will realize taxable gross income to the extent that a profit is generated. The profit, if any, would equal the amount that the fair market value of the holding company stock received by LILCO plus the amount of LILCO's liabilities assumed by the holding company exceed the original cost of the gas and generation assets, without deduction for depreciation. Expenses of the sale are allowed to be deducted. In this situation, it is appropriate to consider the distribution of the assets as one transaction or sale. Accordingly, the profit would be determined based on the sale of the aggregate of all the assets, not the sale of each asset separately.

3. The distribution by LILCO of the holding company stock in the redemption distribution and the distribution of cash in the LIPA merger are also part of the series of transactions LILCO is entering into under threat of condemnation by LIPA. This restructuring is the means by which LIPA will purchase the balance of the LILCO common stock held by LILCO's public shareholders. These transactions constitute a complete termination of the shareholders' interests in LILCO and are considered as payment for the LILCO shares that are deemed to have been redeemed rather than treated as a dividend. Accordingly, these distributions are not treated as dividends subject to the excess dividends tax under section 186 of the Tax Law.

4. With respect to the redemption distribution for purposes of section 186-a of the Tax Law, LILCO will realize gross income taxable to the extent that a profit is generated. The profit, if any, would equal the amount that the fair market value of the LILCO stock deemed received by LILCO exceeds the original cost of the holding company stock exchanged therefor.

Specific Questions and Answers

Question 1. Will the transfer of the Assets by Petitioner to GenSub in exchange for the 50 shares of GenSub common stock and the Note result in gross earnings under section 186 of the Tax Law?

Answer. No. The transfer of the Assets by Petitioner to GenSub in exchange for the 50 shares of GenSub common stock and the Note is part of a series of transactions being entered into by Petitioner as mandated by the PSC pursuant to the Competitive Opportunities Proceeding and the PSC's directive set forth in the Order (Opinion No. 96-12), as implemented under the restructuring plan described in the Restructuring Agreement dated October 9, 1997, as modified January 27, 1998 and confirmed by PSC Order 98-6 issued and effective March 5, 1998, which includes the divestiture of the Assets and the sale of the assets at Auction. Like Con Ed, supra, and LILCO-II, supra, Petitioner does not employ its capital within the meaning of section 186 of the Tax Law for the purpose of being forced to restructure its organization. Accordingly, the consideration received by Petitioner for the Assets is not "receipts from the employment of capital" and does not constitute "gross earnings" and, therefore, is not taxable under the gross earnings tax imposed by section 186 of the Tax Law.

Question 2. Assuming that Petitioner's original aggregate cost, unreduced by depreciation, for the Assets is not less than the aggregate amount that GenSub realizes upon the sale of the Assets, will the transfer of the Assets by Petitioner to GenSub in exchange for the 50 shares of GenSub common stock and the Note result in gross income under section 186-a of the Tax Law?

Answer. No. With respect to the excise tax imposed under section 186-a of the Tax Law, Petitioner would realize "gross income" only to the extent that the transfer of the Assets by Petitioner to GenSub in exchange for the 50 shares of GenSub common stock and the Note generates a profit. The profit, if any, would equal the amount that the fair market value of the GenSub common stock and the Note exceed the original cost of the Assets, without deduction for depreciation. It is appropriate in this situation to consider the distribution of the assets

as one transaction or sale. Accordingly, the profit would be determined based on the sale of the aggregate of all the assets, not the sale of each asset separately.

Question 3. Will the sale of the Assets by GenSub pursuant to the auction result in gross earnings under section 186 of the Tax Law?

Answer. The sale of the Assets, by GenSub, to an unaffiliated party pursuant to the auction is part of a series of transactions being entered into by Petitioner as mandated by the PSC pursuant to the Competitive Opportunities Proceeding and the PSC's directives set forth in the Order (Opinion No. 96-12), as implemented under the restructuring plan described in the Restructuring Agreement dated October 9, 1997, as modified January 27, 1998 and confirmed by PSC Order 98-6 issued and effective March 5, 1998, which includes the divestiture of the Assets and the sale of the assets at Auction. Like Con Ed, supra, and LILCO-II, supra, neither Petitioner nor GenSub employs its capital within the meaning of section 186 of the Tax Law for the purpose of being forced to restructure its organization and auction its assets. Accordingly, the consideration received by GenSub for the Assets is not "receipts from the employment of capital" and does not constitute "gross earnings" and, therefore, is not taxable under the gross earnings tax imposed by section 186 of the Tax Law.

Question 4. Will the sale of the Assets by GenSub pursuant to the auction result in gross income under section 186-a of the Tax Law?

Answer. GenSub would realize "gross income", under section 186-a of the Tax Law, to the extent that a profit is generated from the sale of the Assets by GenSub pursuant to the auction. Following LILCO-I, supra, the profit, if any, would equal the amount that the consideration received by GenSub as a result of the auction exceeds the original cost of the Assets, without deduction for depreciation. Expenses of the sale are allowed to be deducted. It is appropriate in this situation to consider the distribution of the assets as one transaction or sale. Accordingly, the profit would be determined based on the sale of the aggregate of all the assets, not the sale of each asset separately. If the sale of the Assets results in a loss, rather than a profit, such loss may not be deducted from GenSub's other gross income.

Question 5. Will the sales of electricity by GenSub to Petitioner prior to the closing of GenSub's sale of the Assets result in gross earnings under section 186 of the Tax Law?

Answer. GenSub would be in the business of generating and selling electricity. If more than 50 percent of GenSub's gross receipts are from such business, GenSub would be principally engaged in such business, and GenSub would be subject to tax under section 186 of the Tax Law. The tax would be imposed on GenSub's gross earnings, that is, all receipts from the employment of capital without any deduction, from all sources within New York State. If 50 percent or less of its receipts are from generating and selling electricity, the GenSub would be subject to tax under Article 9-A of the Tax Law pursuant to section 209.1 of the Tax Law. If GenSub is subject to tax under section 186 of the Tax

Law, the sales of electricity to Petitioner will constitute gross earnings under section 186 because there is no deduction or exclusion for sales for resale under section 186.

Question 6. Will the sales of electricity by GenSub to Petitioner prior to the closing of GenSub's sale of the Assets result in gross income under section 186-a of the Tax Law?

Answer. No. Pursuant to section 186-a.2(c), GenSub's sale of electricity at wholesale (i.e., sale for resale, made in and out of New York) would be excluded from gross income.

Question 7. Will the amounts that GenSub pays to Petitioner for services rendered to GenSub by Petitioner prior to the closing of GenSub's sale of the Assets result in gross earnings under section 186 of the Tax Law?

Answer. Yes. The amounts that Petitioner receives from GenSub for services rendered to GenSub are receipts from the employment of capital. Under section 186 of the Tax Law, gross earnings includes all receipts from the employment of capital without any deduction. Accordingly, the receipts of Petitioner from such services constitute gross earnings under section 186.

Question 8. Will the amounts that GenSub pays to Petitioner for services rendered to GenSub by Petitioner prior to the closing of GenSub's sale of the Assets be included in gross income under section 186-a of the Tax Law only to the extent that Petitioner has a profit from the rendition of such services?

Answer. Yes. Like Con Ed-II, supra, the services performed by Petitioner for GenSub are not performed in the conduct of Petitioner's principal business of furnishing electricity or electric service. Therefore, the amounts that Petitioner receives from GenSub for services rendered to GenSub are receipts taxable under the gross income category of "profits from any transaction within New York State whatsoever" and only the profits would constitute gross income.

Question 9. Will any of the transactions described in this Advisory Opinion result in a dividend for purposes of the excess dividends tax imposed under section 186 of the Tax Law?

Answer. No. In People ex rel Adams Electric Light Co v Graves, 272 NY 77, 79, the Court of Appeals stated that under the franchise tax imposed by section 186, "[a] dividend implies a division or distribution of corporate profits". Petitioner's distribution to Holdco, directly after the Share Exchange, of all of the common stock of GenSub, is also part of the series of transactions being entered into by Petitioner as mandated by the PSC pursuant to the Competitive Opportunities Proceeding and the PSC's directives set forth in the Order (Opinion No. 96-12), as implemented under the restructuring plan described in the

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Restructure Agreement dated October 9, 1997, as modified January 27, 1998 and confirmed by PSC Order 98-6 issued and effective March 5, 1998, whereby Petitioner is reorganized into the holding company structure. It does not represent a distribution of the profits of Petitioner. Accordingly, these restructuring distributions are not treated as dividends subject to the excess dividends tax imposed under section 186 of the Tax Law.

/s/
DATED: July 29, 1998 John W. Bartlett
Deputy Director
Technical Services Bureau

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