New York State Department of Taxation and Finance
Office of Counsel
Advisory Opinion Unit

TSB-A-12(4)C
Corporation Tax
TSB-A-12(7)S
Sales Tax
April 13, 2012

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. Z111025A

The Department of Taxation and Finance received a Petition for Advisory Opinion from [redacted]. Petitioner asks about the corporation tax and sales and use tax implications of the establishment by Petitioner of a "central counterparty" structure, pursuant to which Petitioner will become a party to all transactions consummated through the electricity markets administered by Petitioner (described more fully below), in accordance with orders of the Federal Energy Regulatory Commission (FERC). We conclude that Petitioner's establishment of the central counterparty structure will not cause Petitioner to be subject to the corporate franchise taxes imposed under Article 9 or 9-A of the Tax Law or cause Petitioner to lose its exempt organization status for sales tax purposes. We further conclude that Petitioner's sales tax compliance procedure of only making sales to persons from whom it receives, in good faith, an exemption document, as described herein, is consistent with its duties as a vendor for sales tax purposes, assuming it retains copies of those exemption documents as required by the Tax Law.

Facts

Petitioner is a New York not-for-profit corporation, which maintains a place of business in New York. Petitioner is an Independent System Operator (described below), and annually files an IRS Form 990, Return of Organization Exempt from Income Tax, to report on its organization and operations. Petitioner is registered for sales tax purposes under Tax Law § 1134.

Overview of ISOs Generally

Independent System Operators ("ISOs") play a central role in the reliability and efficiency of electric power transmission and distribution in major areas of the United States. Historically, the electric power industry was dominated by large, vertically-integrated utilities that owned and controlled the generation, transmission and distribution systems for their respective service areas. Changes in energy and regulatory policy and technology encouraged the development of non-utility generators that often produced electricity more efficiently than that produced by traditional vertically-integrated utilities' older plants. Federal legislation, such as the Public Utility Regulatory Policies Act of 1978, encouraged alternative supply resources and reduced the nation's reliance on traditional vertically-integrated electric utilities. The Energy Policy Act of 1992 mandated that bulk power transmission owners allow other parties to use their electricity grids upon request, and essentially gave FERC the authority to fulfill this mandate. Although this legislation increased access to the grid, transmission customers argued that they still often failed to receive the same service enjoyed by transmission owners' affiliated or related generating entities.

To address these issues, on April 24, 1996, FERC issued Order Nos. 888[1] and 889[2], which enunciated key "open access" principles providing that all transmission users should receive the same level of service and access to transmission systems enjoyed by transmission owners, and requiring that transmission providers uniformly provide timely information regarding transmission capacity, ancillary services and processes. Order No. 888 also specifically encouraged the development of ISOs as a means to facilitate non-discriminatory access to transmission by placing operational control in the hands of an independent entity with no self-interest, financial or otherwise, in administering the open access tariff and operating the transmission grid. In accordance with FERC's vision, an ISO was intended to be responsible within a specific geographic area for overseeing the operation of transmission facilities, administering a tariff for all market participants, and maintaining system reliability.

A. Petitioner's History

Petitioner was incorporated in New York on April 10, 1997. On February 4, 2000, the IRS determined that Petitioner was exempt from Federal income tax under Code section 501(a) as an organization described in Code section 501(c)(3). The Department of Taxation and Finance has previously determined that Petitioner's operations do not constitute a business taxable under (1) former Section 186 of Article 9 of the Tax Law; (2) Section 186-a of Article 9 of the Tax Law; or (3) Article 9-A of the Tax Law. The Department has granted Petitioner an exempt organization certificate under section 1116(a)(4) of the Tax Law.

Petitioner's exempt purpose is to lessen the burdens of government by (i) administering, and ensuring the efficient use and reliable operation of, the New York State bulk power system ("NYS Power System"), (ii) providing open access to the New York State electricity transmission system ("NYS Transmission System"), (iii) overseeing the State's wholesale electricity marketplace, and (iv) managing a comprehensive NYS Power System planning process.

In 1998, Petitioner was conditionally recognized by FERC as the ISO for New York State (the "State"). On December 1, 1999, Petitioner assumed full responsibility for the operation of the NYS Power System. As the ISO, Petitioner serves as the independent, federally-regulated entity responsible for coordinating electric transmission in a non-discriminatory manner and ensuring the safety and reliability of the NYS Power System.

Petitioner is also responsible for providing independent, open and fair access to the NYS Transmission System, facilitating market-based wholesale electricity rates, and ensuring effective and

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[1] *"Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities,"* Order No. 888, FERC Stats. & Regs. ¶ 31,036 (1996), *order on reh'g,* Order No. 888-A, FERC Stats. & Regs. ¶ 31,048, *order on reh'g,* Order No. 888-B, 81 FERC ¶ 61,248 (1997), *order on reh'g,* Order No. 888-C, 82 FERC ¶ 61,046 (1998), *aff'd in relevant part sub nom. Transmission Access Policy Study Group v. FERC,* 225 F.3d 667 (D.C. Cir. 2000), *aff'd sub nom. New York v. FERC,* 535 U.S. 1 (2002) ("Order No. 888"), available at http://www.ferc.gov/legal/maj-ord-reg/land-docs/order 888.asp.

[2] *"Open Access Same-Time Information System (formerly Real-Time Information Networks) and Standards of Conduct,"* Order No. 889, FERC Stats. & Regs. ¶ 31,035 (1996), *order on reh'g,* Order No. 889-A, FERC Stats. & Regs. ¶ 31,049, *reh'g denied,* Order No. 889-B, 81 FERC ¶ 61,253 (1997) ("Order No. 889"), available at http://www.ferc.gov/legal/maj-ord-reg/land-docs/rm95-9-00K.txt.

reliable management and operation of the NYS Power System, which serves approximately 19.2 million customers.[3] Petitioner manages competitive markets for the purchase and sale of electricity and electricity-related products and services for the State. The rules and procedures for the electricity markets administered by Petitioner are set forth in its Open Access Transmission Tariff and Market Administration and Control Area Services Tariff (collectively, "NYISO Tariffs"), which are approved by, and subject to the regulation of, FERC.

Petitioner's current primary source of revenue is the collection of fees from users of the NYS Power System and from participants in the markets administered by Petitioner. The collection of such fees is provided for in the NYISO Tariffs. The fees set forth in the NYISO Tariffs are intended to permit Petitioner to recover its operating and capital costs. The fees charged are proportional to the level of use of, or amount and type of transactions entered into by, the respective user or market participant.

Currently, Petitioner is not a party to any transaction consummated through the markets administered by Petitioner, and Petitioner does not take title to the electric energy or electricity-related products or services bought or sold through the markets it administers. Moreover, the gross proceeds of transactions consummated through the markets administered by Petitioner are not reported as revenue on Petitioner's Form 990. Instead, the FERC-approved tariff fees arising from such transactions are reported on Petitioner's Form 990, as program service revenue.

B. <u>Petitioner's Administration of the Markets</u>

A variety of contracts, agreements and transactions (collectively referred to here as "transactions") for the purchase and sale of electricity (including generation, demand response or virtual bids/transactions) and electricity-related products and services (*e.g.*, transmission congestion contracts and ancillary services such as regulation service, voltage support and Black Start capability) is offered in the markets administered by Petitioner under its FERC-approved tariff. Each transaction is directly related to, and a logical outgrowth of, Petitioner's function as an ISO. These transactions are generally not structured as direct bilateral contracts, i.e. individual purchase and sale contracts between a particular seller and a particular purchaser. Rather, the transactions are generally entered into through a central market administered by Petitioner using an auction system. Under this auction system, Petitioner accepts offers and bids to supply and purchase electricity or other electricity-related rights. Although Petitioner examines all individual offers and bids in the market for, among other things, compliance with Petitioner's credit requirements and other terms and conditions of its tariffs, Petitioner clears market supply against market demand at an aggregate level, without matching specific offers and bids. Thus, market rights and obligations, and associated credits and charges, are assigned to individual buyers and sellers without matching them to specific counterparties.

Petitioner then settles the positions of the market participants, making payments to some and collecting payments from others. In the event a market participant were to default on its obligations incurred through this system, Petitioner's Tariffs permit it to recover the defaulted amount from all other market participants, after the application of collateral and working capital funds. The transactions entered into in Petitioner's markets have been, and are, subject to a long-standing,

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[3] Id.

comprehensive regulatory framework established by FERC pursuant to Part II of the Federal Power Act.[4] The regulatory framework is established by FERC through the adoption of broad principles that the individual ISOs must meet.

C. Petitioner's Credit Practices and FERC Order No. 741

FERC has determined that "clear and consistent credit policies are an important element in ensuring rates that are just, reasonable, and not unduly discriminatory or preferential. The management of risk and credit requires a balance between protecting the markets from costly defaults and ensuring that barriers to entry for market participants are not prohibitive."[5] In accordance with FERC requirements, as part of the NYISO Tariffs, Petitioner has established credit practices with respect to the markets it administers, which credit practices have been filed with, and approved by, FERC.

The recent economic downturn and turmoil in the financial markets caused FERC to re-evaluate the energy market credit policies administered by ISOs. In 2009, FERC raised a question about the ability of an ISO, in the event of the bankruptcy of a market participant, to set off or net the market positions of the bankrupt market participant. Specifically, the concern was that an ISO might not satisfy the "mutuality requirement" to permit setoff when the obligations are based upon different purchase and sale transactions because one could assert that the ISO is not a true counterparty to the bankrupt market participant in the transactions (*i.e.*, the ability of the ISO to offset the revenues realized by the bankrupt market participant in connection with a sale transaction against the expense realized by the bankrupt market participant in connection with a purchase transaction in the same or different market administered by the ISO). This concern arises not only in connection with market participants' purchase and sale of electric energy, but also in connection with market participants' purchase and sale of related products and services. Most of the dollar volume of transactions in markets administered by Petitioner involves market participants that rely on netting to reduce their collateral requirements. Although Petitioner maintains that applicable law permits netting of the market positions of a bankrupt market participant, FERC is concerned that a United States Bankruptcy Court could disagree, leaving the market to absorb the losses to the detriment of the rate-paying public.

To address its concerns about the lack of standardized credit practices in the electric markets and mutualized default risk, in January of 2010, FERC issued a notice of proposed rulemaking (the "NOPR") in which it proposed seven reforms related to the administration of credit in the organized electric markets, including the following:

> Clarification of the status of the ISO/RTO as a party to each transaction so as to eliminate any ambiguity or question as to their ability to net and manage defaults through the offset of market obligations.[6]

That proposed reform seeks clarification of Petitioner's status as a party to each transaction so as to mitigate any ambiguity or question as to its ability to net and manage defaults through the

[4] 16 U.S.C. §824 et seq. (2011).

[5] Order No. 741-A at ¶ 2. FERC previously provided guidance to the industry on appropriate credit policies in Order No. 888 and the *Policy Statement on Electric Creditworthiness*, 109 FERC ¶ 61,186 (2004).

[6] *Credit Reforms in the Organized Wholesale Electric Markets*, Notice of Proposed Rulemaking, 75 Fed. Reg. 4310 (2010)(NOPR) at ¶¶ 15, 19, 23, 26, 27, 29 and 31.

offsetting of market positions. To implement this reform, Petitioner would amend its Tariffs to provide that it would take title for an instant to all electric energy and related products and services that are sold or traded in the markets Petitioner administers, thereby acting as a central counterparty to all transactions consummated through those markets. By clearly establishing itself as a central counterparty to all transactions in the markets that it administers, Petitioner can more readily demonstrate that it satisfies the "mutuality" requirement for netting a market participant's accounts payable and accounts receivable in the event that the market participant files for protection in a bankruptcy proceeding.[7] Protecting Petitioner's netting rights is important because it avoids a scenario in which the bankrupt market participant might be entitled to receive its gross amounts owed without allowing Petitioner first to net out any countervailing payment obligations.

There are a number of ways a market participant could have both payables and receivables with Petitioner. A market participant that is a traditional vertically-integrated utility could also own generating resources, in which case the market participant would receive credits for the electric energy it supplied and would owe charges for electric energy it purchased from the market to serve its load. Or, a market participant that owes the NYISO for its virtual participation could receive credits for congestion rents from financial transmission rights held by the market participant.

By way of a simple example, if Energy Co. is credited $5 for its sale of electric energy, and if Energy Co. owes $3 for its virtual participation, then Petitioner's tariff directs Petitioner to pay Energy Co. just the net amount of $2. If Energy Co. filed for bankruptcy protection and the bankruptcy court did not allow Petitioner to exercise its right to net through set off, then the court might rule that Energy Co. is entitled to receive cash payment for the full $5 without deducting the $3 that Energy Co. owes for its purchases.[8]

Continuing with this example, Petitioner would hold an unsecured claim with respect to the $3 that Energy Co. owes. If the distribution to unsecured creditors in Energy Co.'s bankruptcy proceeding were fifteen cents on the dollar, Petitioner would receive only $0.45 on its $3 unsecured claim. This means the net payment to Energy Co. would be $4.55 in the absence of its right to exercise setoff versus $2 with such right, with the loss falling on other market participants.

Based on these concerns, FERC directed each ISO to submit a compliance filing with tariff revisions that included, as one of several potential options to address the bankruptcy risks, the establishment of a central counterparty structure. Petitioner determined that it will pursue tariff amendments proposing the implementation of the FERC-preferred option to establish itself as a central counterparty to all transactions consummated through the markets it administers, but only if the Department of Taxation and Finance provides a favorable advisory opinion, and the IRS provides a favorable ruling, with respect to the issues presented herein.

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[7] 11 U.S.C. § 553. A creditor may assert a right of setoff under Section 553 if the following conditions are met: "(1) the creditor holds a 'claim' against the debtor that arose before the commencement of the case, (2) the creditor owes a 'debt' to the debtor that also arose before the commencement of the case, (3) the claim and debt are 'mutual;' and (4) the claim and debt are each valid and enforceable." 5 *Collier on Bankruptcy* ¶ 553.03 (15th ed. 2008).

[8] This example assumes Energy Co. would not have posted collateral with Petitioner to cover amounts owed.

As a result of the planned implementation of reforms required by Order No. 741, Petitioner will take title to the subject matter of the transactions entered into in such markets. Petitioner anticipates that becoming the central counterparty to market transactions consummated through the markets administered by Petitioner will have no impact on Petitioner's day-to-day operations and will not affect market clearing prices for electric energy and related products and services. Implementing this change will not impact Petitioner's day-to-day operations.

D. Petitioner's Anticipated Accounting Treatment

Petitioner's independent public accounting firm has indicated that under a "central counterparty" structure pursuant to which Petitioner becomes a party to all transactions consummated in the markets administered by Petitioner, the gross proceeds of market transactions in which Petitioner is treated as the seller will not be required to be reported as revenue on Petitioner's financial statements and that the costs of market transactions in which Petitioner is treated as the buyer will not be required to be reported as expenses on Petitioner's financial statements. The "revenues" and "expenses" reported should be a wash in any event and will not result in any net profit accruing to Petitioner.

Except for electric energy and related products or services purchased to support operation of Petitioner's own physical facilities, Petitioner will not purchase, sell or take physical delivery of electric energy or related products or services for its own ultimate account.

E. Petitioner's IRS Private Letter Ruling

Petitioner has received a private letter ruling from the IRS stating that the establishment of a central counterparty structure pursuant to which Petitioner will become the central counterparty to transactions consummated through the markets administered by Petitioner, in accordance with FERC Order Numbers 741 and 741-A, will not adversely affect Petitioner's status as a tax exempt organization as described in Code Section 501(c)(3).

Analysis

Articles 9 and 9-A

Leaving aside its tax on telecommunication carriers, section 186-a currently only imposes tax on those utilities that are subject to the supervision of the Public Service Commission (PSC) and that engage in "the transmission, transportation or distribution of gas or electricity by means of conduits, mains, pipes, wires, lines or the like." Here, even assuming Petitioner is subject to the supervision of the PSC, which is not clear, it would not be subject to section 186-a tax. Even after adopting the central counterparty structure in its capacity as operator of the New York State Power System, Petitioner is not engaging in the "transmission, transportation or distribution" of "electricity," because that function is carried on by the carriers for whom Petitioner performs its services.

Even after adopting the central counterparty structure, Petitioner would be exempt from Article 9-A tax. 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 1-3.4(b)(6) of the Business Corporation Franchise Tax Regulations ("Article 9-A Regulations") provides an exemption for:

> corporations organized other than for profit which do not have stock or shares or certificates for stock or for shares and which are operated on a nonprofit basis no part of the net earnings of which inures to the benefit of any officer, director, or member, including Not-for -Profit Corporations and Religious Corporations.
>
> (i) A corporation organized other than for profit, as described in this paragraph, which is exempt from Federal income taxation pursuant to subsection (a) of section 501 of the Internal Revenue Code, will be presumed to be exempt from tax under article 9-A.
>
> (ii) The determination of the Internal Revenue Service, denying or revoking exemption from Federal taxation under the Internal Revenue Code, will ordinarily be followed.

In light of Petitioner's receipt of the Private Letter Ruling holding that Petitioner continues to qualify as a corporation that is exempt from federal income under section 501(c)(3) of the IRC, Petitioner is presumed to be exempt from taxation under Article 9-A of the Tax Law pursuant to the above regulation.

<u>Sales and Use Taxes</u>

Section 1105(b) of the Tax Law imposes state and local sales and use tax on the receipts from every sale, other than sales for resale, of electricity and electric service of whatever nature. "Sale" is defined in section 1101(b)(5) as any transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume . . . for a consideration, or any agreement therefore, including the rendering of any service, taxable under this article, for a consideration or any agreement therefor." The persons required to collect the tax include every "vendor" of taxable services (*see* Tax Law § 1131[1]). The term "vendor" includes a "person maintaining a place of business in the state and making sales, whether at such place of business or elsewhere, to persons within the state of tangible personal property or services, the use of which is taxed by this article" (Tax Law § 1101[b][8][i][B]). Petitioner has a place of business in New York. Thus, it will qualify as a "vendor" and must collect tax if it is the seller of services taxable under section 1105(b). Under Petitioner's adoption of the central counterparty structure in the wholesale markets for electric energy and related products that it administers, Petitioner takes title to the electricity for an instant prior to title transferring to the customer. Under this structure, Petitioner is the party that is making the sale (*see* Tax Law § 1101[b][5]). Accordingly, it qualifies as a vendor in regard to those transactions.

Petitioner asserts that its practice has been to only make sales in regard to which it is not required to collect sales and use tax and that, therefore, it follows a procedure of only making sales to persons from whom it, in good faith, timely receives one of the following documents: (1) a Resale Certificate (Form ST-120); (2) an exempt organization exempt purchase certificate (Form ST-119.1); (3) an Exempt Use Certificate (Form ST-121); (4) a Direct Payment Permit (AU-297); or (5) in the case of a governmental entity purchaser, a governmental purchase order. Petitioner's receipt, in good faith, of any of the listed documents within 90 days of the furnishing of the service would relieve it from the obligation to collect sales and use tax in regard to that sale (*see* Tax Law § 1132[c][1]; 20 NYCRR § 532.4[c]). Accordingly, Petitioner's adoption of a central counterparty structure, as described herein, does not necessitate any change in the sales tax compliance procedure described above, assuming that Petitioner maintains copies of those documents in its records as required by Tax Law section 1135 and section 533.2 of the Department's regulations (20 NYCRR § 533.2).

Petitioner's adoption of central counterparty structure will not change its status as an exempt organization under Tax Law § 1116(a)(4). Petitioner continues to be organized and operated exclusively for charitable purposes, as it lessens the burdens of government by administering the market-based regulation of the wholesale electricity market. Adoption of the central counterparty structure was encouraged by FERC as a means of lessening Petitioner's credit risk in the event of a bankruptcy of a participant in Petitioner's markets and does not result in any net profit for Petitioner. This is evidenced by the private letter ruling received by Petitioner that confirms that implementation of the central counterparty structure will not change Petitioner's exempt status under IRC section 501(c)(3). As an exempt organization, Petitioner's purchases of taxable tangible personal property and services will continue to be exempt (*see* Tax Law § 1116[a][4]).

DATED: April 13, 2012

/S/
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Deputy Counsel

NOTE: An Advisory Opinion is issued at the request of a person or entity. It is limited to the facts set forth therein and is binding on the Department only with respect to the person or entity to whom it is issued and only if the person or entity fully and accurately describes all relevant facts. An Advisory Opinion is based on the law, regulations, and Department policies in effect as of the date the Opinion is issued or for the specific time period at issue in the Opinion. The information provided in this document does not cover every situation and is not intended to replace the law or change its meaning.