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

TSB-A-02(13)C
Corporation Tax
July 9, 2002

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C010810A

On August 10, 2001, a Petition for Advisory Opinion was received from KeySpan Corporation and Affiliates, 1 MetroTech Center, Attn: Paul Wright, Brooklyn, New York, 11201.

The issue raised by Petitioner, KeySpan Corporation and Affiliates, is the application of sections 208.9(c-2)(3) and (4), and 208.9(c-3)(3) and (4) of Article 9-A of the Tax Law to depreciable property that is the subject of a “synthetic lease” financing transaction.

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

Petitioner is the parent of a group of calendar year corporations engaged in various utility and energy related businesses. One or more of Petitioner and its subsidiary corporations was a regulated utility or an independent power producer that owned depreciable assets that were made subject to the transitional depreciation rules contained in sections 208.9(c-2)(3) and (4) and 208.9(c-3)(3) and (4) of the Tax Law as added by Chapter 63 of the Laws of 2000.

The regulated utility and independent power producers enter into synthetic leases with respect to the depreciable assets that are subject to the transitional depreciation rules. Petitioner states that a synthetic lease is an off-balance sheet financing transaction between a borrower/lessee (the regulated utility or independent power producer), and a lender/lessor (generally a trust affiliated with financial sector lending institutions). The items of property subject to the synthetic lease in this case are depreciable assets subject to the transitional depreciation rules. Synthetic lease transactions have three core components:

1. In form, the borrower is not a borrower but a lessee under a lease, with options and obligations to purchase the leased asset at the expiration of the lease term. A variety of contractual indemnities, obligations and responsibilities are put in place to vest in the synthetic lessee the economic indicia of ownership of the leased asset.

2. For federal income tax purposes, the synthetic lessee is treated as owning the leased asset. The lease is recharacterized for federal income tax purposes as a financing between the lessee, as borrower, and the lessor, as lender. The lessee thus files its federal income tax returns consistent with the proposition that it owns the asset and owes money to the lessor under a (secured) borrowing; and the lessor treats itself as a lender, receiving debt service payments of principal and interest, not rent.

3. Under generally accepted accounting principles (“GAAP”), the synthetic lease qualifies as an “operating lease.” Consequently, the GAAP based financial statements of the synthetic

lessee show the lessee as paying rent. Its GAAP financial reports do not show the lessee as owning or depreciating the leased asset, nor do they show it as owing the amounts due under the financing.

A lessee's GAAP treatment of synthetically leased assets thus is effectively the opposite of the federal income tax treatment. The synthetic lessee claims depreciation for federal income tax purposes under section 167 of the Internal Revenue Code ("IRC"), but does not report the asset, or any depreciation, on its GAAP financial reports. The lessor does not claim any depreciation deduction with respect to the synthetic leased property for federal income tax purposes.

Discussion

Section 208.9 of the Tax law defines entire net income as "total net income from all sources, which shall be presumably the same as the entire taxable income ... which the taxpayer is required to report to the United States treasury department ... except as hereinafter provided...." Therefore, the taxable income reported for federal income tax purposes is the starting point for computing entire net income. After determining federal taxable income, it must be adjusted as required by section 208.9 of the Tax Law.

Section 208.9(c-2) of the Tax Law provides for adjustments in computing entire net income for qualified public utilities. A "qualified public utility" means a taxpayer that was subject to the ratemaking supervision of the New York State Department of Public Service ("PSC") on December 31, 1999, and for the year ending on December 31, 1999, was subject to tax under former section 186 of Article 9 of the Tax Law.

Section 208.9(c-2)(2)(B) of the Tax Law provides that the term "transition property" means property placed in service by a qualified public utility before January 1, 2000, for which a depreciation deduction is allowed under section 167 of the IRC.

Section 208.9(c-2)(3) of the Tax Law provides that with respect to transition property of a qualified public utility, the deduction for depreciation under section 167 of the IRC is not allowed. Section 208.9(c-2)(4) of the Tax Law provides that with respect to transition property, a deduction is allowed for the depreciation expense shown on the books and records of the taxpayer for the taxable year and determined in accordance with generally accepted accounting principles.

Section 208.9(c-3) of the Tax Law provides for depreciation adjustments by qualified power producers and pipeline companies. A "qualified power producer" means a taxpayer that was not subject to the ratemaking supervision of the PSC on December 31, 1999, and for the year ending on December 31, 1999, was subject to tax under former section 186 of Article 9 of the Tax Law on account of its being principally engaged in the business of supplying electricity.

Section 208.9(c-3)(2)(D) of the Tax Law provides that the term "transition property" means property placed in service by a qualified power producer before January 1, 2000, for which a depreciation deduction is allowed under section 167 of the IRC.

Section 208.9(c-3)(3) of the Tax Law provides that with respect to transition property of a qualified power producer, the deduction for depreciation under section 167 of the IRC is not allowed.

Section 208.9(c-3)(4) of the Tax Law provides that with respect to transition property, a deduction for depreciation expense is allowed, and is computed as follows:

> (1) All transition property shown on the books and records of the taxpayer on January 1, 2000 is treated as a single asset placed in service on such date. The New York basis for purposes of computing the depreciation deduction on such single asset is the net book value of such transition property determined on the first day of the federal taxable year ending in 2000 (or on the date any such property is placed in service, if later), and if the transition property is sold or otherwise disposed of, the New York basis of the single asset is reduced on the date of such sale or disposition by the amount of the adjusted federal tax basis of such property on such date. The "net book value" means cost reduced by accumulated depreciation shown on the books and records of the taxpayer and determined, in the case of a qualified power producer, in accordance with GAAP.
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> (2) The New York depreciation deduction allowed for any taxable year with respect to such single asset shall be computed using the straight-line method, a twenty-year life and a salvage value of zero.

Department of Taxation and Finance Important Notice, N-00-18, August 24, 2000, provides that for purposes of section 208.9(c-3)(4) of the Tax Law, when a fiscal year taxpayer computes its deduction for New York depreciation expense, it treats all of its transition property shown on its books and records on January 1, 2000 as a single asset placed in service on the first day of the federal taxable year that ends in 2000.

For federal income tax purposes, the synthetic lessee has a depreciable interest in the leased property. A qualified public utility and a qualified power producer are allowed a deduction for depreciation under section 167 of the IRC with respect to such synthetically leased transition property. Thus, the condition for the application of the transition rules under sections 208.9(c-2)(2)(B) and 208.9(c-3)(2)(D) of the Tax Law, respectively, is met, and the depreciation deduction allowed for federal income tax purposes with respect to such transition property is disallowed in computing the entire net income of a qualified public utility or a qualified power producer, respectively.

Next, it is necessary to determine the amount of the New York depreciation deduction for depreciation expense that a qualified public utility or a qualified power producer, respectively, is allowed on the synthetically leased transition property under the transition rules in sections 208.9(c-2)(4) and 208.9(c-3)(4) of the Tax Law, respectively. Where a qualified public utility or a qualified power producer is treated for federal income tax purposes as owning synthetically leased transition property, such qualified public utility or qualified power producer, respectively, is also treated as having a depreciable interest in such synthetically leased transition assets under sections 208.9(c-2)(4) and 208.9(c-3)(4) of the Tax Law, respectively, without regard to the GAAP ownership rules.

Therefore, the amount of the New York depreciation deduction for depreciation expense that a qualified public utility is allowed with respect to such synthetically leased transition property is determined by applying the GAAP provisions referenced in the transition rules in section 208.9(c-2)(4) of the Tax Law, "as if" the qualified public utility were the GAAP owner of the transition property. That is, the GAAP rules for determining the "amount" (e.g., useful life, salvage value, cost recovery methods) of the New York depreciation deduction for depreciation expense allowable for transition property are applied to a qualified public utility's synthetically leased assets, without regard to the fact that the GAAP "ownership" rules do not treat the qualified public utility as the owner of such assets.

Likewise, the amount of the New York depreciation deduction for depreciation expense that a qualified power producer is allowed with respect to synthetically leased transition property is determined by applying the GAAP provisions referenced in the transition rules in section 208.9(c-3)(4) of the Tax Law "as if" the qualified power producer were the GAAP owner of the transition property. That is, the GAAP rules for determining the "net book value" of the transition property, which is treated as a single asset for purposes of computing the New York depreciation deduction for depreciation expense allowable for such transition property, are applied to a qualified power producer's synthetically leased assets, without regard to the fact that the GAAP "ownership" rules do not treat the qualified power producer as the owner of such assets.

Conclusion

Under the transition rules in section 208.9(c-2) of the Tax Law, a qualified public utility is required to add back its deduction for federal depreciation allowed under section 167 of the IRC on its synthetically leased transition property, and is then allowed, for purposes of Article 9-A of the Tax Law, to take a New York depreciation deduction for depreciation expense on such property determined in accordance with the depreciation methodologies established under GAAP. The qualified public utility must calculate the amount of such deduction for depreciation expense that is allowed in each taxable year under section 208.9(c-2)(4) of the Tax Law, as if the GAAP depreciation rules applied to its transition property.

Under the transition rules in section 208.9(c-3) of the Tax Law, a qualified power producer is required to add back its deduction for federal depreciation allowed under section 167 of the IRC on its synthetically leased transition property, and is then allowed, for purposes of Article 9-A of the Tax Law, to take a New York depreciation deduction for depreciation expense on such property determined under section 208.9(c-3)(4) of the Tax Law on the basis of transition property treated as a single asset. The qualified power producer must calculate the amount of the accumulated depreciation that is to be subtracted from cost as if the GAAP depreciation rules applied to such property, and thus derive the January 1, 2000 net book value, which is the New York basis for purposes of computing the New York depreciation deduction for depreciation expense of its "single asset" transition property. The qualified power producer must calculate the amount of such deduction for depreciation expense that is allowed in each taxable year using net book value, the straight-line depreciation method, a 20-year life, and a salvage value of zero.

In the calculation of a qualified public utility's or a qualified power producer's New York depreciation deduction for depreciation expense allowed under Article 9-A of the Tax Law for transition property, it does not matter whether the qualified public utility or the qualified power producer in fact maintains GAAP financial reports, or whether a particular asset, or the depreciation thereon is in fact reflected in the qualified public utility's or qualified power producer's GAAP financial reports. However, the qualified public utility or the qualified power producer must maintain a set of books and records to record the application of the transition rules under section 208.9(c-2) and (c-3) of the Tax Law.

DATED: July 9, 2002

/s/
Jonathan Pessen
Tax Regulations Specialist IV
Technical Services Division

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