

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

TSB-A-99(8)C
Corporation Tax
January 27, 1999

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. C981027C

On October 27, 1998, a Petition for Advisory Opinion was received from Rochester Gas and Electric Corporation, 89 East Avenue, Rochester, New York 14649.

The issues raised by Petitioner, Rochester Gas and Electric Corporation, 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:** Will Petitioner's transfer of the stock of Energetix and RGS to Holding Company prior to the binding share exchange trigger "gross earnings" under section 186 of the Tax Law?
- Question 2:** Will Petitioner's transfer of the stock of Energetix and RGS to Holding Company prior to the binding share exchange trigger "gross income" under section 186-a of the Tax Law?
- Question 3:** Will Petitioner's transfer of the stock of Energetix and RGS to Holding Company and the subsequent binding share exchange result in a "dividend" subject to the tax on excess dividends ("Excess Dividends Tax") pursuant to 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 that supplies utility services in western New York. Its principal offices are located in Rochester, New York and its common stock is publicly traded. Moreover, Petitioner is subject to taxes under sections 186 and 186-a of the Tax Law.

Under a proposed reorganization that is expected to take effect in the spring of 1999, Petitioner will become a subsidiary of Holding Company ("Holding Company"). Pursuant to the proposed reorganization, the following steps will occur:

1. Petitioner will create Holding Company as a first tier, wholly owned subsidiary.

TSB-A-99(8)C
Corporation Tax
January 27, 1999

2. Before the binding share exchange described below, Petitioner will contribute the stock of certain unregulated subsidiaries to Holding Company so that after the binding share exchange such companies will be first tier subsidiaries of Holding Company.

3. In accordance with a plan of share exchange adopted pursuant to section 913 of the Business Corporation Law and subject to shareholder approval, each share of Petitioner's common stock immediately prior to the effective time of the reorganization will be exchanged for one share of Holding Company common stock.

4. As a result of the binding share exchange, Holding Company will own 100 percent of Petitioner's common stock. The current preferred shareholders of Petitioner will remain preferred shareholders of Petitioner after the exchange.

After the binding share exchange, Holding Company will become a publicly traded company and will be subject to taxation under Article 9-A of the Tax Law. Petitioner states that before and after the reorganization, Petitioner will be taxed under Article 9 of the Tax Law.

Petitioner is engaging in the proposed reorganization in response to the Public Service Commission's ("PSC") direction to restructure the electric utility industry in New York State. In 1994, the PSC commenced hearings to explore restructuring the electric utility industry to encourage competition and permit customers to choose their electricity providers. In PSC Opinion and Order Regarding Competitive Opportunities for Electric Service, Opinion No. 96-12, issued May 20, 1996, the PSC enunciated its desire to bring New York consumers the innovations and efficiencies of competitive markets, together with economic development, lower electric prices and greater consumer choice, while, at the same time, maintaining the safety and reliability of electric service. In furtherance of this stated goal, the PSC required Petitioner, along with other utilities, to file plans to create a competitive electricity market in New York State¹.

In response to Opinion No. 96-12, Petitioner submitted its plan on October 1, 1996, and the PSC instituted Case 96-E-0898 for the purpose of examining Petitioner's submission. The Initial Settlement Agreement was filed on April 8, 1997, and after revisions, an Amended and Restated

¹ Additionally, the Federal Energy Regulatory Commission ("FERC") issued Order No. 636, in 1992, and Order No. 888, in 1996. Among other things, Order 636 mandates the unbundling of interstate pipeline sales service and establishes certain open access transportation requirements. Order 888 requires public utilities controlling transmission facilities to open the wholesale electricity market to increased competition by filing non-discriminatory open access transmission tariffs. In early 1997, Petitioner and the other New York State electric utilities made such a filing with the FERC.

TSB-A-99(8)C
Corporation Tax
January 27, 1999

Settlement Agreement ("Revised Settlement") was reached on October 23, 1997 by Petitioner, PSC staff, Multiple Intervenors, Joint Supporters, and the National Association of Energy Service Companies. The Revised Settlement was revised by the PSC's Opinion and Order Adopting Terms of Settlement Subject to Conditions and Changes, Opinion No. 98-1 ("Order"), issued and effective January 14, 1998. The Order requires Petitioner to functionally separate its three regulated operations: distribution, generation and retailing. Additionally, any unregulated operations must be structurally separate from the regulated utility functions.

The holding company structure is responsive to the PSC's directive in the Order to promote competition in the utility industry, while at the same time protecting Petitioner's customers and the regulated businesses from the risks inherent in operating competitive businesses. This is accomplished by establishing Petitioner, which will operate the regulated businesses, as a direct subsidiary of Holding Company. Current and future unregulated businesses will operate in companies that are subsidiaries of Holding Company. This corporate structure will protect the regulated businesses from the risks inherent in the Holding Company's competitive businesses.

The two unregulated subsidiaries that Petitioner will contribute to Holding Company prior to the binding share exchange are Energetix Inc. ("Energetix") and RGS Development Corporation ("RGS"). Energetix is an unregulated subsidiary that will bring energy products and services to the market place both within and outside Petitioner's regulated franchise territory. Energetix intends to market electricity, natural gas, oil and propane fuel energy services in an area extending in a 150-mile radius around Rochester. In furtherance of this goal, Energetix recently acquired Griffith Oil Co., Inc. ("Griffith"), the second largest oil and propane distribution company in New York State. In addition to its current products, Griffith will sell electricity, natural gas and other services offered by Energetix to its existing customers. During the second quarter of 1998, Petitioner formed a new unregulated subsidiary, RGS. RGS was formed to pursue unregulated business opportunities in the energy marketplace. It is expected that Petitioner's basis in Energetix and RGS will equal or exceed the fair market value of Energetix and RGS on the date of transfer.

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.

TSB-A-99(8)C
Corporation Tax
January 27, 1999

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 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 PSC 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") 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:

TSB-A-99(8)C
Corporation Tax
January 27, 1999

1. The Existing Subsidiaries Spin-Off or any Genco Spin-Off 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 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. Directly after the Share Exchange, Petitioner will distribute to Holdco all of the common stock of wholly-owned subsidiaries. Like Con Ed, supra, and LILCO, supra, Petitioner does not employ its capital within the meaning of section 186 of the Tax Law for the purpose of restructuring its organization, therefore, these transactions will not generate any "gross earnings" for Petitioner.

With respect to the excise tax imposed under section 186-a of the Tax Law, Petitioner will realize "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 common stock of each of the subsidiaries exceeds Petitioner's book value of the common stock.

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 PSC's Opinion No. 96-12, and implemented under Petitioner's restructuring plan 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.

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.

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

TSB-A-99(8)C
Corporation Tax
January 27, 1999

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.

In this case, Petitioner's transfer of the stock of Energetix and RGS to Holding Company prior to the binding share exchange 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 PSC's Opinion No. 96-12, and implemented under the restructuring plan described in the Initial Settlement Agreement filed April 8, 1997, as amended and restated in the Revised Settlement dated October 23, 1997, as revised by the PSC's Order, Opinion No. 98-1 (Case 96-E-0898) issued and effective January 14, 1998, whereby Petitioner is reorganized into the holding company structure and divests itself of its unregulated operations to separate those operations from its regulated utility functions.

With respect to **Question 1**, 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. Accordingly, the transfer of the stock of Energetix and RGS to Holding Company without receiving any consideration in exchange for such stock, pursuant to the Order, would not result in "receipts from the employment of capital" and there will not be any gross earnings from such transaction under section 186 of the Tax Law.

With respect to **Question 2**, Petitioner would realize "gross income" under section 186-a of the Tax Law, to the extent that a profit is realized from the transfer of the stock of Energetix and RGS to Holding Company pursuant to the Order. The profit, if any, would equal the amount that the fair market value of the stock of each subsidiary, Energetix and RGS, exceeds Petitioner's book value of the stock. Petitioner states that it is expected that its basis in these subsidiaries will equal or exceed the fair market value of the subsidiaries on the date of transfer. If this is indeed the case, then Petitioner will not realize any "gross income" under section 186-a of the Tax Law.

TSB-A-99(8)C
Corporation Tax
January 27, 1999

With respect to **Question 3**, Petitioner's transfer of the stock of Energetix and RGS to Holding Company prior to the binding share exchange, pursuant to the Order, does not represent a distribution of the profits of Petitioner as contemplated in Adams Electric, supra. Accordingly, such transaction would not be treated as a dividend subject to the Excess Dividends Tax under section 186 of the Tax Law.

DATED: January 27, 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.