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

TSB-A-99(1)C
Corporation Tax
January 22, 1999

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C981006B

On October 6, 1998, a Petition for Advisory Opinion was received from Consolidated Edison Company of New York, Inc., 4 Irving Place, Room 1875-S, New York, New York 10003.

The issues raised by Petitioner, Consolidated Edison Company of New York, Inc., result from the proposed corporate restructuring of Petitioner implemented in fulfillment of the New York State Public Service Commission's mandate under its Competitive Opportunities proceeding. The specific questions are:

Question 1: Is any portion of the value of the consideration received by Petitioner from the sale of the generating assets or other property, in accordance with its mandated divestiture of such assets considered "gross earnings" subject to tax under section 186 of the Tax Law?

Question 2: Is the distribution of the proceeds from the sale of the generating assets or other property from Petitioner to its holding company in accordance with its mandated corporate restructuring and divestiture of the generating assets considered a dividend subject to the tax on excess dividends ("Excess Dividends Tax") under section 186 of the Tax Law?

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

Petitioner is a regulated public utility incorporated in New York State on November 10, 1884. Petitioner is a subsidiary of Consolidated Edison, Inc. ("CEI"), a public utility holding company under the Public Utility Holding Company Act of 1935 ("PUCHA") and is exempt from registration with the Securities and Exchange Commission ("SEC") in accordance with section 3(a)(1) of PUCHA. CEI was incorporated in New York State on September 3, 1997. Petitioner supplies electricity and electric services in all of New York City (except a part of the Borough of Queens) and most of Westchester County. It supplies gas and gas services in Manhattan, the Bronx and parts of Queens and Westchester County, as well as steam and steam services in Manhattan.

In August 1994, the New York State Public Service Commission ("PSC") began hearings with respect to restructuring the New York electric industry to foster competition in the generation of electricity and offer customers a choice of energy providers (The Competitive Opportunities Proceeding, Case No. 94-E-0952). On May 20, 1996, the PSC issued Opinion No. 96-12, Opinion and Order Regarding Competitive Opportunities for Electric Service, effective May 20, 1996 (the "Generic Order") in that proceeding. The Generic Order endorsed a fundamental restructuring of the electric utility industry in New York State, based on competition in the generation and energy

services sectors of the industry. The PSC directed Petitioner to file a restructuring plan, addressing, among other things, retail access, divestiture and a corporate reorganization. Petitioner filed its plan on October 1, 1996.

On September 23, 1997, the PSC issued its Order Adopting Terms of Settlement Subject to Conditions and Understandings in Cases 96-E-0897 and 96-E-0916 (the "Order")[1] Among other things, the Order, with the conditions and understandings set forth therein, adopted and incorporated the terms of the Amended and Restated Settlement Agreement dated September 19, 1997 among Petitioner, the PSC staff and other parties (the "Settlement Agreement"). The Settlement Agreement provides for a transition to a competitive electric market through the development of a retail access plan, a rate plan for the period ending March 31, 2002 (the "Transition"), and a reasonable opportunity for recovery of "strandable costs". The retail access plan will eventually permit all of Petitioner's electric customers to buy electricity from other suppliers. The delivery of electricity to customers will continue to be through Petitioner's transmission and distribution systems. Further, the Settlement Agreement required the divestiture by Petitioner to unaffiliated third parties of at least 50 percent of its New York City ("in-City") electric generating fossil-fueled capacity. Under the Settlement Agreement, Petitioner's electric generating fossil-fueled capacity not divested to third parties would have been transferred to an unregulated subsidiary of CEI.

As a result of the Order, Petitioner altered its corporate structure and is in the process of disposing of generating assets.

The Restructuring

A. Holding Company: Petitioner was the parent corporation of an affiliated group of corporations as defined by section 1504 of the Internal Revenue Code ("IRC"). Petitioner's affiliated group of corporations files a consolidated return for federal income tax purposes. On January 1, 1998, pursuant to a mechanism of a binding share exchange, authorized by the New York Business Corporation Law, Petitioner formed a holding company structure. The share exchange was a tax-free reorganization under section 351 of the IRC. The restructuring was accomplished as followed:

1. Petitioner created a wholly-owned subsidiary, CEI, a non-regulated company incorporated in New York on September 3, 1997.

2. Prior to the consummation of the Share Exchange, infra, Petitioner made a capital contribution of cash and the shares of two of its wholly-owned subsidiaries to CEI.

---

[1] The Order was confirmed by the full PSC by Confirming Order, issued October 1, 1997, and readopted in Opinion No. 97-16, issued November 3, 1997.

3. Subsequent to the formation of CEI, Petitioner and CEI executed a share exchange agreement, which was approved by Petitioner's shareholders in December 1997. Pursuant to the share exchange, on January 1, 1998, Petitioner's common stock shareholders, by operation of law, exchanged Petitioner's common stock for CEI common stock on a one-for-one basis ("Share Exchange"). After the Share Exchange was completed, the former Petitioner common shareholders became common shareholders of CEI. Petitioner's preferred stock and debt are not affected by the Share Exchange and remain outstanding securities of Petitioner.

4. After completion of the Share Exchange, Petitioner became a subsidiary of CEI. The consolidated group of corporations of which, prior to the Share Exchange, Petitioner was the common parent for federal income tax purposes, continues after the Share Exchange with CEI as the new common parent corporation.

5. CEI is subject to tax pursuant to Article 9-A of the Tax Law.

6. Petitioner is subject to tax under sections 186 and 186-a of Article 9 of the Tax Law.

B. The Electric Divestiture Plan: On March 2, 1998, Petitioner filed a Generation Divestiture Plan and Petition ("Divestiture Plan")[2] with the PSC. Pursuant to the Divestiture Plan, Petitioner proposed to divest two-thirds of its in-city electric generating capacity, which totals approximately 5,500 megawatts. This capacity is divided into three separate groups or bundles. The three bundles are described as the "Ravenswood", "Astoria" and "Arthur Kill" bundles. The Ravenswood bundle includes the Ravenswood Generating Station located in Queens and 16 gas turbines also located at the Ravenswood facility in Queens. The Astoria bundle includes the Astoria Generating Station in Queens; 32 gas turbines located in the Gowanus section of Brooklyn and 16 gas turbines located in the Sunset Park section of Brooklyn (the "Narrows Turbines"). The Arthur Kill bundle includes the Arthur Kill Generating Station in Staten Island and 20 gas turbines located at the Astoria facility in Queens.

In addition, the Divestiture Plan identified properties that are available for sale to third parties for the purpose of constructing new generating facilities. These sites include (but are not limited to) (1) Astoria (portions not included in the bundles; (2) Hellgate; (3) Kent Avenue; and (4) Sherman Creek. Following the sale of the three asset bundles, Petitioner will solicit offers for its potential generating sites from all bidders.

---

[2] PSC Case No. 96-E-0897.

By Order issued and effective July 21, 1998, the PSC authorized Petitioner to auction its generation facilities as described in its Divestiture Plan subject to certain conditions, including allowing Petitioner to keep the first $50 million in net gains from the auction. The PSC also instructed Petitioner to provide a detailed plan for divestiture of its excess property. By Order issued and effective August 5, 1998[3], the PSC modified its July 21st Order and ordered the sale of all of its in-city electric generating fossil-fueled capacity to third parties, and provides that Petitioner is granted the authority to use at least an additional $50 million in net gains on the auction until 2013, when the operating license for the Indian Point No. 2 nuclear plant expires, after which such funds would be used to pay down the then-existing depreciation expense of Indian Point No. 2 that would otherwise be charged to ratepayers.

The divestiture of Petitioner's electric generation will also include its two-thirds interest in the Bowline Point Generating Station in West Haverstraw, New York that it co-owns with Orange and Rockland Utilities ("O&R"), which owns the remaining one-third interest. By agreement with O&R, Petitioner will offer this two-third (810 megawatt) interest jointly with O&R (with O&R acting as Petitioner's agent) in connection with O&R's independent auction of its electric generating assets. In its Electric Rate and Restructuring Plan, dated November 6, 1996, which the PSC approved in its orders dated November 26, and December 31, 1997, O&R agreed to divest all of its electric generating assets. On April 16, 1998, the PSC approved the process for the auctioning of O&R's electric generating assets, which includes its share of Bowline Point.

Petitioner also proposes to sell its 40 percent share of the Roseton generating station located in Newburgh, New York, in conjunction with Central Hudson's divestiture auction. The Roseton station is co-owned by Central Hudson, 35 percent, and Niagara Mohawk, 25 percent. Pursuant to Rev Rul 68-344, 1968-1 CB 569, the ownership and operation of the Roseton Plant by the owners thereof, as tenants-in-common is considered to be a venture classified as a partnership for federal income tax purposes under section 7701(a)(2) of the IRC. The co-tenant owners of the Roseton Plant did not elect, under section 761(a) of the IRC to be excluded from the application of all or part of Subchapter K of the IRC. The Roseton Plant co-tenants have filed, annually, a partnership return Form 1065. Petitioner submits that its 40 percent interest in the Roseton Plant is a partnership interest for purposes of this advisory opinion. The sale of this plant will not be completed until June 30, 2001, and is governed by Central Hudson's modified Restated Settlement Agreement, as entered into on February 26, 1998, with the PSC.

---

[3] This Order was confirmed by the full PSC by Confirming Order, issued and effective August 19, 1998.

C. The Steam System Plan: In Opinion No. 97-15[4], the PSC directed that a long range steam plan be submitted in time for the PSC's contemporaneous consideration with the electric divestiture plan. On April 15, 1998, Petitioner filed a divestiture plan for its electric/steam generating stations ("Steam Plan") in compliance with Opinion No. 97-15. The Steam Plan proposes the sale, through auction, of the Waterside and East River steam-electric plants. The Steam Plan also proposes the sale of Petitioner's steam only plants.

In each of the aforementioned transactions, it is anticipated that Petitioner, the regulated utility, will sell all of its electric generating assets, except for its nuclear unit, Indian Point No. 2. All of the proceeds from the sales will be paid to Petitioner, the regulated utility. Once Petitioner receives the cash, it may distribute all or part of the money to CEI, its parent holding company.

Discussion

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 was 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

---

[4] In this Opinion, the PSC also approved, subject to certain conditions, a rate settlement agreement that established steam rates for Petitioner for the three year period ending September 30, 2000. Cases 96-S-1065 and 96-S-1121, Opinion and Order Adopting Terms of Settlement Agreement Subject to Conditions, issued September 25, 1997.

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.

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 of the Tax Law "[a] dividend on corporate stock implies a division or distribution of corporate profits." In that case, the Court held that the transfer of a portion of earned surplus to its non-par capital stock account, pursuant to a resolution of its board of directors, was not a distribution of dividends for tax purposes. Neither money nor property nor stock dividend went into the hands of stockholders. No stockholder acquired a right to receive any equivalent of the amount transferred unless further corporate action was taken.

Petitioner is one of several utilities in New York State being compelled by the PSC to reorganize their corporate structure and sell off some of their business to unrelated third parties pursuant to the PSC's Competitive Opportunities Proceeding and the PSC's policy objectives set forth in the Order (Opinion No. 96-12). With respect to such mandated restructuring and divestiture, the Commissioner of Taxation and Finance has issued an advisory opinion to Central Hudson Gas & Electric Corporation, Adv Op Comm T&F, July 29, 1998, TSB-A-98(12)C. (See also, Long Island Lighting Company, Adv Op Comm T&F, February 27, 1998, TSB-A-98(3)C ("LILCO-II") and New York State Electric & Gas Corporation, Adv Op Comm T&F, July 29, 1998, TSB-A-98(11)C.) The Central Hudson, supra, advisory opinion, reached several conclusions, including the following:

1. The sale of electric generation assets pursuant to the auction process, implementing the petitioner's restructuring agreement that was confirmed by a PSC order, does not represent the employment of capital, and that the consideration received by the petitioner for the generation assets does not constitute "gross earnings" taxable under section 186 of the Tax Law.

2. Petitioner's distribution to Holdco, directly after the Share Exchange, of all of the common stock of the corporations included in the Existing Subsidiaries Spin-Off and any Genco Spin-Off, is 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 policy objectives set forth in the Order (Opinion No. 96-12), and implemented under the restructuring plan described in the Restated Settlement Agreement dated January 2, 1998 and modified February 26, 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 under section 186 of the Tax Law. The opinion held further that the answer would not change if Petitioner invests up to $100 million of equity in the Existing Subsidiaries prior to the Share Exchange and the Existing Subsidiaries Spin-Off.

Conclusions

Issue 1. The sale of the generating assets and other property representing the other potential generating sites, including Astoria, Hellgate, Kent Avenue and Sherman Creek, pursuant to the auction process 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 policy objectives set forth in the Generic Order (Opinion No. 96-12), and implemented under Petitioner's Order dated September 19, 1997 and confirmed by the PSC in Opinion No. 97-16, issued November 3, 1997, and in accordance with the Divestiture Plan, Order issued and effective July 21, 1998, modified by Order issued and effective August 5, 1998, and confirmed by the full PSC by Confirming Order, issued and effective August 19, 1998. Through this series of transactions, Petitioner is to divest itself of all of its in-city electric generating fossil-fueled capacity to third parties and excess property that is available for the purpose of constructing new generating facilities, its two-third interest in the Bowline Point Generating Station and its 40 percent share of the Roseton Generating Station via auction. Like Con Ed, supra, and Central Hudson, 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 and auction its assets. Therefore, the amounts received by Petitioner for these assets as a result of the auction process are not receipts from the employment of capital, and do not constitute "gross earnings". Accordingly, the amounts received from the divestiture of these generating assets and potential generating sites pursuant to the Order are not taxable under the gross earnings tax imposed by section 186 of the Tax Law.

With respect to the Steam Plan, if the auction of the Waterside and East River steam-electric plants is conducted pursuant to an Order of the PSC approving and confirming Petitioner's proposed divestiture plan for its electric/steam generating stations in compliance with Opinion 97-15, the amounts received by Petitioner for these electric/steam generating stations as a result of the auction process would not be receipts from the employment of capital, and would not constitute "gross earnings". Accordingly, the amounts received from the divestiture of the these generating assets pursuant to the PSC's Order approving and confirming Petitioner' s proposed Steam Plan would not be taxable under the gross earnings tax imposed by section 186 of the Tax Law.

Issue 2. The distribution of the proceeds from the sale of the generating assets and other property representing the other potential generating sites, including Astoria, Hellgate, Kent Avenue and Sherman Creek, from Petitioner to CEI 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 policy objectives set forth in the Generic Order (Opinion No. 96-12), and implemented under Petitioner's Order dated September 19, 1997 and confirmed by the PSC in Opinion No 97-16, issued

November 3, 1997, and in accordance with the Divestiture Plan, Order issued and effective July 21, 1998, modified by Order issued and effective August 5, 1998, and confirmed by the full PSC by Confirming Order, issued and effective August 19, 1998. Through this series of transactions, Petitioner is reorganized into the holding company structure and is divesting itself of its generation assets and other potential generating sites. Such distribution of the auction proceeds does not represent a distribution of the profits of Petitioner as contemplated in Adams Electric, supra. Accordingly, the distribution of the proceeds from the sale, at auction, of the generating assets and other property representing the other potential generating sites, would not be distributions treated as dividends subject to the Excess Dividends Tax under section 186 of the Tax Law.

With respect to the Steam Plan, if the distribution of the proceeds from the Waterside and East River steam-electric plants is a transaction that is part of a series of transactions being entered into by Petitioner pursuant to an Order of the PSC approving and confirming Petitioner's proposed divestiture plan for its electric/steam generating stations in compliance with Opinion 97-15, whereby Petitioner is reorganized into the holding company structure and is divesting itself of these electric/steam generating stations, such transaction would not represent a distribution of the profits of Petitioner as contemplated in Adams Electric, supra. Accordingly, the distribution of the proceeds from the sale, at auction, of the Waterside and East River steam-electric plants, would not be distributions treated as dividends subject to the Excess Dividends Tax under section 186 of the Tax Law.

DATED: January 22, 1999

/s/
John W. Bartlett
Deputy Director
Technical Services Bureau

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