

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

TSB-A-99(13)C
Corporation Tax
January 28, 1999

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. C980909B

On September 9, 1998, a Petition for Advisory Opinion was received from Central Hudson Gas & Electric Corporation, 284 South Avenue, Poughkeepsie, New York 12601.

The issues raised by Petitioner, Central Hudson Gas & Electric Corporation, result from the proposed corporate restructuring of Petitioner implemented in fulfillment of the New York State Public Service Commission's mandate under its Competitive Opportunities proceeding. The specific questions are:

- Question 1:** Would the investment, by Petitioner, of the Auction proceeds into an unregulated subsidiary of Holdco through either Transaction A or Transaction B, described below, be subject to the tax on excess dividends under section 186 of the Tax Law ("Excess Dividends Tax")?
- Question 2:** If in Transaction A Holdco distributed the Auction proceeds to its shareholders instead of contributing the funds to an unregulated subsidiary, would the transaction be subject to the Excess Dividends Tax?
- Question 3:** If Petitioner distributed funds (other than Auction proceeds) to Holdco for contribution to an unregulated subsidiary, through either Transaction A or Transaction B, would the transaction be subject to the Excess Dividends Tax?

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

Background

Petitioner is a combination gas and electric utility engaged principally in generation, transmission, distribution and sale of electric energy and the sale, transportation and distribution of natural gas in the Hudson River Valley of New York. 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 State Public Service Commission ("PSC").

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, and a schedule for the introduction of 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, and incorporated into PSC Opinion No. 98-13, issued and effective June 30, 1998.

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

- Petitioner is required to functionally unbundle its fossil-fuel generation in 1998, and complete 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.

- Petitioner is permitted to transfer up to \$100 million of equity from Petitioner to unregulated affiliates prior to the formation of the holding company.
- Petitioner will cause a holding company to be formed not later than June 30, 2001.

Restructuring

The 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 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"). 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. The proposed restructured organization is subject to change as to final form.

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

Consummation of the Share Exchange and/or the subsequent implementing transactions requires certain approvals of FERC and the Nuclear Regulatory Commission ("NRC"), and the Securities and Exchange Commission ("SEC"), in addition to that of the PSC. Petitioner has received such approvals.

The approval of Petitioner's Common Stock shareholders is required to effect the transactions described herein. Petitioner held a Special Meeting of Shareholders on September 25, 1998, at which the shareholders approved the transactions. The Share Exchange and Existing Subsidiaries Spin-Off are expected to take effect in the first half of 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 of 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 would be sold) 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 be 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 (collectively, the "CH Generation Assets"). 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.

Pursuant to the Restated Settlement Agreement, Petitioner must sell the CH Generation Assets pursuant to the Auction Process either to an affiliate of Petitioner or an unaffiliated party. The consideration received by Petitioner, up to the net book value of the CH Generation Assets, will be available for investment in unregulated operations without further PSC approval or authorization.

The investment of the Auction proceeds into unregulated operations would be accomplished either:

- A. by a distribution from Petitioner to Holdco which would then contribute the capital to one of its unregulated subsidiaries ("Transaction A") or
- B. by Petitioner contributing the capital to its own subsidiary which would then be spun-off to Holdco ("Transaction B").

Either method would have the same result of moving the Auction proceeds from Petitioner to an unregulated subsidiary of Holdco.

Discussion

Section 186 of the Tax Law imposes a franchise tax upon every corporation, joint-stock company or association formed for or principally engaged in the business of supplying gas, when delivered through mains or pipes, or electricity, "for the privilege of exercising its corporate franchise or carrying on its business in such corporate or organized capacity in this state". The tax is three-quarters of one percent on the taxpayer's gross earnings from all sources within New York State, and four and one-half percent on the amount of dividends paid during each year ending on the thirty-first day of December in excess of four percent on the actual amount of paid-in capital employed in New York State by the taxpayer.

In People ex rel Adams Electric Light Co v Graves, 272 NY 77,79, the Court of Appeals stated that under the franchise tax imposed by section 186 of the Tax Law "[a] dividend on corporate stock implies a division or distribution of corporate profits." In that case, the Court held that the transfer of a portion of earned surplus to its non-par capital stock account, pursuant to a resolution of its board of directors, was not a distribution of dividends for tax purposes. Neither money nor property nor stock dividend went into the hands of stockholders. No stockholder acquired a right to receive any equivalent of the amount transferred unless further corporate action was taken.

On July 29, 1998, an advisory opinion issued to Petitioner, TSB-A-98(12)C, addressed several questions pertaining to the tax ramifications resulting from its corporate restructuring under the PSC's Competitive Opportunities Proceeding. One of the holdings in that opinion stated that "Petitioner's distribution to Holdco, directly after the Share Exchange, of all of the common stock of the corporations included in the Existing Subsidiaries Spin-Off and any Genco Spin-Off, is part

of the series of transactions being entered into by Petitioner as mandated by the PSC pursuant to the 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." The opinion held further that the answer would not change if Petitioner invests up to \$100 million of equity in the Existing Subsidiaries prior to the Share Exchange and the Existing Subsidiaries Spin-Off.

With respect to **Question 1**, the investment of the Auction proceeds into unregulated operations that would not require further approval or authorization by the PSC, and which would be accomplished by either Transaction A or Transaction B, as described above, is part of the series of transactions being entered into by Petitioner as mandated by the PSC pursuant to the Competitive Opportunities Proceeding and the PSC's policy objectives set forth in the Order (Opinion No. 96-12), and implemented under the restructuring plan described in the Restated Settlement Agreement dated January 2, 1998, modified February 26, 1998, and incorporated into PSC Opinion NO. 98-13, issued and effective June 30, 1998, whereby Petitioner is reorganized into the holding company structure and divests itself of its CH Generating Assets. It does not represent a distribution of the profits of Petitioner as contemplated in Adams Electric, *supra*. Accordingly, the investment of the Auction proceeds into such unregulated operations, that would be accomplished by either Transaction A or Transaction B, would not be treated as dividends subject to the Excess Dividends Tax under section 186 of the Tax Law.

With respect to Transaction B, a spin-off of a subsidiary to a parent corporation could result in a dividend subject to the Excess Dividends Tax under section 186 of the Tax Law. However, to the extent the spin-off of such subsidiary to Holdco is part of the Existing Subsidiaries Spin-Off or Genco Spin-Off referenced in the Answer to Question 10 of the previous advisory opinion issued to Petitioner on July 29, 1998, such spin-off would be within the context 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, modified February 26, 1998, and incorporated into PSC Opinion No. 98-13, issued and effective June 30, 1998, and such spin-off would not constitute a dividend subject to the Excess Dividends Tax under section 186 of the Tax Law.

With respect to **Question 2**, it would not matter whether, in Transaction A, Holdco distributes the Auction proceeds to its shareholders instead of contributing the funds to an unregulated subsidiary. The distribution of the Auction proceeds from Petitioner to Holdco would be made within the context 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, modified February 26, 1998, and incorporated into PSC Opinion No. 98-13, issued and effective June 30, 1998. Accordingly, pursuant to Adams Electric, supra, such distribution from Petitioner to Holdco would not constitute a dividend subject to the Excess Dividends Tax under section 186 of the Tax Law.

With respect to **Question 3**, if Petitioner distributes funds (other than Auction proceeds) to Holdco for contribution to an unregulated subsidiary through Transaction A, such distribution would be made outside the context 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, modified February 26, 1998, and incorporated into PSC Opinion NO. 98-13, issued and effective June 30, 1998. Accordingly, pursuant to Adams Electric, supra, such distribution of funds accomplished by Transaction A would be a distribution to its shareholder, and would constitute a dividend subject to the Excess Dividends Tax under section 186 of the Tax Law.

If Petitioner distributes funds (other than Auction proceeds) to its own subsidiary before it is spun-off to Holdco under Transaction B, in accordance with the Answer to Question 10 in the previous advisory opinion issued to Petitioner on July 29, 1998, such distribution of funds would not constitute a dividend subject to the Excess Dividends Tax under section 186 of the Tax Law.

Further, to the extent the spin-off of such subsidiary to Holdco under Transaction B is part of the Existing Subsidiaries Spin-Off or Genco Spin-Off referenced in the Answer to Question 10 of the previous advisory opinion issued to Petitioner on July 29, 1998, such spin-off would be within the context 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, modified February 26, 1998, and incorporated into PSC Opinion No. 98-13, issued and effective June 30, 1998. Accordingly, such spin-off would not constitute a dividend subject to the Excess Dividends Tax under section 186 of the Tax Law.

However, pursuant to Adams Electric, supra, a spin-off of a subsidiary to a parent corporation outside the context 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, modified February 26, 1998,

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and incorporated into PSC Opinion No. 98-13, issued and effective June 30, 1998, could result in a dividend subject to the Excess Dividends Tax under section 186 of the Tax Law.

DATED: January 28, 1999

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

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