New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division

TSB-A-03(5)C
Corporation Tax
May 8, 2003

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C021015A

On October 15, 2002, a Petition for Advisory Opinion was received from KPMG LLP, c/o Harold F. Soshnick, 345 Park Avenue, New York, New York 10154.

The issues raised by Petitioner, KPMG LLP, are:

1. Whether the capacity charge adjustment and interest that XYZ received from Company A on disputed receivables is gross operating income subject to tax under section 186-a of the Tax Law.

2. If the capacity charge adjustment is taxable, for what taxable year should XYZ include the amount of the capacity charge adjustment and interest income (if includible) awarded in the hearing and at what tax rate(s)?

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

XYZ, a limited partnership, is a utility conducting business in New York. XYZ is not subject to the supervision of the New York State Department of Public Service, and is classified as a second class utility under section 186-a(1)(c) of the Tax Law. XYZ entered into a fixed price contract with Company A, a third party, to provide services from an energy facility in New York in return for monthly capacity and fuel charges ("Capacity and Fuel Charges"). The energy services provided by XYZ to Company A comprised furnishing high temperature water for the consumption or use by Company A. The parties agreed by contract to a "Capacity Charge Adjustment" in the event the tax laws changed after award of the contract; for example, federal investment tax credits and federal tax depreciation changed in the Tax Reform Act of 1986. The modification to the contract for the change in tax laws is referred to as the "Capacity Charge Adjustment."

XYZ and Company A executed a modification to the contract that increased the monthly Capacity Charge paid by Company A because passage of tax law changes altered the rate of return on XYZ's investment assumed in XYZ's initial Capacity Charge. Subsequent to this modification, a dispute arose between the parties regarding whether the adjustment provision in the contract was applicable to the tax law changes, what methodology should be used to compute the Capacity Charge Adjustment and whether a Capacity Charge Adjustment was due.

In August 1993, Company A determined that the Capacity Charge Adjustment provision of the contract did not apply to the tax law changes and that XYZ had failed to disclose certain required information to Company A in connection with the Capacity Charge Adjustment. As a result of this determination, Company A unilaterally rescinded the Capacity Charge Adjustment and further reduced the initial Capacity Charge to recoup previously alleged overpayments by Company A.

XYZ continued to invoice Company A for the Capacity Charge Adjustment until the contract was terminated in 1999.

XYZ appealed this action of Company A to an appropriate body (the board) with jurisdiction to resolve contract disputes between XYZ and Company A. After a hearing the board determined that the Capacity Charge Adjustment provision of the contract did apply to the tax law changes but that XYZ had failed to disclose certain relevant data to Company A which entitled Company A to a reduction in the Capacity Charge Adjustment. The board returned the matter to the parties for determination of the reduction. When the parties could not reach agreement on the reduction, the board heard further testimony and on April 5, 2002, rendered a second decision. In that decision, the board reinstated the Capacity Charge Adjustment in full. In addition, the board held that XYZ was entitled to interest on the Capacity Charge Adjustment amounts withheld from XYZ from October 11, 1993 until XYZ is actually paid those amounts. Company A has not appealed the decision, and the decision is final. XYZ billed Company A in 2002 for the total amount of unpaid receivables due plus interest as a result of the board decision. Payment has not yet been received.

Applicable Law and Regulations

Section 186-a.1(c) of the Tax Law provides, in part:

> a tax equal to three and one-quarter percent through December thirty-first, nineteen hundred ninety-nine, two and one-tenth percent from January first, two thousand through December thirty-first, two thousand, two percent from January first, two thousand one through December thirty-first, two thousand one, one and nine-tenths percent from January first, two thousand two through December thirty-first, two thousand two, eighty-five one hundredths of one percent from January first, two thousand three through December thirty-first, two thousand three ... of its gross operating income is hereby imposed upon every other utility [a utility not subject to the supervision of the New York State Department of Public Service] doing business in this state which has a gross operating income for the year ending December thirty-first in excess of five hundred dollars, which taxes shall be in addition to any and all other taxes and fees imposed by any other provision of law for the same period.

Section 186-a.2(a) of the Tax law provides, in part:

> the word "utility" includes ... every person ... who sells gas, electricity, steam, water or refrigeration, delivered through mains, pipes or wires, or furnishes gas, electric, steam, water or refrigerator 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, or of whether use is made of the public streets;

Section 186-a.2(d) of the Tax Law provides, in part:

> the words "gross operating income" mean and include receipts received in or by reason of any sale, conditional or otherwise, made for ultimate consumption or use by the purchaser of gas, electricity, steam, water or refrigeration, or in or by reason of the furnishing for such consumption or use of gas, electric, steam, water or refrigerator service in this state, including cash, credits and property of any kind or nature, without any deduction therefrom on account of the cost of the property sold, the cost of materials used, labor or services or other costs, interest or discount paid, or any other expenses whatsoever....

Section 46.2 of the Tax on the Furnishing of Utility Services Regulations (Regulations), discusses methods of accounting with respect to utilities not subject to the supervision of the New York State Department of Public Service that are taxable on their gross operating income, and provides that:

> (a) A utility in this class keeping its accounts on the cash basis will include in gross operating income cash received by reason of any sale made or service rendered, all amounts allowed as credits against charges for sales made or services rendered, and credits allowed for property of any kind or nature.
>
> (b) A utility keeping its accounts on the accrual basis will include in gross operating income all receipts accrued on its books for the reporting period, but will be permitted to deduct such sums as represent, for example, uncollectible accounts, returned merchandise, etc., regardless of when the sales were made or services rendered, thus achieving substantially, if not exactly, the same results as would be attained by accounting and reporting on the cash basis.

Opinion

The provisions of Article 9 of the Tax Law are not federally conformed. Therefore, the determination of the treatment of an item of income for purposes of section 186-a of the Tax Law is made using the definitions contained in such section and applying generally accepted accounting principles.

In this case, Petitioner states that XYZ entered into a fixed price contract with Company A to provide energy services in return for monthly Capacity and Fuel Charges. The parties agreed by contract to a Capacity Charge Adjustment in the event the tax laws changed after award of the contract. Pursuant to such provision, the parties executed a modification to the contract for the Capacity Charge Adjustment that increased the monthly Capacity Charge paid by Company A. XYZ continued to invoice Company A for the Capacity Charge Adjustment until the contract was terminated in 1999.

Subsequent to the contract modification, a dispute arose between the parties, and in August 1993, Company A determined that the Capacity Charge Adjustment provision of the contract did

not apply to the tax law changes and that XYZ failed to disclose certain required information to Company A in connection with the adjustment. As a result, Company A unilaterally rescinded the Capacity Charge Adjustment and further reduced the initial Capacity Charge to recoup previously alleged overpayments by Company A.

XYZ appealed this action of Company A to the board. After a hearing, the board determined that the Capacity Charge Adjustment provision of the contract did apply to the tax law changes but that XYZ had failed to disclose certain relevant data to Company A which entitled Company A to a reduction in the Capacity Charge Adjustment. The board returned the matter to the parties for determination of the amount of the reduction. When the parties could not reach agreement on the amount of the reduction, the board heard further testimony, and on April 5, 2002, rendered a second decision. In that decision, the board held that the full Capacity Charge Adjustment amounts withheld from XYZ were due and that XYZ was entitled to interest on those amounts from October 11, 1993, until XYZ is actually paid those amounts. XYZ billed Company A in 2002 for the total amount of unpaid receivables due plus interest as a result of the board decision.

With respect to Issue 1, XYZ's gross operating income under section 186-a.2(d) of the Tax Law includes receipts from the furnishing of energy services for the consumption or use by Company A. Since the parties agreed by contract to a "Capacity Charge Adjustment" in the event the tax laws changed after award of the contract, the charges for such adjustment to the contracted fixed price for the furnishing of such energy services also constitute gross operating income of XYZ. However, the interest charges for the late payment by Company A of the charges billed by XYZ are not charges for the provision of furnishing energy services, and do not constitute gross operating income of XYZ.

With respect to Issue 2, if XYZ keeps its accounts on the cash basis, pursuant to section 46.2(a) of the Regulations, XYZ must include in its gross operating income for each taxable year, the amount it received during the taxable year from Company A for the furnishing of energy services. In this case, the charges for Capacity Charge Adjustment will be included in XYZ's gross operating income in the taxable year that it receives such amount from Company A, excluding any interest charges, and would be taxed at the tax rate applicable for such taxable year.

However, if XYZ keeps its accounts on the accrual basis, then pursuant to section 46.2(b) of the Regulations, XYZ will include in its gross operating income for each taxable year, all receipts accrued on its books for the taxable year for furnishing energy services to Company A, but would be permitted to deduct such sums representing uncollectible accounts, etc., regardless of when the services were rendered. Petitioner states that even though Company A unilaterally rescinded the Capacity Charge Adjustment, XYZ invoiced Company A for the Capacity Charge Adjustment amounts during the term of the contract until the contract was terminated in 1999. The unpaid Capacity Charge Adjustment amounts did not represent an uncollectible account during the years of the contract. Further, in XYZ's view, it had properly executed a modification to the contract for the Capacity Charge Adjustment, and it was never established that the charges for such Capacity Charge Adjustment were invoiced in error. Therefore, the receipts accruing on XYZ's books for

each taxable year would include the amounts for the Capacity Charge Adjustment that were invoiced to Company A during that year. Accordingly, XYZ must include in its gross operating income for each taxable year the amounts it accrued on its books during the taxable year for the invoiced Capacity Charge Adjustment, and would be taxed at the tax rate applicable for such taxable year.

DATED: May 8, 2003

/s/
Jonathan Pessen
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Technical Services Division

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