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

TSB-A-99(3)C
Corporation Tax
January 26, 1999

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C980715A

On July 15, 1998, a Petition for Advisory Opinion was received from Niagara Mohawk Power Corporation, 300 Erie Boulevard West, Syracuse, New York 13202.

The issue raised by Petitioner, Niagara Mohawk Power Corporation, is whether the proposed transfer of Opinac N.A. stock from Petitioner to Holdco after the share exchange will constitute a "dividend paid" for purposes of the tax imposed under section 186 of the Tax Law on excess dividends paid.

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

Petitioner is an investor-owned public utility company incorporated in New York and it is primarily engaged in the generation, transmission, distribution and sale of electricity and the distribution of natural gas in New York. Petitioner presently owns 100 percent of the outstanding common stock of three domestic corporations: NM Receivable ("NMR"), NM Holdings ("NMH") and Opinac N.A. ("Opinac NA") Opinac NA owns all of the outstanding common stock of two corporations: Opinac Energy Corporation ("Opinac"), a Canadian corporation, and Plum Street Enterprises, Inc. ("PSE"), a Delaware corporation.

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 New York Public Service Commission ("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 ("Generic Order"). The PSC's Generic 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.

On February 24, 1998, the PSC approved a rates and restructuring plan ("PowerChoice") for Petitioner aimed at reducing electricity rates for many of Petitioner's current customers and allowing the customers to choose their energy supplier.

Subsequently, on March 20, 1998, the PSC issued to Petitioner, Opinion 98-8, Opinion and Order Adopting Terms of Settlement Agreement Subject to Modifications and Conditions (Case 94-E-0098 and Case 94-E-0099) (the "Order") which, *inter alia*, approved PowerChoice. The key elements of the Order include:

(i) approval of Petitioner's Master Restructuring Agreement ("MRA") (discussed *infra*),

(ii) a revenue reduction of $111.8 million (exclusive of reductions in the New York State Gross Receipts Tax) for all customer classes to be phased in over a three-year period beginning upon the consummation of the MRA,

(iii) a cap on prices to electric customers in years four and five of the five-year rate plan,

(iv) an allowance for Petitioner to recover stranded costs (including the costs associated with the MRA),

(v) permission by the PSC to establish a regulatory asset, reflecting the recoverable costs of the MRA which will be amortized over a maximum of ten years ("MRA Regulatory Asset") (discussed *infra*),

(vi) an agreement by Petitioner to divest its fossil and hydro electric generating facilities within a defined time period and retain its nuclear generating facilities with a commitment to explore their divestiture at a later date,

(vii) an agreement by Petitioner to provide its retail electric customers with the option to choose their supplier of electricity by no later than December 1999, and

(viii) an agreement to allow Petitioner to form a holding company structure to separate its utility businesses from its unregulated businesses.

As previously stated, the PSC approved the MRA which allowed Petitioner to terminate, restructure or amend 27 of its power purchase agreements ("PPAs") with 14 independent power producers ("IPPs"). Seventeen PPAs were terminated.[1] All of the IPPs which had their PPAs with

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[1] As part of the Public Utility Regulatory Policies Act of 1978, Pub. L. 95-617, 92 Stat, 3117 ("PURPA"), Petitioner was required to offer to purchase electricity from qualifying small power producers and qualifying cogenerators (collectively "QFs"). Pursuant to PURPA, the

Petitioner terminated, restated, or amended, qualify as QFs. In exchange for terminating, restructuring or amending the PPAs, on June 30, 1998, the IPPs received from Petitioner approximately $3.9 billion in cash, 42.9 million shares of Petitioner's common stock (representing approximately 23 percent of Petitioner's outstanding shares following issuance), and financial instruments structured as indexed swap contracts. Petitioner will be permitted to recover its MRA related costs for book purposes over a ten-year period by establishing the MRA Regulatory Asset which will be amortized ratably.[2] Petitioner's rates as contemplated under PowerChoice are designed to permit recovery of the MRA Regulatory Asset over this ten-year period. The Order limited the estimated value of the Regulatory Asset to approximately four billion dollars, resulting in a charge to earnings of $190 million in 1997.

As a result of making the payments under the MRA, Petitioner will have neither accumulated earnings and profits, nor current earnings and profits in 1998, the year the payments are made. Earnings and profits ("E&P") is the standard promulgated under the Internal Revenue Code of 1986 ("IRC"), as amended and in effect, to measure whether a corporation's distribution of cash or property is a dividend for tax purposes.[3] For book purposes, Petitioner would no longer have

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Federal Energy Regulatory Commission ("FERC") promulgated regulations which mandated that a utility purchase electricity from a QF at a rate up to the utility's full forecasted avoided cost. Avoided cost is the additional cost that the utility would have incurred had it instead generated the purchased electricity itself or obtained it from another source. Specific implementation of the QF rules under PURPA was delegated in New York to the PSC. In 1981, the PSC passed the "Six-Cent Law" establishing six cents per kilowatt as the floor on avoided costs for projects less than 80 megawatt in size. PURPA and the Six-Cent Law, in combination with other factors, attracted large numbers of QFs to New York State. Since PURPA and the Six-Cent Law passed, Petitioner has been required to purchase electricity from QFs in quantities in excess of its demand and at prices in excess of that available to Petitioner by internal generation or for purchase in the wholesale market. In order to mitigate the escalating costs of the PPAs, Petitioner entered into negotiations with the QFs to terminate, amend or restate the PPAs. These negotiations led to the MRA. On June 30, 1998, the MRA was consummated and Petitioner terminated 17 of its PPA with QFs.

[2] A regulatory asset is created by a regulatory directive to defer an otherwise current expenditure until such time as the asset is to be charged off per the directive. Such charge off generally coincides with the rate-recovery period allowed the PSC.

[3] Section 316(a) of the IRC provides as follows: "For purposes of this subtitle, the term 'dividend' means any distribution of property made by a corporation to its shareholders — (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. Except as provided in this subtitle,

retained earnings as well in 1998, but for the specific provision in the Order establishing the MRA Regulatory Asset which allows Petitioner to account for the payments under the MRA over a ten-year period. Without the creation of the MRA Regulatory Asset as mandated by the PSC, Petitioner's retained earnings would be completely eliminated by the payments to IPPs under the MRA.

As part of PowerChoice, subsequent to the consummation of the MRA, Petitioner will, under the authority of the Order and with the assent of the PSC, restructure its present corporate structure into a holding company structure. In order to transform its present corporate structure to a holding company structure, Petitioner intends to complete the following three transactions in the order presented ("Restructuring Transactions"):

(1) Petitioner will form a wholly owned subsidiary ("Holdco") in a tax-free transaction that qualifies under section 351 of the IRC.[4]

(2) Complete a share exchange between the shareholders of Petitioner pursuant to section 913 of the Business Corporation Law[5], whereby shares of Petitioner are exchanged for the shares of Holdco (no actual physical exchange occurs, but rather the shares are deemed exchanged).

(3) Petitioner will then transfer all of the common stock of Opinac NA to Holdco.

As a result of the Restructuring Transactions, the former public shareholders of Petitioner will own all of the outstanding common stock of Holdco, and Petitioner will become a wholly owned subsidiary of Holdco. Holdco will also own all of the common stock of Opinac NA. Petitioner will

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every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection."

[4] Section 351(a) of the IRC provides, in pertinent part, "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation".

[5] A binding share exchange is a transaction in which one corporation, the "acquiring" corporation, obtains all the shares of a "subject" corporation in an exchange that is binding on the owners of the shares of the acquired corporation. A share exchange differs from a merger or consolidation in that the acquired corporation does not lose its identity but continues in existence as a wholly owned subsidiary of the acquiring corporation.

continue to own all the common stock of NMR and NMH. Opinac NA will continue to hold all of the common stock of Opinac and PSE.

Petitioner states that it is presently and will continue to be subject to tax pursuant to sections 186 and 186-a of Article 9 of the Tax Law.

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, "[a] dividend implies a division or distribution of corporate profits."

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 pursuant to the PSC's Competitive Opportunities Proceeding and the PSC's policy objectives set forth in the Generic Order (Opinion No. 96-12). With respect to such mandated restructuring, the Commissioner of Taxation and Finance has issued Advisory opinions to Central Hudson Gas & Electric Corporation, Adv Op Comm T&F, July 29, 1998, TSB-A-98(12)C, and New York State Electric & Gas Corporation, Adv Op Comm T&F, July 29, 1998, TSB-A-98(11)C. In each of those opinions, it was held that a distribution, to the newly organized holding company, of all of the common stock of certain subsidiaries of the petitioner implementing the petitioner's restructuring agreement that was confirmed by a PSC order, does not represent a distribution of the profits of the petitioner. Accordingly, these restructuring distributions were not treated as dividends subject to the excess dividends tax under section 186 of the Tax Law.

In this case, Petitioner's distribution to Holdco, directly after the share exchange, of all of the outstanding common stock of Opinic NA, 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 Generic Order (Opinion No. 96-12), and implemented under the restructuring plan described in PowerChoice and approved in PSC Opinion No. 98-8 issued March 20, 1998, the Order, and PSC Order Concerning Compliance Filing Regarding Holding Company, issued and effective September 30, 1998, whereby Petitioner is reorganized into the holding company structure. It does not represent a distribution of the profits of Petitioner.

Accordingly, like Central Hudson, supra, and NYS Gas & Electric, supra, these restructuring distributions are not treated as dividends subject to the excess dividends tax under section 186 of the Tax Law.

DATED: January 26, 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.