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March 10, 2015

TY:

Legend

Taxpayer =

RTO =

Membership Agreement =

State A =
Year 1 =
Service Area =

Service Center =
Y =

Z =
Section a =

Section b =
Section c =
Section d =
Section e =
Section f =
Section g =

Dear :

This is in response to your request dated October 24, 2014, as supplemented by a letter dated December 2, 2014, 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.

FACTS

Taxpayer is a State A regional, consumer-owned, rural electric power cooperative corporation incorporated to generate and deliver electric power and other energy at wholesale to its member systems, many of which are rural electric cooperatives. For federal income tax purposes, Taxpayer is governed by the rules applicable to cooperatives that were in effect prior to the enactment of subchapter T of the Internal Revenue Code of 1986 by the Revenue Code of 1962. Taxpayer is not under examination.[1] Taxpayer uses the accrual method of accounting and employs the calendar year as its tax year. Taxpayer files its returns with Service Center.

Taxpayer is organized and operated on a not-for-profit basis. However, Taxpayer is taxable for federal income tax purposes. Taxpayer is a membership organization with no capital stock. Taxpayer has several classes of membership the qualifications, rights and obligation of which are set forth in Taxpayer's corporate bylaws. In accordance with the laws of State A and its own corporate bylaws, Taxpayer's margins and reserves belong to its customer-owners and must be used to improve or maintain operations, set aside in reserves, or be distributed to the membership. All margins allocated to the membership are allocated on the basis of business done with Taxpayer in a given year.

Taxpayer operates in Service Area. Taxpayer provides at cost electric service to its members as part of a three-tier delivery system. It sells wholesale power to certain members who then sell power to their respective distribution members, who, in turn, sell power at retail to their respective end-use customers. Taxpayer has certain members that are themselves distribution cooperatives. Taxpayer also will sell power at wholesale to unrelated utilities and other entities in the normal course of managing generation capacity that is temporarily surplus to the needs of its members. Taxpayer does not make retail sales directly to end-user retail customers.

Taxpayer is owned by the cooperative members and consumers it serves so end-user customers have substantial input with respect to control and direction of the conduct of Taxpayer's business activities. Taxpayer is governed by a Board of Directors elected by its membership, none of whom is a "related party" with respect to each other pursuant § 318 of the Code. The Board of Directors sets policies that Taxpayer's management implements. With several exceptions, each director has been elected to the board of his or her respective intermediate generation and transmission system.

[1] Taxpayer does have issues before Appeals on a separate matter. The Appeals Officer was contacted in connection with this ruling request and confirmed that Appeals has no objection to ruling in this case.

Taxpayer participates in the federal loan program established by the Rural Electrification Act of 1936, which is administered by the Rural Utilities Service ("RUS"). As a consumer-owned, RUS borrower, Taxpayer is not a public utility subject to comprehensive regulation by the Federal Energy Regulatory Commission ("FERC") or subject to regulation by state utilities commissions. As a RUS borrower, Taxpayer has planned and constructed all its facilities for the sole purpose of serving the current and projected power requirements of its members. It is precluded by the terms and conditions associated with its RUS borrowing from constructing facilities that would support merchant functions (i.e., those functions that attempt to profit from the sales of power to unrelated third parties), although Taxpayer does sell power to unrelated third parties from time-to-time, but only if such power is from temporary surplus to the power needs of its membership and only under very limited circumstances.

Taxpayer's Board of Directors set the rates with respect to its sales of electric capacity, power and energy in accordance with Taxpayer's bylaws and in compliance with its loan covenants, power sales contracts and general cooperative principles. At the end of each calendar year, the Board of Directors reviews Taxpayer's financial position and allocates to its members revenues in excess of operating expenses. The allocations are made on a pro-rata basis, based upon electric energy purchased by each member during the preceding year, and are redeemed in cash to the patrons at times when the Board determines that it is appropriate given Taxpayer's financial needs. As the power requirements of its member systems have grown, Taxpayer has taken steps to ensure the availability of power supply sufficient to meet the needs of its members.

Y and Z are two entities separate and independent from Taxpayer. Taxpayer, Y and Z (collectively, "IS owners"), each own transmission facilities that they operate on a coordinated basis known as an "integrated system" ("IS"). The IS owners operate under a non-jurisdictional Open Access Transmission Tariff that has been filed with the FERC. Y and Z are not members of Taxpayer and are not parties to this ruling request.

The IS owners have decided to transition from the current IS transmission arrangement to a Regional Transmission Organization by becoming members of RTO. Each IS owners has executed a separate membership agreement with RTO. RTO is a not-for-profit § 501(c)(6) organization. RTO has numerous members including investor-owned utilities, municipal systems, cooperatives, wholesale generators, power marketers and independent transmission companies. RTO's primary purposes include facilitating joint planning and coordination of the generation and transmission systems of its members; facilitating maintenance of coordinated operations and service reliability of its member systems; providing a method for member dispute resolution; and preserving or enhancing interconnected system reliability. RTO is mandated by FERC to ensure reliable supplies of power, adequate transmission infrastructure, and competitive wholesale prices of electricity.

RTO's members, not RTO, own the transmission facilities comprising the grid or the generation resources comprising the energy markets. Pursuant to its FERC approved Tariff and the terms of membership agreement with its members, RTO coordinates and directs the real time operations of the members' facilities comprising RTO transmission system ("Transmission System") to ensure that power reaches customers efficiently and timely. RTO provides the following services to its members: (i) Tariff administration to ensure that transmission services are offered over the Transmission System on a nondiscriminatory basis; (ii) Reliability coordination to ensure the Transmission System's reliability; (iii) Monitoring compliance with applicable reliability guidelines, standards, policies, rules, regulations, orders, etc.; (iv) Records management with respect to maintaining and providing access to RTO's books, records, business practices, and control procedures as necessary to assist members in complying with statutory and regulatory requirements including provision of quarterly and annual reports; (v) Joint planning of activities, scheduling and overseeing the maintenance of the Transmission System; (vi) Market operations to control the dispatch and curtailment of the Transmission System; (vii) Expansion coordination of the Transmission System; (viii) Monitoring the Transmission System in real time; and (ix) Revenue management using its best efforts to maximize revenue derived from the use of individual member transmission facilities ("Tariff Facilities") that comprise Transmission System including collecting and distribution revenue to its members.

To cover its costs, RTO collects nominal, annual membership fees from each member as well as administrative charges that are applied to all transmission service on the Transmission System. RTO's Board of Directors establishes the administrative rate applied to the transmission service. RTO retains only that portion of the amounts collected that represent its administrative charges. It distributes the balance of the revenues collected to its member systems based upon the revenue distribution provisions of the Tariff. RTO does not earn a profit. Members are entitled to recover all costs and expenses associated with ownership, maintenance, operation, repair and replacement of their respective transmission facilities included in the RTO Transmission System, which generally includes a FERC approved rate of return on their respective investments in those facilities.

To become a member of RTO, Taxpayer has executed and delivered to RTO the Membership Agreement, which describes the respective rights and obligations of the members to each other and to RTO, as well as RTO's commitments and obligations to its members. Under Membership Agreement, RTO's responsibilities include certain operational and planning activities in administering transmission service over the Transmission System and ensuring reliability of facilities subject to RTO. Membership Agreement is fully effective in accordance with its terms subject to final FERC approval.

Pursuant to Section a of the Membership Agreement, Taxpayer will transfer "functional control" of its Tariff Facilities to RTO, which, according to Taxpayer, means that RTO will direct operation of Taxpayer's Tariff Facilities in administering transmission service

under RTO's Tariff. However, under Section b, while RTO directs operations pursuant to its Tariff, Taxpayer retains physical control and operational control of the Tariff Facilities as discussed below. Further, under Section a, Taxpayer retains all rights of ownership including legal and equitable title in its Tariff Facilities. In addition, Section c sets forth RTO's fiduciary obligations with respect to Taxpayer's Tariff Facilities, which include collecting and distributing revenue on behalf of Taxpayer and using its best efforts to maximize that revenue. RTO is required to use its best efforts to administer Taxpayer's Tariff Facilities in the most efficient manner possible consistent with FERC approved RTO Tariff. In addition, RTO is required to collect and remit to Taxpayer all revenue collected by RTO for use of those facilities less only RTO's administrative costs and fees, which will not include any profit for RTO.

Sections a and b further provide that Taxpayer will retain certain operational authority over its Tariff Facilities in order to protect the public safety and the safety of its workers, or control as necessary to preserve its rights and obligations in serving its customers in accordance with state law. RTO must to coordinate operational control with Taxpayer whenever processing requests for transmission service over Taxpayer's Tariff Facilities.

Under Section d of Membership Agreement, RTO is required to maintain adequate books and records in order to comply with applicable federal and state regulatory requirements and to permit inspection of its books, records, business practices, control procedures, required audit test results, and related financial transactions and settlement activities. Accordingly, RTO must collect and remit monthly to Taxpayer the revenue received by it from third parties attributable to the use of Taxpayer's Tariff Facilities and to provide quarterly and annual written reports to Taxpayer.

Pursuant to Section e of Membership Agreement, Taxpayer will have the unilateral right to terminate RTO's right to use and possess Taxpayer's Tariff Facilities. Taxpayer thus may unilaterally withdraw from Membership Agreement subject only to advance notice and withdrawal fee requirements set forth in Membership Agreement.

Pursuant to Section f, Taxpayer agrees to become subject to RTO's bylaws and have certain voting rights. Taxpayer expects to participate in the election of RTO directors and work with other RTO members in various operational groups, which focus upon specific topics relating to RTO's operations and activities. Taxpayer will be represented on those committees officially by elected representatives and unofficially by such employers and other representatives as it chooses.

Sections a and g of Membership Agreement require Taxpayer to maintain its Tariff Facilities in accordance with Good Utility Practice. Taxpayer is obligated to coordinate and obtain RTO approval for maintenance on its Tariff Facilities. Where Taxpayer owns or controls generation facilities within RTO's region affecting Electric Transmission System capability or reliability, Taxpayer agrees to coordinate maintenance of such facilities with RTO in accordance with this agreement. Taxpayer asserts that pursuant

to these provisions, it will remain fully responsible for all operating, maintenance, repair and replacement costs, and all losses relating to the Tariff Facilities.

The Membership Agreement does not contain any provisions that transfer risk of loss for Taxpayer's Tariff Facilities to RTO. Consequently, Taxpayer asserts that it will retain the full risk of any loss, physical or economic, with respect to Taxpayer's Tariff Facilities.

Under Membership Agreement, Taxpayer is subject to the provisions for coordinated dispatch, maintenance, and planning. Taxpayer also must subject its Tariff Facilities to RTO administration relating to rates, terms and conditions of the RTO Tariff. Thus, while RTO will have the authority to direct day-to-day operations of the Tariff Facilities, Taxpayer will retain physical and operational control of its Tariff Facilities.

Taxpayer makes the following additional representations concerning becoming a member of RTO pursuant to signing Membership Agreement:

1. The remaining useful lives of the owned and leased Tariff Facilities which Taxpayer expects to include in the RTO Transmission System as its Tariff Facilities are reasonably expected to be in excess of 25 years.
2. Taxpayer's Tariff Facilities are, and will continue to be, located on land owned by Taxpayer or on land with respect to which Taxpayer has rights of possession.
3. After the transfer date, Taxpayer's Tariff Facilities will be used to transmit its own energy and the energy of unrelated third parties. Taxpayer will be compensated for the use of its facilities by third-party customers of the Transmission System in accordance with the terms and conditions of the RTO Tariff.
4. Taxpayer will maintain full physical possession, financial responsibility for and operational control over its Tariff Facilities, subject only to the administrative oversight and operational authority granted RTO by the Membership Agreement.
5. Taxpayer will be compensated for third-party use of its Tariff Facilities as described above.
6. RTO will not acquire or be subject to any risk of loss with respect to Taxpayer's Tariff Facilities, and likewise will not be entitled to earn any profit or otherwise to benefit economically from the use of Taxpayer's Tariff Facilities – other than to recover its costs and expenses associated with performing functions and responsibilities set forth in the Membership Agreement and described above.

Taxpayer has requested a ruling that the Membership Agreement executed by and between Taxpayer and RTO will treated as a management contract for Federal income tax purposes.

LAW AND ANALYSIS

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); Nigh v. Commissioner, T.C. Memo 1990-349; Meagher v. Commissioner, T.C. Memo 1977-270.

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) thus 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, however, Taxpayer is a service recipient with respect to its transmission system. Therefore, § 7701(e) has limited applicability. Nevertheless, the legislative history to § 7701(e) and case law are helpful for determining the proper characterization of the agreement between Taxpayer and RTO.

Section 7701(e)(1) was added to the Code by § 31(e) of the Tax Reform Act of 1984, Pub. L. No. 98-369. 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 (Part 2), 98th Cong., 2nd 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 paragraph 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 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 Membership Agreement, Taxpayer retains sufficient control and risk of loss over its Tariff Facilities for the

Membership Agreement to be treated as a management contract.[2] Concerning the control factor, several provisions of the Membership Agreement indicate that Taxpayer retains control over its Tariff Facilities. As outlined in the facts, these provisions require RTO to: (i) maintain adequate records in order to comply with applicable federal and state regulatory requirements, and to permit inspection of those records by Taxpayer; and (ii) exercise its fiduciary duty to use best efforts to maximize revenue to Taxpayer with regard to Taxpayer's Tariff Facilities, to collect and remit net revenues to Taxpayer, and to provide quarterly and annual reports to Taxpayer. Further, Taxpayer retains greater operational control over the Tariff Facilities than did the taxpayers in Meagher, supra. In the instant case, Taxpayer retains operational control over the Tariff Facilities when necessary to serve its customers or to ensure that it will meet its regulatory requirements, and RTO must coordinate with Taxpayer when scheduling transmission service over Taxpayer's Tariff Facilities.

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. In the instant case, Taxpayer has the unilateral right to withdraw from membership in RTO and thus to terminate RTO's use of Taxpayer's Tariff Facilities. In addition, 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. Taxpayer here represents that it can sell any of its Tariff Facilities subject only to advance notice and withdrawal fee requirements set forth in Membership Agreement. Such withdrawal and sale are consistent with a management contract.

Concerning the risk of loss factor, there is no provision in the Membership Agreement that shifts the risk of loss with respect to the Taxpayer's Tariff Facilities to RTO. As owner of these properties and facilities, Taxpayer remains ultimately responsible for all operating and maintenance costs. Any losses incurred in operating the Tariff Facilities System are solely for the account of Taxpayer. As represented by Taxpayer, RTO will not acquire or be subject to any risk of loss with respect to Taxpayer's Tariff Facilities, and likewise will not be entitled to earn any profit or otherwise to benefit economically from the use of Taxpayer's Tariff Facilities, other than to recover its costs and expenses associated with performing functions and responsibilities set forth in the Membership Agreement. Lastly, RTO's compensation depends upon gross revenue for transmission service. It is unable to profit from that service. Consequently, RTO has no interest in, and therefore has no risk from the net operating profits of Taxpayer's Tariff Facilities.

In our view, the relationship of the parties under the Management Agreement is consistent with the control and risk of loss analysis in Example (3) and the cases cited above for concluding that this transaction is, in fact, a management contract.

HOLDING

[2] PLR 199940040 (July 13, 1999) contains an excellent discussion of the law in this area and how it applies to facts very similar to the facts in the instant case.

We therefore conclude that the Membership Agreement between Taxpayer and RTO concerning the use and operation of Taxpayer's Tariff Facilities will be considered a management contract for Federal income tax purposes.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. It has no force or effect with respect to Y and Z, the other IS Owners, who may also become involved as members of RTO. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to the Federal income tax return of Taxpayer for the taxable year in which the transaction covered by this ruling letter occurs. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. No opinion is expressed or implied by this office concerning the correctness of the representations made by Taxpayer. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

William A. Jackson
Branch Chief, Branch 5
Office of Associate Chief Counsel
(Income Tax & Accounting)