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Department of the Treasury

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Legend:

Taxpayer =

ISO =

Owners =

State A =

District A =

State B =

Exhibit A =

Transmission Area =

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ISO Agreement =

Dear Sir:

This is in response to your request dated March 5, 1999, as supplemented by letter dated May 20, 1999, for a private letter ruling that the proposed transaction constitutes a management contract for Federal income tax purposes. The facts as represented are set forth below.

Taxpayer is a taxable rural electric cooperative with its principal place of business in State A. Taxpayer uses the accrual method of accounting and employs the calendar year as its tax year. Taxpayer is under the audit jurisdiction of District A. Taxpayer generates and transmits electricity at wholesale through its electric transmission system. According to the Taxpayer, the electric industry is undergoing structural changes as a result of deregulation. One change involves the formation of independent systems operators to manage the nation's electrical transmission assets.

The Federal Energy Regulatory Commission ("FERC") in Order No. 888, "Promoting Wholesale Competition Through Open-Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs," 61 Fed. Reg. 21,540 (May 10, 1996) ("Order 888"), determined that the transfer by the generators of electric power of control of (but not ownership to) their electric transmission assets to independent system operators would further deregulation and competition in the electric generation industry by "unbundling" the generation and transmission of power. The goal of Order 888 is to vest control of large segments of the nation's electric transmission assets in a small number of independent authorities. The effect of this would be to increase the availability of electrical transmission services on a nondiscriminatory basis over broad regions at "non-pancaked" rates (i.e., payment of a single charge for the transmission of electricity over a broad region, rather than the payment of multiple charges with respect to each transmission system included within the region). At present, the FERC has not mandated the transfer of transmission systems to independent system operators, opting instead for the less intrusive "functional unbundling" approach. However, the FERC has indicated that independent system operators have the potential to provide regional efficiencies, to facilitate economically efficient pricing, and to remedy undue discrimination and mitigate market power. Accordingly, the FERC has encouraged the creation of independent system operators. See Section IV(A)(2) of Order 888.

Additionally, in section IV(F)(4) of Order 888, the FERC set forth certain principles for use in assessing proposals submitted to it concerning the creation of

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independent system operators. These principles include: the governance of the operator must be independent of any individual market participant (e.g., transmission systems owners, power marketers, or end-users) and must provide for fair representation; the operator and its employees must have no financial interest in the economic performance of any market participant and the transmission owners must not be empowered to control the operator or dictate its operations (although the operator must be accountable as a fiduciary for the assets of the transmission owners). In addition, the operator must establish strict conflict of interest standards for its employees and must ensure that any contractual arrangements between the operator and market participants are at arm's length; the operator must provide open access to transmission at nonpancaked rates pursuant to a single, unbundled, grid-wide tariff that applies to all eligible users in a nondiscriminatory manner; and the operator must have primary responsibility for ensuring the reliability of the transmission grid operations (including oversight of maintenance and planning to ensure reliability).

Section IV(F)(4) continues by providing that the operator must control operation of interconnected transmission facilities within its region; the operator must have the authority to identify and relieve congested parts of the system; the operator must provide for appropriate management and administration by employing a staff capable of expanding, maintaining, and operating the transmission system and operating a trade settlement system and energy auction; and the operator's pricing policies must be efficient, non-discriminatory, provide cost recovery to transmission owners and fairly address system congestion. Further, the operator must coordinate power scheduling with other operators of transmission systems to ensure system reliability.

Pursuant to Order 888, the Owners, which include Taxpayer, filed a request with the FERC for authorization to establish ISO, a not-for-profit entity to be organized under State B. Taxpayer anticipates that ISO will apply for an exemption from tax under section 501(c)(3) or 501(c)(4) of the Internal Revenue Code.

Pursuant to the ISO Agreement, Taxpayer agreed that it would cede functional control over its "Transmission Systems" to ISO as of the "Transfer Date," which is the date that the ISO can demonstrate that it is functionally able and ready to take over the provision of electricity transmission services. "Transmission Systems" includes (i) all networked transmission facilities above 100 kilovolts, and (ii) all networked transformers where the two highest voltages qualify under the voltage criteria of item (i) above. The facilities may also include other facilities that the ISO directs the Owner(s) to assign to it subject to the procedures set forth in the ISO Agreement. The ISO Agreement identifies the facilities comprising the Transmission System to be transferred by the Taxpayer and other members of the ISO Owner Group.

Under the ISO Agreement, the ISO will have the responsibility of:

(i) ensuring that transmission services are offered over the Transmission System

on a nondiscriminatory basis;

(ii) ensuring the Transmission System's reliability;

(iii) complying with the applicable reliability guidelines, standards, policies, rules, regulations, orders, license requirements, and all other requirements of the North American Electric Reliability Counsel and of applicable regional reliability councils;

(iv) engaging in appropriate planning activities;

(v) scheduling and overseeing the maintenance of the Transmission System;

(vi) controlling the dispatch and curtailments of the Transmission System;

(vii) directing construction of transmission facilities;

(viii) developing monitoring procedures; and

(ix) maximizing the revenues derived from the use of the Owners' transmission facilities.

In addition, the ISO Agreement requires the ISO Board to make written reports to the Owners informing them of the activities of the ISO and to act in accordance with "good utility practice" and in conformity with "operating procedures" established by the ISO and the Owners of the Transmission System when operating the system. The initial term of the ISO Agreement is thirty years and may be extended by the agreement of fifty percent or more of the Owners. Each of the Owners may withdraw from the ISO at any time after five years (with certain exceptions permitting early withdrawal).

Significantly, the ISO Agreement states that for so long as an Owner is a member of the ISO, such Owner retains all "[l]egal and equitable title to the respective properties comprising the Transmission System...including, but not limited to, the right...to build, acquire, sell, dispose of [or] use [such properties] as security" – so long as the exercise of such rights do not impair the reliability of the Transmission System. Moreover, each Owner is required to physically operate and maintain its Transmission System at its own cost and expense.

The ISO Agreement authorizes the ISO to submit proposed transmission pricing to the FERC for approval. The ISO, however, does not guarantee any return of, or on, Taxpayer's or any other Owner's investment in the Transmission System. Instead, any and all revenues received by the ISO are received by it "solely as agent for the Owners or their designees" and are required to be distributed to the Owners in accordance with the ISO Agreement, which provides for the distribution of such revenues proportionate to the revenue requirements of each of the Owners. The rates charged by the ISO for

use of the Transmission System also include an "adder" that is intended to cover the ISO's costs of performing its duties under the ISO Agreement. Significantly, this "adder" does not include a profit component.

The Taxpayer makes the following representations in its submission:

1. The remaining useful life of the Transmission System over which the Taxpayer will cede operational control to the ISO is reasonably expected to be in excess of fifty years.

2. Taxpayer's Transmission System is, and will continue to be, located on land owned by Taxpayer or on land with respect to which Taxpayer has rights to possession.

3. After the Transfer Date, Taxpayer's Transmission System will be used to transmit its own energy and the energy of other parties.

4. The "fair market value wheeling rates" currently authorized by the FERC for the use of the Taxpayer's Transmission System do not separately state charges for services and for the use of property, and it is not anticipated that any future rates authorized by the FERC for the Transmission System of the Owners will separately state charges for services and for the use of property.

The Taxpayer has requested a ruling that for Federal income tax purposes, the ISO Agreement for the use and operation of the Transmission System will be treated as a management contract.

Courts have long held that the substance of an agreement rather than its form determines its true character as a management contract, lease, or other arrangement. Amerco v. Commissioner, 82 T.C. 654 (1984); Kingsbury v. Commissioner, 65 T.C. 1068 (1976). According to the Tax Court, the two primary factors that indicate the existence of a management contract are (1) control of the venture by the property owner and (2) risk of loss on the property owner. Amerco, 82 T.C. at 670; Freesen v. Commissioner, 84 T.C. 920 (1985), rev'd on other grounds, 798 F.2d 195 (7th Cir. 1986); Meagher v. Commissioner, T.C. Memo 1977-270.

In Meagher v. Commissioner, T.C. Memo 1977-270, the taxpayers owned a railroad tank car and entered into a "management contract" with Relco Tank Lines pursuant to which Relco agreed to perform all administrative functions necessary to operate the car (including collecting the mileage or per diem earnings); to repair and maintain the car; to keep records of the car's operation; to insure the car; and to use its "best efforts" to lease the car to shippers, railroads, or others. The taxpayers agreed to pay Relco a quarterly fee equal to 35 percent of the gross operating profit earned by the car and to defend and hold Relco harmless from any loss or damage to the car.

In order to determine whether the "management contract" was in fact a lease, the Tax Court examined whether the owners of the railroad tank car retained control over the venture and had the risk of loss with respect to the property. Concerning the control factor, the Tax Court in Meagher found that although the taxpayers did not directly control the leasing activities of Relco, they did insert provisions in the agreement requiring Relco to keep adequate records of the car's operation; to use its best efforts to lease the car; to obtain insurance coverage for the car naming taxpayers as co-beneficiaries; and to pay the net earnings of the car to taxpayers within ninety days after the end of the calendar quarter. The court found that such provisions provided the taxpayers with sufficient control over the venture to support a conclusion that the agreement was a management contract. Concerning the risk of loss factor, the court acknowledged that the taxpayers agreed to reimburse Relco upon demand for any expenses incurred by the tank car in excess of a $200.00 reserve and to defend, indemnify, and hold Relco harmless from and against all risk of loss or damage to the tank car as well as all claims, damage, expenses or liabilities incurred by, or asserted against Relco, as a result of the operation, possession, control or use of the tank car. Consequently, the court also found that the taxpayers' risk of loss was sufficient to support a finding that the transaction was a management contract.

An analysis of the above factors indicates that under the ISO Agreement, Taxpayer retains sufficient control and risk of loss over its Transmission System for the ISO Agreement to be treated as a management contract. Concerning the control factor, certain provisions of the ISO Agreement indicate that Taxpayer retains control over its properties and facilities with respect to its Transmission System. These provisions require the ISO to: (i) maximize transmission revenue; (ii) maintain adequate records in order to comply with applicable federal and state regulatory requirements, and to permit inspection of its books by the Owners, including Taxpayer; (iii) collect and and remit monthly to the Owners, including Taxpayer, the revenue received by it from users of the Transmission System; and to provide quarterly reports to the Owners, including Taxpayer, of the ISO and annual written reports.

Concerning the risk of loss factor, we note that there is no provision in the ISO Agreement that shifts the risk of loss with respect to the Taxpayer's Transmission System to ISO. As owner of the properties and facilities that comprise its Transmission System, Taxpayer remains ultimately responsible for all operating and maintenance costs. Any losses incurred in operating the Transmission System are solely for the account of the Taxpayer. As the above contractual provisions indicate, ISO has not guaranteed Taxpayer any return of, or on, its investment in its Transmission System. Under these provisions, ISO merely collects revenues from the users of the Transmission System, as agent for the Taxpayer and the other Owners and then remits the revenue to the Taxpayer and the other Owners. The Taxpayer will receive an amount from the operation of its Transmission System that is not fixed (like rent), but, instead, will vary directly in proportion to the profitability of the Transmission System. ISO will receive only an amount sufficient to cover its costs without regard to the

profitability of the Taxpayer's Transmission System. Consequently, the Taxpayer retains the risk that operating its Transmission System will result in an operating loss.

Further, the ability of a property owner to terminate the user's right to use and possess the property is indicative of a management contract. See Nigh v. Commissioner, T.C. Memo 1990-349. The ability of an owner to sell or assign property without the user's consent is also indicative of a management contract. See Amerco, 82 T.C. at 682. In this case, Taxpayer retains the unilateral right to terminate its arrangement with ISO at any time after an initial 5-year period (provided proper notice is given and such termination does not interfere with the Transmission System of the remaining ISO Owners) and to sell or mortgage its Transmission System at any time without the consent of the ISO (although the consent of the FERC may be necessary). Such termination, sale and mortgage rights are consistent with a management contract. As owner of its Transmission System, any increase or decrease in the value of that system will accrue to the Taxpayer, not to ISO.

Section 7701(e)(1) of the Code provides that a contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease, taking into account all relevant factors including whether or not--(A) the service recipient is in physical possession of the property; (B) the service recipient controls the property; (C) the service recipient has a significant economic or possessory interest in the property; (D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract; (E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient; and (F) the total contract price does not substantially exceed the rental value of the property for the contract period.

Section 7701(e) sets forth rules for determining whether an entity is properly characterized as a lessor or a service provider with respect to its property. In the instant case, the Taxpayer is a service recipient with respect to its transmission system. Therefore, section 7701(e) is not applicable. However, the case law and the legislative history to section 7701(e) are helpful for determining the proper characterization of this transaction.

Section 7701(e)(1) was added to the Code by the Tax Reform Act of 1984. The legislative history indicates that although each factor must be considered, some factors may be more significant than others in the context of the entire transaction. See S. Rpt. No. 169, 98th Cong., 2d Sess. 137-138 (1984); H. R. Rep. No. 432, 98th Cong., 1st Sess. 1152-1156 (1984). For instance, Example (3) in the House Report, specifically references the control and risk of loss tests for determining if a transaction structured as a management contract is, in fact, a lease. In Example (3), E, a tax-exempt entity, owned Section-8-assisted low-income housing projects. E sold the property to T, a partnership of taxable persons. In order to ensure that the purposes of the Section 8

housing program are fulfilled, T retained E to manage the property under a long-term management contract pursuant to which E continued to perform many of the same managerial and administrative functions that it performed before the sale. T, however, exercised a degree of control over E's activities because the management contract required E to keep records of operations, use its best efforts to lease the property and to pay net earnings to T within a reasonable period. E was compensated by a fee determined on an arm's length basis. T bore the risk that the property would decline in value and that the property would be lost or destroyed. E does not have an option to repurchase the property.

Example (3) states that the mere fact that E, a tax-exempt entity, continues to control the maintenance and operation of the property under a management contract does not provide a basis for treating the arrangement as a lease. However, Example (3) also notes that the bill leaves open the possibility that an arrangement structured as a management contract could be treated as a lease (under which the tax-exempt entity provides services to third parties for its own benefit) under present law. Example (3) specifically cites to McNabb v. Commissioner, 81-1 USTC ¶ 9143 (W.D. Wash. 1980); Meagher v. Commissioner, supra. H. R. Rep. No. 432, supra., at 156. See also S. Prt. 169 (Senate Print), 98th Cong., 2d Sess. 140, Example (3) (1984).

In our view, the relationship of the parties under the ISO Agreement is consistent with the control and risk of loss analysis in Example (3) above. We note that this transaction is designed to accord with the desire of the FERC, as expressed in Order 888, to provide for the "functional unbundling" of electric power through the creation of independent system operators. Moreover, there is no indication that ISO will be providing services to third parties for its own benefit since it will be subject to the regulation of the FERC and it is contractually bound to a custodial trust relationship to the Taxpayer; has been organized as a not-for-profit corporation; and must remit all amounts collected (above its own costs) to the Taxpayer (as well as the other Owners). Further, the rights and responsibilities of the parties are consistent with the control and risk of loss factors set forth by case law for concluding that a transaction is, in fact, a management contract.

We therefore conclude that the ISO Agreement between the Taxpayer and ISO for the use and operation of the Taxpayer's Transmission System will be considered a management contract for Federal income tax purposes.

No opinion is expressed or implied by this office concerning the correctness of the representations made by the Taxpayer. This ruling is directed only to the Taxpayer who requested it. It has no force or effect with respect to any other Owner who is involved with the ISO. Section 6110(3) of the Internal Revenue Code provides that it may not be used or cited as precedent. A copy of this letter should be attached to the Federal income tax return of the Taxpayer for the taxable year in which the transaction covered by this ruling letter occurs. In accordance with the power of attorney on file, we are sending copies of this letter to the Taxpayer's authorized representative.

Assistant Chief Counsel
Income Tax & Accounting)

By: RMCasey
Robert M. Casey
Senior Technician Reviewer

cc: