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

TSB-A-98(2)R
Real Estate Transfer Tax
TSB-A-98(12)C
Corporation Tax
TSB-A-98(2)M
Petroleum Business Tax
Stock Transfer Tax
July 29, 1998

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. Z980128C

On January 28, 1998, a Petition for Advisory Opinion was received from Central Hudson Gas & Electric Corporation, 284 South Avenue, Poughkeepsie, New York 12601-4879. Additional information related to the Petition was received on March 17, 1998.

The issues raised by Petitioner, Central Hudson Gas & Electric Corporation, contain several questions pertaining to the tax ramifications resulting from the proposed corporate restructuring of Petitioner under the New York Public Service Commission's Competitive Opportunities Proceeding. The issues are:

Issue A: New York State Real Estate Transfer Tax
Issue B: Sections 186 and 186-a — Spin-Offs and Generation Assets
Issue C: Genco Operations
Issue D: Subsidiary Capital Tax Under Article 9-A of the Tax Law
Issue E: Stock Transfer Tax Under Article 12 of the Tax Law

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

Background Facts

Petitioner is a combination gas and electric utility engaged principally in the generation, transmission, distribution and sale of electric energy and the sale, transportation and distribution of natural gas in the Hudson River Valley area of New York. Petitioner provides electricity to more than 261,000 customers and natural gas to more than 59,000 customers. Petitioner's wholesale rates and services are regulated by the Federal Energy Regulatory Commission ("FERC") and its retail rates and services are regulated by the New York Public Service Commission ("PSC").

Petitioner is one of several utilities in New York State that are restructuring their corporate organizations and possibly selling off some of their business enterprises to unrelated third parties in order to make their businesses more competitive and to bring down electric rates paid by customers.

Petitioner's proposed restructuring, described below, is in response to the Competitive Opportunities Proceeding instituted in 1994 by the PSC in Case No. 94-E-0952 ("Competitive Opportunities Proceeding"), which endorsed a fundamental restructuring of the electric utility industry in New York State based on competition in the generation and energy services sectors of that industry. The PSC enunciated its policy objectives in an order (Opinion No. 96-12), issued May

20, 1996 ("Order"). The PSC's Order, among other things, required all the electric utilities subject to the Competitive Opportunities Proceeding to file a restructuring plan by October 1, 1996, which plan was required to address, among other things, the structure of the utility, both in the short and long term, a schedule for the introduction of retail access and a rate plan to be effective for a significant portion of the transition to retail access.

Under Petitioner's proceeding with the PSC (Case 96-E-0909), in furtherance of the Competitive Opportunities Proceeding and the Order, Petitioner, PSC Staff and certain other parties entered into a Settlement Agreement ("Settlement Agreement") on March 20, 1997 which provides for a transition to a competitive electric market and authorizes a corporate restructuring of Petitioner into a holding company structure. The PSC indicated that further negotiations were needed on certain issues, and after such negotiations, Petitioner, PSC Staff and certain other parties entered into An Amended and Restated Settlement Agreement ("Restated Settlement Agreement"), dated January 2, 1998. In the PSC's Order Adopting Terms of Settlement Subject to Modifications and Conditions, issued and effective February 19, 1998 modifying, approving and adopting the Restated Settlement Agreement, the PSC states that the Restated Settlement Agreement "generally offer[s] a sound regulatory framework for Central Hudson, its competitors, and its customers in the transition to fully competitive generation and energy service markets. . . ." The PSC also stated in this order that it was "requiring modifications and adding conditions" to the Restated Settlement Agreement. A conforming Modifications of Amended and Restated Settlement Agreement, dated February 26, 1998, was entered into by Petitioner, the PSC Staff and certain other parties and was filed with the PSC, which provides a written statement of unconditional acceptance of the modifications and conditions contained in the PSC's order issued February 19, 1998.

The modified Restated Settlement Agreement (as agreed on February 26, 1998), provides, among other things:

- Petitioner's nine percent interest in the Nine Mile 2 Plant is to remain with Petitioner with an agreement that Petitioner will participate in good faith consideration of any New York State nuclear solution;

- Functional unbundling of Petitioner's fossil generation in 1998, followed by structural separation by June 30, 2001;

- An auction of Petitioner's fossil-fueled generation will be completed by June 30, 2001; an auction plan is to be submitted to the PSC six months prior to such auction. However, the auction can be accelerated earlier on direction of the PSC if the PSC finds that it is in the public interest;

- An unregulated affiliate of Petitioner may bid in the auction;

- In the event Petitioner elects not to bid in the auction, Petitioner will retain 10 percent of the proceeds above such book value, subject to a $17.5 million cap; proceeds above book value not retained by Petitioner will be used to offset Petitioner's fossil-fueled generation related regulatory assets and its net investment in the Nine Mile 2 Plant;

- The target date for the formation of a holding company is January 1, 1999, but not later than June 30, 2001;

- Permission for Petitioner to transfer up to $100 million of equity from Petitioner to unregulated affiliates prior to the formation of the holding company;

- Upon approval of the Restated Settlement Agreement, Petitioner will withdraw from the Petitioner's lawsuit pending against the PSC to annul the PSC's Order (Opinion No. 96-12).

Proposed Restructuring

The modified Restated Settlement Agreement is expected to result in the following:

1. Holding Company and Spin-Offs. Pursuant to a corporate restructuring, Petitioner would be wholly-owned by a newly formed New York corporation ("Holdco"). The holding company structure would, subject to receipt of requisite regulatory approvals and favorable state and federal tax rulings, be established pursuant to a Plan of Exchange ("Plan of Exchange"). Under the Plan of Exchange, all outstanding shares of Petitioner's Common Stock ("CH Common Stock"), would be exchanged ("Share Exchange") on a share-for-share basis for Holdco Common Stock ("Holdco Common Stock"). The Share Exchange would be effected pursuant to section 913 of the New York Business Corporation Law ("BCL") by the filing of a Certificate of Exchange with the New York State Department of State. Upon consummation of the Share Exchange, each holder of CH Common Stock immediately prior to the Share Exchange would own a corresponding number of shares and percentage of the outstanding Holdco Common Stock, and Holdco would own all of the outstanding shares of CH Common Stock.

Directly after the Share Exchange, Petitioner would distribute ("Existing Subsidiaries Spin-Off") to Holdco all of the common stock of all but one of its current wholly-owned subsidiaries ("Existing Subsidiaries"), subject to receipt of favorable state and federal tax rulings. Central Hudson Enterprises Corporation ("CHEC") is the only active subsidiary of Petitioner with any substance. CHEC's common stock would be included in the Existing Subsidiaries Spin-Off (as such Spin-Off relates to CHEC, the "CHEC Spin-Off"). The proposed Plan of Exchange and the proposed restructured organization are both tentative and subject to changes as to final form.

The Share Exchange would not result in any change to the then outstanding preferred stock or debt securities of Petitioner, which would continue to be securities and obligations of Petitioner after the Share Exchange.

Prior to the Share Exchange and the Existing Subsidiaries Spin-Off, Petitioner will invest up to $100 million of equity into the Existing Subsidiaries.

Consummation of the Share Exchange and/or the subsequent implementing transactions would require certain approvals of FERC and the Nuclear Regulatory Commission ("NRC"), and perhaps the Securities and Exchange Commission ("SEC"), in addition to that of the PSC. Petitioner intends to file requisite documents and/or applications with the SEC, FERC and the NRC as soon as practicable.

The approval of Petitioner's Common Stock shareholders would be required to effect the transactions described herein. Petitioner would seek shareholder approval at a Special Meeting of Shareholders. Presently, such meeting is expected to be held in October 1998 and the Share Exchange and Existing Subsidiaries Spin-Off are expected to be effective on January 1, 1999. The separation of the Generation Assets, described in (2) below, would take place sometime between January 1, 1999 and July 1, 2001.

2. Genco/Petitioner

Giving effect to the steps in (1) above, Petitioner would be wholly-owned by Holdco and would continue to be engaged in the PSC/FERC regulated business of the generation, transmission and distribution of electricity, and the transmission and distribution of gas. Holdco and/or Petitioner may own one or more subsidiaries each which would own and operate only assets for the generation of electricity (any such subsidiary being herein called a "Genco").

Pursuant to the modified Restated Settlement Agreement, by July 1, 2001, the fossil-fueled electric generation assets ("CH Generation Assets") of Petitioner (together with related assets, obligations and liabilities) would be sold. As an alternative, such assets may be transferred to a Genco which would be spun off to Holdco, owned by Holdco for a transition period ("Transition Period"), and thereafter sold (either the CH Generation Assets or the subsidiary stock) by July 1, 2001. Any such sale would be made pursuant to an "auction process", set forth in Part VII of the Settlement Agreement (herein called the "Auction" or Auction Process"), and transfer of title must take place by July 1, 2001. An affiliated entity of Holdco, including a Genco, could be the successful bidder at such Auction.

The CH Generation Assets would include Petitioner's Danskammer Electric Generation Plant, located in Roseton, New York and Petitioner's 35 percent ownership interest in the Roseton Electric Generation Plant located in Roseton,

New York ("Roseton Plant") and owned as tenants-in-common by Petitioner, Niagara Mohawk Power Corporation and Consolidated Edison Company of New York, Inc. Petitioner's hydro-electric facilities, combustion turbines and its interest in Unit 2 of the Nine Mile Point Nuclear Station would continue to be owned by Petitioner.

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 of Form 1065. Petitioner submits that its 35 percent interest in the Roseton Plant ("Petitioner's Roseton Plant Interest") is a partnership interest for purposes of this advisory opinion.

As previously noted, during the Transition Period, the CH Generation Assets may first be transferred to a Genco in a tax-free exchange under section 351 of the IRC, and thereafter the stock ownership of that Genco would be distributed tax free to Holdco pursuant to section 355 of the IRC ("Genco Spin-Off"). The transfer to such a Genco of the CH Generation Assets would be in exchange for all of the outstanding common stock of that Genco ("Genco Common Stock").

Petitioner, after the transfer or sale of the CH Generation Assets, would continue to be in the business of generating, transmitting and distributing electricity and transmitting and distributing gas. Petitioner would also acquire electricity from various sources, including from one or more Gencos.

Prior to the Share Exchange, Petitioner also may form a Genco to acquire electric generation assets of other utilities ("Other Utility Generation Assets"). As part of the Existing Subsidiaries Spin-Off, such a Genco's Common Stock would be distributed to Holdco by Petitioner (also, a "Genco Spin-Off").

After the Share Exchange, Holdco may form other Gencos solely for the purpose of owning and operating other electric generation assets.

Each Genco would be in the business of generating and selling electricity principally in the wholesale market, either to Petitioner, third parties, or into a "power exchange" (which would establish visible spot market prices for wholesale electricity), but the Genco could also sell at retail to residential and/or industrial/commercial customers. Each Genco would not own or operate any transmission or distribution facilities. Each Genco would own and operate one or more "electric plants" as defined in section 2.12 of the Public Service Law, and would sell electricity for consumption in New York. Therefore, Petitioner states that each Genco would be an "electric corporation" under section 2.13 of the Public Service Law and would be subject to regulation by the PSC. Each

Genco's wholesale rates would be established under the jurisdiction of the FERC and retail rates would be subject to the jurisdiction of the PSC. A Genco would import gas into New York State for the generation of its electricity.

Petitioner expects to file a request for a private letter ruling with the Internal Revenue Service ("IRS"), in early 1998, requesting the following favorable rulings:

1. The Share Exchange would be tax free under section 351 of the IRC.

2. The CHEC Spin-Off would be tax free under section 355 of the IRC. Currently, Petitioner's only active subsidiary is CHEC. Without such favorable ruling, the IRS may consider that Petitioner had a taxable gain (under section 311(b) of the IRC) to the extent of the excess of the fair market value of CHEC stock over the adjusted basis of such stock in the hands of Petitioner. Because Holdco and Petitioner would be part of the same consolidated tax group, such gain generally would be deferred until such group or any of the spin-off companies were dissolved, a member left the group or the asset giving rise to the deferred gain were transferred to an unaffiliated third party. (See Treasury Regulations §1.1502-13(c))

Petitioner's plans with respect to the CH Generation Assets and/or the Other Utility Generation Assets, are not firm enough to be the subject of an IRS ruling request under section 355 of the IRC. However, the issues under section 355, as described above would be the same as for the CHEC Spin-Off. However, any Genco Spin-Off involving assets not owned by the Genco at least for five years prior to such Spin-Off, may not be exempt under section 355 of the IRC.

Issue A: New York State Real Estate Transfer Tax

Applicable Law

Section 1402 of the Tax Law imposes the real estate transfer tax on each conveyance of real property or interest therein when the consideration exceeds five hundred dollars. The term "conveyance" is defined in section 1401(e) of the Tax Law. Included in the definition of conveyance is the transfer or transfers of any interest in real property by any method, including the transfer or acquisition of a controlling interest in any entity with an interest in real property.

Subdivision (b) of section 1401 of the Tax Law provides:

(b) "Controlling interest" means (i) in the case of a corporation, either fifty percent or more of the total combined voting power of

> all classes of stock of such corporation, or fifty percent or more of the capital, profits or beneficial interest in such voting stock of such corporation, and (ii) in the case of a partnership, association, trust or other entity, fifty percent or more of the capital, profits or beneficial interest in such partnership, association, trust or other entity.
>
> Subdivision (f) of section 1401 of the Tax Law provides:
>
> (f) "Interest in the real property" includes title in fee, a leasehold interest, a beneficial interest, an encumbrance, development rights, air space and air rights, or any other interest with the right to use or occupancy of real property or the right to receive rents, profits or other income derived from real property. . . .

Finally, section 1405(b)(6) of the Tax Law sets forth that conveyances are exempt from the real estate transfer tax to the extent that they "effectuate a mere change of identity or form of ownership or organization where there is no change in beneficial ownership."

Question 1. Is the Share Exchange a mere change of form of ownership or organization where there is no change in beneficial ownership (collectively, a "Mere Change"), and, therefore, exempt, pursuant to section 1405(b)(6) of the Tax Law, from tax, to the extent applicable, under section 1402(a) of the Tax Law?

Answer. In the Share Exchange, Holdco will acquire 100% of the common stock of Petitioner. As Petitioner is an entity with an interest in real property, the Share Exchange will result in Holdco acquiring a controlling interest in an entity with an interest in real property. Therefore, the Share Exchange results in a taxable conveyance of real property in accordance with the aforementioned sections 1402, 1401(b) and 1401(e) of the Tax Law.

However, since the former common stock shareholders of Petitioner will receive a proportionately equal amount of Holdco common stock as a result of the Share Exchange, the Share Exchange would be exempt from the real estate transfer tax based on the mere change of identity or form of ownership exemption provided in section 1405(b)(6) of the Tax Law.

Question 2. Is the Existing Subsidiaries Spin-Off by Petitioner of its ownership in its wholly-owned subsidiary, CHEC, to Holdco by a distribution of stock, a Mere Change and, therefore, exempt, pursuant to section 1405(b)(6) of the Tax Law, from tax, to the extent applicable, under section 1402(a) of the Tax Law?

Answer. In the Spin-Off of CHEC, Petitioner would distribute to Holdco 100% of the common stock of CHEC. As CHEC is an entity with an interest in real property, the Spin-Off will result in Holdco acquiring a controlling interest in an entity with an interest in real property. Therefore, the Spin-Off of CHEC results in a taxable conveyance of real property in accordance with the aforementioned sections 1402, 1401(b) and 1401(e) of the Tax Law.

However, as a result of the Share Exchange, Holdco became the sole owner of Petitioner and, thus, the indirect owner of CHEC. Therefore, the Spin-Off of CHEC represents a mere change of identity with no change in beneficial ownership and would be exempt from the real estate transfer tax as provided in section 1405(b)(6) of the Tax Law.

Question 3. Is the transfer by Petitioner of CH Generation Assets to an affiliated Genco in exchange for all of the outstanding common stock of that Genco a Mere Change and, therefore, exempt, pursuant to section 1405(b)(6) of the Tax Law, from tax, to the extent applicable, under section 1402(a) of the Tax Law?

Answer. The CH Generation Assets consist of Petitioner's Danskammer Electric Generation Plant and Petitioner's 35% tenants-in-common ownership interest in the Roseton Electric Generation Plant. The conveyance of the Danskammer Electric Generation Plant to an affiliated Genco represents the transfer of Petitioner's title in fee to the Danskammer Plant and is a taxable conveyance of real property in accordance with the aforementioned sections 1402 and 1401(e) of the Tax Law.

Ownership of real property as tenants-in-common is distinguishable from ownership in an entity that owns real property. Ownership as tenants-in-common represents an undivided, direct interest in the real property, while ownership of an entity that itself owns real property represents an indirect interest in such real property. Because a tenants-in-common interest represents a direct ownership interest in real property and not an interest in an entity owning real property, the provisions of Article 31 regarding the transfer or acquisition of a controlling interest do not apply to the transfer of a tenants-in-common interest in real property. Petitioner owns an undivided, 35% tenants-in-common interest in the Roseton Plant. Therefore, the conveyance of such interest to an affiliated Genco represents the transfer of a direct interest in real property and is a taxable conveyance of real property in accordance with the aforementioned sections 1402 and 1401(e) of the Tax Law, without regard to the percentage of ownership represented by Petitioner's tenants-in-common interest.

However, because Petitioner would receive all of the outstanding stock of the Genco in return for the conveyance to the Genco of the title in fee to the Danskammer Plant and the conveyance to the Genco of the tenants-in-common interest in the Roseton Plant, such conveyances both represent a mere change of

identity with no change in beneficial ownership and would be exempt from the real estate transfer tax as provided in section 1405(b)(6) of the Tax Law.

Question 4. Is each Genco Spin-Off by Petitioner of the ownership of one or more Gencos to Holdco by a distribution of stock, during the period when Petitioner, Holdco and the Genco in question are affiliates, a Mere Change and, therefore, exempt pursuant to section 1405(b)(6) of the Tax Law from tax, to the extent applicable, under section 1402(a) of the Tax Law?

Answer. In a Genco Spin-Off, Petitioner would distribute to Holdco 100% of the common stock of a wholly-owned Genco. If the subject Genco owned an interest in real property at the time of the distribution, the Spin-Off would result in Holdco acquiring a controlling interest in an entity with an interest in real property, and would thus be a taxable conveyance of real property in accordance with the aforementioned sections 1402, 1401(b) and 1401(e) of the Tax Law.

However, as a result of the Share Exchange, Holdco became the sole owner of Petitioner and, thus, the indirect owner of any Genco wholly-owned by Petitioner. Therefore, if a Genco Spin-Off did result in a taxable conveyance of real property, such Spin-Off would represent a mere change of identity with no change in beneficial ownership and would be exempt from the real estate transfer tax pursuant to section 1405(b)(6) of the Tax Law.

Question 5. Is the sale of CH Generation Assets, or the sale of shares of stock in a Genco owning the CH Generation Assets, to an affiliate of Holdco, pursuant to the Auction Process, a Mere Change and, therefore, exempt, pursuant to section 1405(b)(6) of the Tax Law, from tax, to the extent applicable, under section 1402(a) of the Tax Law?

Answer. The sale of CH Generation Assets (consisting of the conveyance of the title in fee to the Danskammer Plant and Petitioner's tenants-in-common interest in the Roseton Plant) to an affiliate of Holdco would result in a taxable conveyance of real property in accordance with the aforementioned sections 1402 and 1401(e) of the Tax Law, for the same reasons outlined in the response to question 3, above.

Assuming that the sale of shares of stock in a Genco owning the CH Generation Assets represented the transfer of a controlling interest in such Genco, the sale would result in a taxable conveyance of real property in accordance with the aforementioned sections 1402, 1401(b) and 1401(e) of the Tax Law.

However, to the extent that there exists a commonality of ownership between Petitioner and the affiliate-purchaser at the time of the Auction, the sale of CH Generation Assets, or the shares of stock in a Genco owning the CH Generation Assets, would be exempt from the real estate transfer tax based on the mere change of identity or form of ownership exemption provided in section 1405(b)(6) of the Tax Law.

Question 6. Is a transfer of Petitioner's Roseton Plant Interest subject to tax under section 1402(a) of the Tax Law?

Answer. As outlined in the responses to questions 3 and 5, above, Petitioner's 35% tenants-in-common interest in the Roseton Plant is considered to be a direct ownership interest in real property and is not considered to be an interest in an entity owning real property. Therefore, a transfer of Petitioner's tenants-in-common interest, whether effectuated by a direct transfer of such interest or by a transfer of stock of an entity (*e.g.*, a Genco) owning Petitioner's interest, would be a taxable conveyance of real property.

However, to the extent that there exists a commonality of ownership between the grantor and the grantee in a conveyance of Petitioner's tenants-in-common interest in the Roseton Plant, the transfer of Petitioner's interest, or the transfer of shares of stock in an entity owning such interest, would be exempt from the real estate transfer tax based on the mere change of identity or form of ownership exemption provided in section 1405(b)(6) of the Tax Law.

Issue B: Sections 186 and 186-a — Spin-Offs and Generation Assets

Applicable Law

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 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 an excise 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.

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 Long Island Lighting Company, Adv Op Comm T&F, 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 their corporate structure and possibly sell off some of their 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.

Question 7. Would tax-exempt treatment under section 351 and 355 of the IRC, of the (i) Existing Subsidiaries Spin-Off, (ii) the transfer by Petitioner of the CH Generation Assets to Genco and (iii) any Genco Spin-Off, as applicable, be recognized as exempting Petitioner from (x) both of the taxes (*i.e.*, .75% of "gross earnings" and 4.5% of excess dividends), to the extent applicable to those transactions, under section 186 of the Tax Law and (y) the tax on "gross income", to the extent applicable to those transactions, under section 186-a of the Tax Law?

Answer. No. Unlike Article 9-A of the Tax Law which uses federal taxable income as the starting point for computing entire net income, sections 186 and 186-a of the Tax Law are not federally conformed. The determination of what constitutes "gross earnings" and "dividends" for purposes of section 186 and "gross income" for purposes of section 186-a is made using the definitions contained in such sections, including case law in these areas, and applying generally accepted accounting principles.

Question 8. If tax exempt treatment under section 351 of the IRC were not recognized for purposes of sections 186 and 186-a of the Tax Law with respect to the transfer of the CH Generation Assets by Petitioner to a Genco, would any portion of the consideration received by Petitioner (*i.e.*, Genco Common Stock) be considered as "gross earnings" under section 186 of the Tax Law or as "gross income" under section 186-a of the Tax Law?

Answer. The transfer of the CH Generation Assets by Petitioner to a Genco in exchange for all of the Genco's outstanding common stock 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 Restated Settlement Agreement dated January 2, 1998, as modified February 26, 1998, which includes the structural separation of the CH Generation 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 CH Generation Assets is not "receipts from the employment of capital" and does not constitute "gross earnings" and, therefore, is not taxable under the franchise tax imposed by section 186 of the Tax Law.

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 Genco common stock exceeds the original cost of the CH Generation Assets, without deduction for depreciation, except that with respect to Petitioner's Roseton Plant Interest that is treated as a partnership interest, "original cost" means the amount of Petitioner's original contribution establishing it ownership

interest in the Roseton Plant plus any additional contributions that Petitioner made. 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 9. If tax exempt treatment under section 355 of the IRC were not recognized for purposes of sections 186 and 186-a of the Tax Law with respect to the Existing Subsidiaries Spin-Off or any Genco Spin-Off (*i.e.*, for purposes of taxation under the IRC, each of such Spin-Offs would be considered to be a taxable distribution by Petitioner of appreciated property under section 311(b) of the IRC), would any amount be recognized by Petitioner as "gross earnings" under section 186 of the Tax Law or as "gross income" under section 186-a of the Tax Law?

Answer. Similar to Question 8, 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, including CHEC, Resources, Greene Point and possibly the Genco created to acquire Other Utility Generation Assets. 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 restructuring it organization. Accordingly, 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.

Question 10. If tax exempt treatment were not recognized for purposes of section 186 of the Tax Law, and assuming Petitioner were subject to the 4.5% excess dividends tax under section 186 ("Excess Dividends Tax"), would any portion of the value of the stock in the Existing Subsidiaries Spin-Off and any Genco Spin-Off be subject to the Excess Dividends Tax? If no, would the answer 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?

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 the corporations included in the Existing Subsidiaries Spin-Off and any Genco Spin-Off, 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 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.

Further, 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.

Question 11. If either Petitioner or a Genco were to sell the CH Generation Assets to an unaffiliated party pursuant to the Auction Process, would any portion of the value of the consideration received by Petitioner or Genco be considered as "gross earnings" under section 186 of the Tax Law or as "gross income" under section 186-a of the Tax Law?

Answer. The sale of the CH Generation Assets, by either Petitioner or a Genco, to an unaffiliated party 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 Order (Opinion No. 96-12), and implemented under the restructuring plan described in the Restated Settlement Agreement dated January 2, 1998, as modified February 26, 1998, which includes the structural separation of the CH Generation Assets and the sale of the assets at Auction. Like Con Ed, supra, and LILCO-II, supra, neither Petitioner nor Genco 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 Petitioner for the CH Generation 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.

With respect to the tax imposed under section 186-a of the Tax Law, Petitioner or Genco will realize "gross income" to the extent that a profit is generated from the sale of the CH Generation Assets, by either Petitioner or a Genco, to an unaffiliated party pursuant to the Auction Process. Following LILCO-I, supra, the profit, if any, would equal the amount that the consideration received by Petitioner or Genco as a result of the Auction Process exceeds the original cost of the CH Generation Assets, without deduction for depreciation, except that, with respect to Petitioner's Roseton Plant Interest that is treated

as a partnership interest, "original cost" means the amount of Petitioner's original contribution establishing its ownership interest in the Roseton Plant plus any additional contributions that Petitioner made. 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 CH Generation Assets results in a loss, rather than a profit, such loss may not be deducted from Petitioner's or Genco's other gross income.

Question 12. If Petitioner were to sell its stock ownership in a Genco to an unaffiliated party, would any portion of the value of the consideration received by Petitioner be considered as "gross earnings" under section 186 of the Tax Law or as "gross income" under section 186-a of the Tax Law?

Answer. Following LILCO-I, supra, gross earnings, for purposes of section 186 of the Tax Law, would include the gain on Petitioner's sale of the Genco stock to an unaffiliated party. The gain, if any, would equal the amount that the consideration Petitioner receives for the stock exceeds Petitioner's investment in the stock. No deductions are allowed, therefore, expenses that are attributable to the sale would not be deductible. If the sale of the Genco stock results in a loss, rather than a gain, such loss may not be deducted from Petitioner's gain from the sale of other securities or from any other gross earnings.

With respect to section 186-a of the Tax Law, Petitioner would realize gross income to the extent that a profit is generated from the sale of the Genco stock to an unaffiliated party. The profit, if any, would equal the amount that the consideration that Petitioner receives for the stock exceeds Petitioner's investment in the stock. Expenses of the sale are allowed to be deducted. If the sale of the Genco stock results in a loss, rather than a profit, such loss may not be deducted from Petitioner's profit from the sale of other securities or from any other gross income.

Issue C: Genco Operations

Applicable Law

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.

Section 186 of the Tax Law imposes a franchise tax upon every corporation, formed for or principally engaged in the business of supplying water, steam or 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".

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 189.2 of the Tax Law imposes on every gas importer a monthly privilege tax on the privilege or act of importing gas services or causing gas services to be imported into New York State for its own use or consumption in New York State. Section 189.1 of the Tax Law provides, in pertinent part, as follows:

> (a) The term "gas services" means gas delivered through mains or pipes.
>
> (b) The term "gas importer" means every person who imports or causes to be imported into this state services which have been purchased outside the state for its own use or consumption in this state, provided such term does not include a public utility subject to the jurisdiction of the public service commission as to the matter of rates on sales to customers.

Subdivision (k) of section 300 of Article 13-A provides in part:

> (k) "Commercial gallonage" means gallonage (1) which is nonautomotive-type diesel motor fuel (which is not enhanced diesel motor fuel) or residual petroleum product . . . which does not (and will not) qualify (A) for the utility credit or reimbursement provided for in section three hundred one-d of this article. . . .

Section 301-c(i) provides for a reimbursement to a consumer of "commercial gallonage."

Section 301-d of Article 13-A provides a petroleum business which is an electric corporation (as defined in section 2.13 of the Public Service Law) and which is subject to the supervision of the PSC with a credit or reimbursement against the tax imposed by section 301-a of Article 13-A, with respect to diesel

motor fuel (which is not enhanced diesel motor fuel) and residual petroleum product used by such electric corporation to fuel generators for the purpose of manufacturing or producing electricity.

Question 13. Would the operations of each Genco subject such Genco to taxation under section 186 of the Tax Law (and, if so, to what extent) or taxation under section 209 of the Tax Law?

Answer. Each Genco would be in the business of generating and selling electricity. If more than 50 percent of a Genco's gross receipts are from such business, the Genco would be principally engaged in such business, and the Genco would be subject to tax under section 186 of the Tax Law. The tax would be imposed on the Genco'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 Genco would be subject to tax under Article 9-A of the Tax Law pursuant to section 209.1 of the Tax Law.

Question 14. Would such operations subject such Genco to taxation under section 186-a of the Tax Law, and if so, to what extent?

Answer. Petitioner states that each Genco is an electric corporation pursuant to the Public Service Law and its retail rates would be subject to the jurisdiction of the PSC and that each Genco would be subject to the supervision of the PSC. Therefore, each Genco would be subject to section 186-a of the Tax Law on its gross income. However, pursuant to section 186-a.2(c), a Genco's sale of electricity at wholesale (*i.e.*, sale for resale, made in and out of New York) and retail to a purchaser for consumption or use outside New York would be excluded from gross income.

Question 15. Would such operations make such Genco eligible for the credit or reimbursement provided under either section 301-d or 301-c(i) of the Tax Law?

Answer. Because Petitioner states that the Genco would be an electric corporation, as defined in section 2.13 of the Public Service Law, and would be subject to supervision of the PSC, such Genco would be eligible for a credit or reimbursement pursuant to the provisions of section 301-d of the Tax Law for any unenhanced diesel motor fuel or residual petroleum product used by such Genco to fuel its generators for the purpose of manufacturing or producing electricity. However, because such fuel would qualify for the credit/reimbursement provided by section 301-d, it would not meet the definition of "commercial gallonage" found in section 300(k) and, therefore, would not be eligible for the reimbursement provided by section 301-c(i).

Question 16. Would such operations exempt such Genco from being a "gas importer" within the meaning of section 189.1(b) of the Tax Law?

Answer. Yes. Since Petitioner states that each Genco would be subject to the supervision of the PSC with respect to the rates for electric retail sales, each would be a public utility, and each Genco would not be a gas importer as defined in section 189.1(b) of the Tax Law. However, if a Genco were not subject to the supervision of the PSC with respect to the rates for electric retail sales, it would be a gas importer under section 189.1 of the Tax Law and would be subject to the tax imposed under section 189.2 of the Tax Law on the gas that it imports into New York for use in its generation of electricity.

Question 17. Assuming the answer to Question 13 above is that any such Genco would be subject to taxation under section 186 of the Tax Law, would any credit or other offset be available to any such Genco to the extent its "gross earnings" under such section, relate to electric sales to Petitioner while they are affiliates?

Answer. No. Section 186 does not provide for a deduction or exclusion in the case of sales for resale, even with respect to a sale for resale with an affiliate. Further, there is no provision under section 186 for the allowance of any credit with respect to such sales, and unlike Article 9-A of the Tax Law, section 186 does not provide for the filing of combined returns for affiliated corporations. While double taxation of sales of electricity from a Genco to Petitioner for resale to a consumer may occur as a result 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 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, any relief from such double taxation with respect to those sales of electricity from a Genco to Petitioner for resale to a consumer would require legislation.

Issue D: Subsidiary Capital Tax under Article 9-A of the Tax Law

Applicable law

Section 210.1(e) of the Tax Law provides that the subsidiary capital base is computed on the taxpayer's subsidiary capital allocated within New York State. Section 208.3 of the Tax Law states that the term "subsidiary" means a corporation of which over 50 percent of the number of shares of stock entitling the holders thereof to vote for the election of directors or trustees is owned by the taxpayer. Section 208.4(a) of the Tax Law states that the term "subsidiary capital" means investments in the stock of subsidiaries and any indebtedness from subsidiaries, exclusive of accounts receivable acquired in the ordinary course of trade or business for services rendered or for sales of

property held primarily for sale to customers, whether or not evidenced by written instrument, on which interest is not claimed and deducted by the subsidiary for purposes of Article 9-A, 32 or 33 of the Tax Law, provided, however, that, in the discretion of the Commissioner of Taxation and Finance, there shall be deducted from subsidiary capital any liabilities which are directly or indirectly attributable to subsidiary capital.

Question 18. Assuming Petitioner and any Genco were subject to taxation under section 186 or 186-a of the Tax Law, assuming Holdco were taxable under section 209 of the Tax Law, and assuming Holdco's investment (direct or indirect) in any such Genco and Petitioner were "subsidiary capital" (as defined in section 208.4(a) of the Tax Law), for purpose of Holdco's computation of tax under section 210.1(e) of the Tax Law would a credit or offset be available to Holdco for taxes paid by Petitioner and any such Genco under said sections 186 and 186-a, with respect to the "subsidiary capital" component of Holdco's section 210.1(e) computation?

Answer. No. There is no provision in Article 9-A of the Tax Law for a credit or offset, for taxes paid by Petitioner and any Genco under sections 186 and 186-a, when Holdco computes its subsidiary capital base under section 210.1(e) of the Tax Law. Any relief with respect to the subsidiary capital tax base would require legislation.

Issue E: Stock Transfer Tax under Article 12 of the Tax Law

Applicable Law

Subdivision (1) of section 270 of Article 12 of the Tax Law provides in part:

> There is hereby imposed . . . a tax . . . on all sales, or agreements to sell, or memoranda of sales and all deliveries or transfers of shares or certificates of stock . . . in any domestic or foreign association, company or corporation . . . whether made upon or shown by the books of the association, company, corporation, or trustee, or by any assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of sale or transfer, whether intermediate or final, and whether investing the holder with the beneficial interest in or legal title to said stock, or other certificates taxable hereunder, or merely with the possession or use thereof for any purpose. . . .

Subdivision (h) of section 440.1 of the Stock Transfer Tax Regulations provides as follows:

> (h) The tax imposed by article 12 of the Tax Law does not apply to the original issuance of stock.

Subdivision (j) of section 440.1 of the Stock Transfer Tax regulations provides in part:

> (j) The following are examples of transactions not subject to tax:
>
> * * *
>
> (2) The surrender of a single certificate for reissuance to the same stockholder of several certificates representing, in the aggregate, the same number of shares.
>
> (3) The surrender of a number of certificates of reissuance, to the same stockholder, of a single certificate for the same number of shares.

Question 19. Is the Share Exchange subject to the Stock Transfer Tax imposed pursuant to Article 12 of the Tax Law?

Answer. The Share Exchange between Petitioner and Holdco will not be subject to the Stock Transfer Tax. Upon consummation of the Share Exchange, the shares of Petitioner no longer represent legally valid stock of Petitioner, but instead represent an ownership interest in Holdco and are, in effect, originally issued shares of Holdco. The original issuance of stock is exempt from the imposition of the Stock Transfer Tax (Regulations, section 440.1(h)).

No physical exchange of certificates is necessary to reflect the change in ownership interest effectuated by the Share Exchange with respect to the certificates held by the former shareholders of Petitioner. However, if a physical exchange of certificates does take place, these shareholders would be deemed to be exchanging existing Holdco stock (certificates of Petitioner, which represent newly issued shares of Holdco) for new certificates of Holdco stock

(new certificates of Holdco stock bearing the name of Holdco). The mere physical replacement of existing certificates with new certificates of the same issue, similar to the transactions exemplified in paragraphs (2) and (3) of section 440.1(j) of the Regulations, where there is no change in the underlying ownership interest, does not result in any Stock Transfer Tax liability.

DATED: July 29, 1998

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

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