

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

TSB-A-99(7)C
Corporation Tax
January 27, 1999

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. C980922D

On September 22, 1998, a Petition for Advisory Opinion was received from Rochester Gas and Electric Corporation, 89 East Avenue, Rochester, New York 14649.

The issue raised by Petitioner, Rochester Gas and Electric Corporation, is whether either of the transactions enumerated below, transacted subsequent to purchase of Holding Company stock in the open market, will be treated as a dividend subject to tax on excess dividends ("Excess Dividends Tax") under section 186 of the Tax Law. The transactions are:

Transaction 1. Petitioner distributes the Holding Company stock to Holding Company.

Transaction 2. Petitioner transfers the Holding Company stock to Holding Company in exchange for Petitioner's stock held by Holding Company.

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

Petitioner is a regulated public utility incorporated in New York State that supplies utility services in western New York. Its principal offices are located in Rochester, New York and its common stock is publicly traded. In 1998, Petitioner commenced a stock repurchase program pursuant to which it has repurchased and will continue to repurchase its common stock on the open market, subject to PSC approval and market conditions.

Under a proposed reorganization that is expected to take effect in the spring of 1999, Petitioner will become a subsidiary of Holding Company ("Holding Company"). Pursuant to the proposed reorganization, the following steps will occur:

1. Petitioner will create Holding Company as a first tier, wholly owned subsidiary.¹
2. In accordance with a plan of share exchange adopted pursuant to section 913 of the Business Corporation Law, each share of Petitioner's common stock immediately

¹ Simultaneously with or shortly before the binding share exchange, it is expected that Petitioner will contribute the stock of certain unregulated subsidiaries to Holding Company so that after the binding share exchange such companies will be first tier subsidiaries of Holding Company.

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prior to the effective time of the reorganization will be exchanged for one share of Holding Company common stock.

3. As a result of the binding share exchange, Holding Company will own 100 percent of Petitioner's common stock. The current preferred shareholders of Petitioner will remain preferred shareholders of Petitioner after the exchange.

After the binding share exchange, Holding Company will become a publicly traded company and will be subject to taxation under Article 9-A of the Tax Law. Petitioner states that before and after the reorganization, it will be taxed under section 186 of the Tax Law.

Petitioner is engaging in the proposed reorganization in response to the Public Service Commission's ("PSC") direction to restructure the electric utility industry in New York State. In 1994, the PSC commenced hearings to explore restructuring the electric utility industry to encourage competition and permit customers to choose their electricity providers. In PSC Opinion and Order Regarding Competitive Opportunities for Electric Service, Opinion No. 96-12, issued May 20, 1996, the PSC enunciated its desire to bring New York consumers the innovations and efficiencies of competitive markets, together with economic development, lower electric prices and greater consumer choice, while, at the same time, maintaining the safety and reliability of electric service. In furtherance of this stated goal, the PSC required Petitioner, along with other utilities, to file plans to create a competitive electricity market in New York State.

In response to Opinion No. 96-12, Petitioner submitted its plan on October 1, 1996, and the PSC instituted Case 96-E-0898 for the purpose of examining Petitioner's submission. The initial Settlement Agreement was filed on April 8, 1997, and after revisions, an Amended and Restated Settlement Agreement ("Revised Settlement") was reached on October 23, 1997 by Petitioner PSC staff, Multiple Intervenors, Joint supporters, and the National Association of Energy Service Companies. The Revised Settlement was revised by the PSC's Opinion and Order Adopting Terms of Settlement Subject to Conditions and Changes, Opinion No. 98-1 ("Order"), issued and effective January 14, 1998. On July 30, 1998, Petitioner submitted to the PSC its Petition to Form a Holding Company and for Certain Related Transactions.

In response to the Order, and subject to PSC approval of its July 30, 1998 submission, Petitioner will establish a holding company structure under which one regulated and one or more unregulated companies may operate. The holding company structure is responsive to the PSC's directive to promote competition in the utility industry, while at the same time protecting Petitioner's customers and the regulated businesses from the risks inherent in operating competitive businesses. This is accomplished by establishing Petitioner, which will operate the regulated businesses, as a direct subsidiary of Holding Company. Current and future unregulated businesses will operate in

companies that are subsidiaries of Holding Company. This corporate structure will protect the regulated businesses from the risks inherent in the Holding Company's competitive businesses.

Subsequent to the formation of Holding Company, Petitioner plans to continue its commitment to carry out the stock repurchase program that it announced prior to the formation of the Holding Company. The repurchase program will be carried out by Petitioner directly purchasing the publicly traded common stock of Holding Company, its parent corporation, on the open market, subject to PSC approval and market conditions. Under the program, Petitioner expects to repurchase up to 4.5 million shares of publicly traded common stock during the period 1998 through 2000.

Immediately after repurchasing the Holding Company stock, one of three possible scenarios may occur:

1. Petitioner will distribute the Holding Company stock to Holding Company;
2. Petitioner will transfer the Holding Company stock to Holding Company in exchange for Petitioner's stock held by Holding Company; or
3. Petitioner will hold on to the repurchased Holding Company stock.

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.

In Central Hudson Gas & Electric Corporation, Adv Op Comm T&F, July 29, 1998, TSB-A-98(12)C, several questions pertaining to the tax ramifications resulting from petitioner's corporate

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restructuring under the PSC's Competitive Opportunities Proceeding were addressed. 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.

In this case, with respect to **Transaction 1**, the distribution of the Holding Company stock to Holding Company, for no consideration, subsequent to Petitioner's purchase of the Holding Company stock in the open market through its stock repurchase program, 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 PSC Opinion No. 96-12, and implemented under the restructuring plan described in the Revised Settlement dated October 23, 1997, revised by the PSC's Opinion and Order Adopting Terms of Settlement Subject to Conditions and Changes, Opinion No. 98-1 ("Order"), issued and effective January 14, 1998. Accordingly, pursuant to Adams Electric, supra, such distribution to Holding Company would constitute a dividend subject to the Excess Dividends Tax under section 186 of the Tax Law. The dividend would equal the fair market value of the Holding Company stock determined using generally accepted accounting principles.

With respect to **Transaction 2**, the distribution of the Holding Company stock to Holding Company in exchange for Petitioner's stock that is held by Holding Company, would also be a transaction 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 PSC Opinion No. 96-12, and implemented under the restructuring plan described in the Revised Settlement dated October 23, 1997, revised by the PSC's Opinion and Order Adopting Terms of Settlement Subject to Conditions and Changes, Opinion No. 98-1 ("Order"), issued and effective January 14, 1998. If the fair market value of the Holding Company stock distributed equals the fair market value of Petitioner's stock received in exchange, such distribution of stock to Holding Company would not constitute a dividend subject to the Excess Dividends Tax under section 186 of the Tax Law. For purposes of the previous sentence, fair market value is determined using generally accepted accounting principles. However, if the fair market value of the Holding Company stock distributed to the Holding Company exceeds the fair market value of

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Petitioner's stock received by Petitioner in exchange, the difference in value would constitute a dividend, pursuant to Adams Electric, supra, that is subject to the Excess Dividends Tax under section 186 of the Tax Law.

DATED: January 27, 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.