STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C000110B

On January 10, 2000, a Petition for Advisory Opinion was received from KPMG LLP, Attn. Victor Gatti, 345 Park Avenue, New York, New York 10154-0102.

The issues raised by Petitioner, KPMG LLP, are:

1. Whether the taxpayer described below is subject to franchise tax under section 186 of Article 9 of the Tax Law or Article 9-A of the Tax Law.

2. Whether the taxpayer described below is subject to the excise tax imposed under section 186-a of Article 9 of the Tax Law.

3. Whether the termination payments the taxpayer derived from a restructuring pursuant to the PowerChoice filing are included in the taxpayer's gross earnings for purposes of section 186 of the Tax Law.

4. Whether the termination payments the taxpayer derived from a restructuring pursuant to the PowerChoice filing are included in the taxpayer's gross receipts for purposes of section 186-a of the Tax Law.

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

The Taxpayer is a partner in a general partnership (the "Partnership") that has been providing electricity and steam generating services in New York State since 1988. The Partnership is not subject to the supervision of the New York State Public Service Commission ("PSC"). The Taxpayer is involved in the day-to-day operations of the Partnership. The Taxpayer's pro rata share of gross receipts from the Partnership's sales of electricity and steam constitute more than 50 percent of the Taxpayer's gross receipts. The Taxpayer has never been subject to the supervision of the PSC.

From 1988 to the present, the Partnership has provided electricity to Niagara Mohawk Power Corporation ("NMPC") and high temperature water (steam) to an unrelated third party, under two separate generation contracts.[1] One hundred percent of the revenues received from NMPC were from wholesale sales for "resale." No sales of electricity were made to ultimate consumers.

NMPC is an investor-owned public utility company incorporated in New York. NMPC is primarily engaged in the generation, transmission, distribution and sale of electricity; as well as the

[1] The third party is not relevant to this discussion.

distribution and sale of natural gas in New York. NMPC is subject to regulation by the PSC and the Federal Energy Regulatory Commission ("FERC").

The PSC, in its Competitive Opportunities Proceeding instituted in 1994 in Case No. 94-E-0952 ("Competitive Opportunities Proceeding"), 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. In Opinion No. 96-12, the PSC expressed its "vision for the future of the electric industry in light of competitive opportunities ...," and added that utilities, including NMPC, and independent power producers "are strongly encouraged to pursue agreements that reduce rates to benefit ratepayers. If parties are unwilling, however, to restructure those contracts voluntarily, the [PSC] shall pursue policies to mitigate the impact of such contracts on rates." The PSC further directed the independent power producers "to move forward aggressively in appropriate forums to seek solutions such as a buyout of contracts or a renegotiation of them so as to align them more closely with a competitive framework." Opinion No. 96-12 went on to require each utility to file a rate/restructuring plan "consistent with our policy and vision for increased competition."

In 1995, NMPC filed a proposed restructuring plan (the "PowerChoice filing") with the PSC, in response to the PSC's Competitive Opportunities Proceeding, which was designed to stabilize or reduce retail prices. Under the prior "regulated" New York utility law, electric utilities were required to offer to purchase all electricity generated by qualifying small power producers and qualifying cogenerators (collectively referred to here and elsewhere as independent power producers or "IPPs") operating in NMPC's service area. Prior law also established a minimum price of six cents per kilowatt-hour ("kwh") for electricity purchased from IPPs. In 1998, NMPC had excess capacity and could generate additional electricity at a marginal cost of between one and one-half cents and three cents per kwh. Alternatively, NMPC could purchase electricity in the market at prices substantially lower than the six cents per kwh rate mandated in many of its existing contracts with IPPs.

In order to substantially reduce the severe economic burden of its existing IPP contracts, and consistent with the NMPC PowerChoice filing in response to PSC Opinion No. 96-12, NMPC and certain IPPs executed the Master Restructuring Agreement By and Between Niagara Mohawk Power Corporation and Independent Power Producers ("MRA") on July 9, 1997 to terminate or restructure 29 IPP contracts. The purpose of the MRA was to enable NMPC to both reduce its costs for electricity and to operate more effectively in a deregulated electric power market. Petitioner states that, to a great extent, the IPPs were compelled to take this action in light of certain public statements by NMPC that it would "take" the IPP projects under the eminent domain powers afforded to it by the New York Transportation Corporation Law §11(3-a).[2]

[2] In its 1995 PowerChoice filing NMPC state that, if negotiations with IPPs failed to produce the necessary cost savings:

On March 20, 1998, the PSC issued Opinion No. 98-8 (Case 94-E-0098 and Case 94-E-0099) "Opinion and Order Adopting Terms of Settlement Agreement Subject to Modifications and Conditions" with respect to NMPC's Power Choice Settlement Document, as revised March 19, 1998, which included the MRA that NMPC entered into with 16 IPPs to terminate or restructure 29 IPP contracts. Under Opinion No. 98-8, the Partnership was compelled to participate in a restructuring of its independent power producer agreement with NMPC, pursuant to the MRA.

Under the MRA: (i) one contract was amended by modifying the price and certain other terms; (ii) ten contracts were restructured and restated with different terms; and (iii) eighteen of the contracts were terminated. The MRA did not foreclose the possibility of future business relationships between NMPC and the IPPs whose contracts were terminated. Such relationships could include new contracts, marketing arrangements and/or interconnection arrangements.[3] The contract of the Partnership was among those that were terminated, and the Partnership received termination payments from one of the contracts under the MRA. Under the MRA, the Partnership received proceeds which were used to retire debt, and make termination payments and distributions to its partners.

Discussion

Issue 1.

Section 209.1 of Article 9-A of the Tax Law imposes an annual franchise tax on domestic and 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 1-3.2(a)(5) of the Business Corporation Franchise Tax Regulations provides that if a partnership is exercising any of the privileges of section 209.1 of the Tax Law, then all of its general corporate partners are subject to the tax imposed under Article 9-A of the Tax Law. However, section 209.4 of the Tax Law, prior to the repeal of section 186 by Chapter 63 of the Laws of 2000, provided that a corporation liable for tax under section 186 of Article 9 of the Tax Law was not subject to tax under Article 9-A of the Tax Law. Beginning on and after January 1, 2000, corporations previously subject to tax under section 186 are now subject to tax under Article 9-A of the Tax Law.

> [NMPC] proposes to utilize its power of eminent domain to acquire generating units owned by [the IPPs] with which it has power purchase agreements, and subsequently resell them at auction, in order to increase competition in the wholesale power market. NYPSC Cases 94-E-0098 and 94-E-0099. The public statements by NMPC included statements in the PowerChoice filing.

[3] The new contractual relationships may take different forms, including fixed price swap contracts, indexed swap contracts, power call contracts, and elective power supply agreements.

Section 186 of Article 9 of the Tax Law, prior to its repeal by Chapter 63 of the Laws of 2000, imposed a franchise tax on a corporation, joint stock company or association "formed for or principally engaged in the business of supplying ... steam ... when delivered through mains or pipes, or electricity, or principally engaged in two or more of such businesses ...." The tax was imposed for the privilege of exercising a corporate franchise or carrying on business in a corporate or organized capacity in New York State and was based, in part, upon gross earnings from all sources within New York State.

For purposes of section 186, where a partnership was in the business of supplying steam and electricity in New York, a corporate general partner was, generally, also engaged in the business of supplying steam and electricity in New York. In interpreting section 209.1 of the Tax Law, section 1-3.2(a)(5) of the Article 9-A Regulations sets forth a general rule which holds that if a partnership is exercising any of the privileges of section 209.1, then all of its corporate general partners are subject to the tax imposed by Article 9-A. The same interpretation was made for purposes of Article 9 of the Tax Law in The Partners of Buffalo Telephone Company, Adv Op Comm T & F, February 22, 1989, TSB-A-89(3)C. The Advisory Opinion held that where a partnership is engaged in a telephone business in New York State, each corporate partner is also engaged in a telephone business in New York State, and each corporate general partner of the partnership that is principally engaged in such telephone business is subject to tax under sections 183 and 184 of Article 9.

In GTE Spacenet Corp. v NYS Dept of Taxation and Finance, 224 AD2d 283, the Court held that while the partnership was arguably engaged in activities enumerated in sections 183, 183-a, 184 and 184-a of the Tax Law, the evidence demonstrated that the partners were engaged in the investment business and were not engaged in the conduct of any of the businesses enumerated in sections 183, 183-a, 184 and 184-a of the Tax Law because the partners were mere passive investors and did not participate in the day-to-day management or operations of the partnership. Therefore, the partners were subject to tax under Article 9-A and were not subject to the franchise taxes imposed pursuant to sections 183, 183-a, 184 and 184-a of the Tax Law.

To determine the classification and proper taxability of a corporation under either Article 9 or Article 9-A, an examination of the nature of the corporation's activities is necessary, regardless of the purpose for which the corporation was organized. See Matter of McAllister Bros., Inc. v Bates, 272 App Div 511, 517 (3rd Dept. 1947). 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., Joseph Bucciero Contracting Inc., Adv Op St Tax Commn, July 23, 1981, TSB-A-81(5)C.

Generally, partnerships are not subject to the franchise tax imposed under Article 9-A of the Tax Law or under section 186 of Article 9 of the Tax Law, prior to its repeal. Accordingly, in this case, Partnership would not be subject to tax under Article 9-A or section 186 of Article 9 of the Tax Law, prior to its repeal.

In this case, Taxpayer is a general partner in the Partnership, and participates in the day-to-day operations of the Partnership. Accordingly, Taxpayer is more than a mere passive investor, and Taxpayer's circumstances are distinguished from GTE Spacenet, supra. More than 50 percent of the Taxpayer's gross receipts are its pro rata share of the Partnership's gross receipts from sales of electricity and steam. Therefore, following Partners of Buffalo Telephone, supra, Taxpayer is principally engaged in the business of supplying electricity and steam, and was subject to tax under section 186 of Article 9 of the Tax Law until its repeal. Beginning on and after January 1, 2000, Taxpayer is subject to tax under Article 9-A of the Tax Law.

Issue 2.

Section 186-a of the Tax Law imposes a tax on the furnishing of utility services. With respect to a utility which is not subject to the supervision of the PSC, the tax is imposed if it "sells ... electricity [or] steam ... delivered through mains, pipes or wires, or furnishes electric [or] steam ... service, 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 tax, for such utilities, is equal to two and one-tenth percent from January 1, 2000 through December 31, 2000, of the gross operating income of such a utility doing business in New York State which has annual gross operating income in excess of $500. The tax imposed under section 186-a of the Tax Law is imposed in addition to any and all other taxes and fees imposed by any other provision of law for the same period.

For purposes of section 186-a of the Tax Law, the word "utility" includes a person and the word "person" includes, among others, a partnership. Thus, section 186-a imposes a tax upon incorporated and unincorporated entities alike, including a partnership (see, Partners of Buffalo Telephone Company, supra.). The Partnership is not subject to the supervision of the PSC. Therefore, the Partnership would be subject to the tax imposed under section 186-a of Article 9 on its gross operating income from the sale of electricity or steam, and from the furnishing of electric or steam service, for ultimate consumption or use within New York State.

The Taxpayer is not subject to tax under section 186-a of the Tax Law on its pro rata share of the gross operating income of the Partnership. However, the Taxpayer may be subject to tax under section 186-a of the Tax Law if it has gross operating income that is attributable to an activity subject to tax under section 186-a, other than the Taxpayer's pro rata share of the Partnership's gross operating income that is subject to tax under section 186-a of the Tax Law.

Issue 3.

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 of the Tax Law 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.

Several utilities in New York State are being compelled by the PSC to reorganize their corporate structure and possibly 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 Opinion No. 96-12. With respect to such mandated restructuring, 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 and New York State Electric & Gas Corporation, Adv Op Comm T&F, July 29, 1998, TSB-A-98(11)C.) The Central Hudson advisory opinion reached several conclusions, including the conclusion that the sale of electric generation assets pursuant to the auction process, implementing the petitioner's restructuring agreement that was confirmed by a PSC order, does not represent the employment of capital, and that the consideration received by the petitioner for the generation assets does not constitute "gross earnings" taxable under section 186 of the Tax Law.

In this case, the Partnership is one of several IPPs and utilities in New York State being mandated by the PSC, pursuant to the Competitive Opportunities Proceeding and the PSC's policy objectives set forth in Opinion No. 96-12, to restructure IPP contracts by such means as a buyout or renegotiation of the contracts that would mitigate the impact of such contracts on rates to benefit ratepayers, so as to align them more closely with a competitive framework. Such mandated restructuring, was implemented by NMPC under the restructuring plan described in the PowerChoice filing and approved in PSC Opinion No. 98-8. Pursuant to the MRA, as required by the Power Choice Agreement and Opinion No. 98-8, the Partnership terminated its contract with NMPC in 1998.

Like Con Ed, supra, and Central Hudson, supra, the Partnership did not employ its capital within the meaning of section 186 of the Tax Law, prior to its repeal, for the purpose of being forced to restructure its IPP contract with NMPC. Following Central Hudson, supra, the Taxpayer's pro rata share of the termination payments received by the Partnership, pursuant to such restructuring agreement that was confirmed by Opinion No.98-8, does not represent the employment of capital, and the Taxpayer's pro rata share of the termination payments received by the Partnership for the termination of its IPP contract with NMPC does not constitute "gross earnings" of the Taxpayer taxable under section 186 of the Tax Law.

Issue 4.

As stated in Issue 2, the Partnership, not Taxpayer, is subject to the tax imposed under section 186-a of the Tax Law on its gross operating income. However, the termination payments received by the Partnership from the termination of its IPP contract with NMPC, pursuant to mandate by the PSC, pursuant to the Competitive Opportunities Proceeding and the PSC's policy objectives set forth in Opinion No. 96-12, and implemented under the restructuring plan described in the PowerChoice filing and approved in PSC Opinion No. 98-8 to restructure IPP contracts by such means as a buyout or renegotiation of the contracts, do not constitute receipts from the sale of electricity or electric services. Therefore, such payments do not constitute gross operating income of the Partnership taxable under section 186-a of the Tax Law.

DATED: October 11, 2000

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