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January \_\_, 2003

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Internal Revenue Service  
Commissioner, TE/GE  
Attention: T:EP:RA  
P.O. Box 27063  
McPherson Station  
Washington, D.C. 20038

10474.0098

**Re: Ruling Request re Code Section 501(c)(12)**

Dear IRS Representative:

On behalf of Chugach Electric Association, Inc. (“Chugach” or the “Taxpayer”) we respectfully request a ruling on the consequences under Section 501(c)(12) of the Internal Revenue Code of 1986, as amended (the “Code”) of the retirement of former patrons’ capital credits at a discounted present value as described below.

**A. STATEMENT OF FACTS**

**1. Taxpayer Information**

**a. Description of Parties**

Chugach, an Alaska electric non-profit cooperative membership corporation, is a rural electric cooperative exempt from federal income tax as an entity described in Code Section 501(c)(12). Chugach’s principal offices are located at 5601 Minnesota Drive, Anchorage, Alaska 99518, and its phone number is (907) 563-7494. Chugach’s federal employer identification number is 92-0014224. Chugach files its federal income tax returns on IRS Form 990 and uses a calendar year-end.

Chugach is the largest electric cooperative and the largest electric utility in Alaska. It provides retail service to two-thirds of the homes and businesses in Anchorage and makes wholesale sales of electricity to other utilities in the “railbelt” region (the area served by the rail lines linking Fairbanks, Anchorage and the Kenai Peninsula, where nearly two-thirds of Alaska’s population resides). Currently, Chugach has more than 58,000 patrons and serves more than 71,000 customer meters. A copy of Chugach’s 2001 annual report is attached as Exhibit \_\_\_\_.

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Chugach has consistently satisfied the requirement of Code Section 501(c)(12) that 85 percent or more of its income consist of amounts collected from patrons for the sole purpose of meeting losses and expenses. Chugach does not generate any unrelated business taxable income.

**b. Detailed Description of Proposed Transaction**

As directed by its bylaws, Chugach operates “on a cooperative, nonprofit basis for the mutual benefit of its patrons.” A copy of Chugach’s bylaws is attached as Exhibit \_\_\_\_.

Chugach maintains a patronage capital system that provides for the allocation and retirement of capital credits earned by its patrons. Each year, Chugach allocates the amount by which its income from furnishing electricity exceeds its operating costs and expenses, in the form of capital credits, to its patrons on the basis of their patronage. Chugach later “retires” the capital credits by distributing cash to the patrons and former patrons to whom those capital credits were previously allocated. Currently, Chugach retires capital credits at face value on an approximately 17-year, first-in first-out basis subject to a determination by its board of directors (the “Board”) that Chugach’s financial condition will not be impaired by such retirement. For deceased individual patrons, however, Chugach may retire capital credits early.

Chugach currently has approximately 53,300 patrons and approximately 214,470 *former* patrons with active capital credit accounts (*i.e.*, accounts with capital credits that have not yet been retired). As of December 31, 2001, Chugach had retired almost all of the capital credits allocated in 1985. Thus, the current capital accounts represent capital credits allocated in 1985 or later years.

Article VII of Chugach’s bylaws contains the governing provisions for the patronage capital system. It states that:

In order to induce patronage and to assure that the Association will operate on a nonprofit basis, the Association is obliged to account on a patronage basis to all its patrons, members and non-members alike, for all amounts received from the furnishing of electric energy in excess of operating costs and expenses properly chargeable against the furnishing of electric energy. All such amounts in excess of operating costs and expenses are received with the understanding that they are furnished by the patrons, members and non-members alike, as capital. The Association is obligated to pay all such amounts in excess of operating costs and expenses to the patrons by credits to a capital account for each patron. The books and records of the Association shall be set up and kept in such a manner that at the end of each fiscal year the amount of capital, if any, so furnished by each patron, is clearly reflected and credited in an appropriate

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record to the capital account of each patron, and the Association shall within a reasonable time after the close of the fiscal year notify each patron of the amount of capital so credited to his account. All such amounts credited to the capital account of any patron shall have the same status as though they had been paid to the patron in cash in pursuance of a legal obligation to do so, and the patron had then furnished the Association corresponding amounts for capital.

Chugach Bylaws, Article VII. A copy of the Chugach Bylaws is attached as Exhibit \_\_\_\_.

The bylaws do not require Chugach to retire capital credits on any particular timeline, but instead provide that:

In the event of dissolution or liquidation of the Association, after all outstanding indebtedness of the Association shall have been paid, outstanding capital credits shall be retired without priority on a pro rata basis before any payments are made on account of property rights of members. If at any time prior to dissolution or liquidation, the board of directors shall determine that the financial condition of the Association will not be impaired thereby, the capital then credited to patrons' accounts may be retired in full or in part, according to policies adopted by the Board.

Chugach Bylaws, Article VII.

In accordance with Article VII of the bylaws, the Board adopted Board Policy 126, which governs the current patronage capital system. This policy provides that:

1. All margins received by the Association shall, insofar as permitted by law and approved by the Board of Directors, be allocated to its members on a patronage basis (as may be defined by specific agreements) in accordance with Article VII of the Bylaws. Any amount so allocated shall be included as part of the capital credited to the accounts of members, as herein provided.
2. At the Board's option, early retirements of capital credits may be discounted at the current Chugach cost of capital.
3. No retirements of capital credits will be made without approval of the Board of Directors. However, payments to estates of deceased members will be made upon submission of the appropriate paperwork.

Chugach Board Policy 126, Section E. A copy of Chugach Board Policy 126 is attached as Exhibit \_\_\_\_.

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As mentioned above, Chugach has the authority to retire capital credits of deceased patrons earlier than they would otherwise be retired. Specifically, the bylaws provide that:

Notwithstanding any other provisions of these bylaws, the board of directors, at its discretion, shall have the power at any time, upon the death of any patron, if the legal representative of his estate shall request in writing that the capital credited to any such patron be retired prior to the time such capital would otherwise be retired under the provisions of these bylaws, to retire capital credited to any such patron immediately upon such terms and conditions as the board of directors, acting under policies of general application, and the legal representative of such patron's estate shall agree upon, provided, however, that the financial condition of the Association will not be impaired thereby.

Chugach Bylaws, Article VII.

Chugach has approximately 214,470 former patrons with capital credits that must be accounted for in its patronage capital system (compared to its 53,300 current patrons). Only 20 percent of the persons who were patrons of Chugach in 1985 are still active patrons. Because the 1985 and more recently incurred capital credits have not been completely retired, Chugach must maintain records for all of the remaining 214,470 accounts. Due in large part to the administrative cost of maintaining accounts for former patrons, Chugach management proposed that the Board specifically authorize the early retirement of former patrons' capital credits at a discounted present value. A second reason for proposing an early retirement program is to provide former patrons with the valuable option of receiving payments earlier than they would otherwise receive them under the regular 17-year retirement cycle.

At its September 18, 2002 meeting, the Board adopted a resolution authorizing the General Manager to prepare a plan for retiring capital credits early at a discounted present value (the "Plan"). This resolution is attached as Exhibit \_\_\_\_. The resolution limits the amount available for early payments to former patrons (including estates of deceased individual patrons) to \$500,000 annually to ensure that funds continue to be available for regular capital credit retirements without impairing Chugach's financial condition. The Board directed that the discount rate to be used in calculating the present value of such early payments be set in accordance with Board Policy 126, which policy provides that the discount rate will be Chugach's current cost of capital. To ensure that the adoption of the Plan does not jeopardize Chugach's tax-exempt status, the implementation of the Plan is contingent upon the receipt of a favorable response to this ruling request.

Under the Plan as prepared by Chugach management, only former patrons whose accounts have been inactive for at least 60 days and not reinstated as of the eligibility date for participation in the Plan set by the Board will be eligible to receive discounted present value

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payments in early retirement of their capital accounts. The purpose of the waiting period is to ensure that a patron whose patronage recently terminated will not be reactivating service. Chugach will reserve the right to refuse to retire capital credits of any patron who Chugach believes has terminated its patronage for the primary purpose of participating in the Plan and with the intention of reactivating service. Estates of deceased patrons will not be subject to this 60-day waiting period.

Former patrons will be informed of the Plan in two low-cost ways in order to minimize administration costs. First, notices will be sent to former patrons in December of each year along with capital credit retirement checks that are distributed under Chugach's normal annual capital credit retirement cycle. Second, information about the Plan will be placed on Chugach's website. A former patron who is interested in participating in the Plan will contact Chugach to find out the discounted payment the former patron would receive, the date on which the discounted payment would likely be transmitted, the face amount of capital credits the former patron has, and the schedule under which those credits would likely be retired under the normal retirement cycle then in effect. A former patron who wants to participate in the Plan can request early payment of all, but not less than all, of its capital credits. This request can be made by phone, email, fax or regular mail.

The discount rate applicable to payments under the Plan will be set by the Board to approximate Chugach's cost of equity capital. In making this determination, the Board will look to the most recent cost of equity capital set by the Regulatory Commission of Alaska (the "RCA") for Chugach's electricity ratemaking purposes.<sup>1</sup> Alternatively, the Board may use the 10-year National Rural Utilities Cooperative Finance Corporation ("NRUCFC") borrowing rate plus 3 percent, if that rate is higher than the rate set by the Commission.<sup>2</sup> Except in the initial year of the Plan, the Board will set the discount rate in December for payments to be made under the Plan in the succeeding calendar year. In the initial year, the Board will set the discount rate after receiving a favorable response to this ruling request.

Former patrons whose capital credits are retired under the Plan will receive the present value of their retired capital credits, discounted at the rate set by the Board from the year in which the credits would otherwise be retired under Chugach's regular retirement cycle to the date of the payment. For this purpose, the number of years in Chugach's regular retirement cycle will be estimated based on the funding available for regular retirements as updated

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<sup>1</sup> The RCA has not set Chugach's cost of equity capital for ratemaking purposes recently, but is expected to set one soon as a result of a pending rate case.

<sup>2</sup> The 10-year NRUCFC rate is currently 6.9%, so the discount rate using this method would be 9.9%.

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annually by the Board in the business plan. Thus, these former patrons will receive 100 percent of the value of their capital credits (adjusted to take into account the time value of money). Once all of their capital credits have been retired under the Plan, these former patrons will no longer have a capital credit account with Chugach because such accounts would be paid and retired in full. For accounting purposes, Chugach will record the amount by which the face value of capital credits retired under the Plan exceeds the discounted present value of such credits to “donated capital.”

Although the funding available for early retirements in the first year of the Plan will be \$500,000, this amount may be increased or decreased in the Board’s discretion for future years of the Plan. Furthermore, the Board will reserve the right to reduce funding for or to terminate the Plan at any time.

Discounted payments will be made on a first come, first served basis. The maximum annual payment to be made to any former patron under the Plan will not exceed 10 percent of the total funding authorized by the Board for the Plan for that calendar year. If funding is not adequate to accommodate all former patrons requesting discounted payments, a waiting list will be created for payments to be made during the succeeding calendar year. Once the discount rate is set for the succeeding Plan year, Chugach will notify each former patron on the waiting list of the updated discounted payment the former patron would receive, the date on which the updated discounted payment would likely be transmitted, the face amount of capital credits the former patron has, and the schedule under which those credits would likely be retired under the normal retirement cycle then in effect. The persons on the waiting list will then be entitled to elect to participate in the Plan for the succeeding year before new participants become eligible to participate.

Payments will not be made to former patrons with an outstanding Chugach bill. To participate, those persons will be required to either pay their outstanding bills or allow Chugach to reduce the amounts otherwise payable under the Plan by an amount necessary to satisfy outstanding bills.

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**B. RULINGS REQUESTED**

1. The retirement of former patrons' capital credits pursuant to the Plan will not adversely affect Chugach's tax exempt status as an organization described in Code Section 501(c)(12).
2. The retirement of former patrons' capital credits pursuant to the Plan will not generate any income for purposes of the 85 percent member income requirement of Code Section 501(c)(12).

**C. STATEMENT OF LAW**

Code Section 501(c)(12) provides exemption from federal income tax for benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies and like organizations, but only if 85 percent or more of the income of such organizations consists of amounts collected from members for the sole purpose of meeting losses and expenses. In Revenue Ruling 67-265, 1967-2 C.B. 205, the Internal Revenue Service (the "Service") ruled that rural electric cooperatives were exempt "like organizations" within the meaning of Code Section 501(c)(12).

Tax-exempt cooperatives, like their taxable counterparts, must operate on a cooperative basis. According to the Tax Court, this requires:

- (1) subordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits arising therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and the allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of the operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the cooperative endeavor.

*Puget Sound Plywood, Inc. v. Comm'r*, 44 T.C. 305 (1965).

Revenue Ruling 72-36, 1972-1 C.B. 151, contains additional guidelines for tax-exempt cooperatives. It provides that funds may be retained in excess of those needed to meet current losses and expenses for such purposes as retiring indebtedness incurred in acquiring assets, expanding the services of the cooperative or maintaining reserves for necessary purposes. This ruling also provides that the cooperative must keep such records as are necessary to determine each member's rights and interest in the assets of the cooperative. Revenue Ruling 72-36 prohibits the forfeiture of a member's rights and interest in a cooperative's assets upon the withdrawal of a member or termination of membership.

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In addition to operating on a cooperative basis, a mutual electric company like Chugach must satisfy the 85 percent test in order to be exempt. The 85 percent test is satisfied only if 85 percent or more of a cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses. The 85 percent test is applied on an annual basis, using the accounting period of the cooperative in question. Rev. Rul. 65-99, 1965-1 C.B. 242.

Neither Revenue Ruling 72-36 nor any other published guidance addresses the retirement of capital credits by a tax-exempt cooperative at a discounted present value. The Service, however, has considered whether the retirement of capital credits at a discounted present value by a taxable cooperative generates income. In *Gold Kist Inc v. Commissioner*, 104 T.C. 696 (1995), *rev'd* 110 F.3d 769 (11th Cir. 1997), the Service's position was that Gold Kist, a taxable Subchapter T cooperative, generated income when it redeemed qualified written notices of allocation at discounted values. This position was based on the tax benefit rule, a judicially created principle that serves to correct transactional inequities created by the annual federal income tax accounting system. The tax benefit rule operates to cancel out earlier deductions when an examination of the facts shows that a later event is fundamentally inconsistent with the premise on which the earlier deduction was initially based. *Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370 (1983). This "cancellation" is performed by including amounts in income in later years. According to the Service, the tax benefit rule applied to the redemptions by Gold Kist because the cooperative claimed a tax deduction when it issued the qualified written notices of allocation, and this deduction should have been adjusted in the later years in which the notices were redeemed at a discount. According to the Service, the spread between the amount of the notices and the discounted retirement payments should have been included in the taxable cooperative's income. Although the Tax Court agreed with the Service's position, the Eleventh Circuit reversed the Tax Court and held that the tax benefit rule did not apply to the redemptions.

#### **D. ANALYSIS**

1. The retirement of former patrons' capital credits pursuant to the Plan will not adversely affect Chugach's tax exempt status as an organization described in Code Section 501(c)(12)

The early retirement of former patrons' capital credits at a discounted present value should not affect Chugach's exempt status. Consistent with cooperative principles and Revenue Ruling 72-36, Chugach will continue to maintain a patronage accounting system that allocates capital credits to its patrons based on their patronage. Under the Plan, some or all of the capital credits in the accounts of former patrons will be retired earlier than they otherwise would have been retired under the 17-year regular retirement cycle. Although this may result in the retirement of credits on other than a strictly first-in, first-out basis, neither

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the Code, the Treasury Regulations, Revenue Ruling 72-36 nor any other published guidance prohibits the retirement of credits in such a manner or requires that cooperatives use a strict first-in, first-out retirement system. In any event, participation in the Plan is voluntary and limited to former patrons, which means that the majority of credits retired will likely be older rather than recently-allocated.

The Plan will not cause former patrons to forfeit any of their rights or interests in Chugach's assets. Under the regular 17-year retirement cycle, these former patrons would wait 17 years before receiving a cash retirement payment from Chugach. Under the Plan, these former patrons will receive a cash retirement payment much earlier (up to 17 years earlier). Given the time value of money, it is appropriate to discount cash retirement payments under the Plan to amounts equal to the present value of the cash payments that would otherwise have been made in future years. In fact, without such discounting, the former patrons would be receiving more assets than they are entitled to at the detriment of current and future patrons. The discount rate under the Plan is an appropriate rate for this purpose because it will be set to approximate Chugach's cost of equity capital. Finally, because the present value of an early payment under the Plan is the economic equivalent of future payments under the 17-year retirement cycle, the former patrons participating in the Plan will receive the entire value of their capital credits. Thus, once all of their capital credits have been retired -- either under the Plan alone or under a combination of Plan and regular cycle retirements -- their accounts can be closed without any forfeiture of the former patrons' rights or interests in Chugach's assets.

2. The retirement of former patrons' capital credits pursuant to the Plan will not generate any income for purposes of the 85 percent member income requirement of Code Section 501(c)(12)

Unlike Subchapter T cooperatives, 501(c)(12) cooperatives like Chugach are not taxable except to the extent they have unrelated business taxable income or fail to satisfy the 85 percent test. Because Chugach does not generate unrelated business taxable income and has consistently satisfied the 85 percent test, the allocation of capital credits by Chugach to its patrons does not create a tax deduction. Thus, the initial allocation of capital credits does not generate any tax benefit that could be recaptured in a later year. For this reason, the tax benefit rule would not apply to a later redemption of those credits by Chugach at a discounted present value. Because the tax benefit rule is the basis for the Service's position that discounted capital redemptions generate income, without a tax benefit there will be no income. Thus, the redemption of capital credits at a discounted present value will not generate any income for purposes of the 85 percent test, and the amount by which the face value of the retired credits exceeds the discounted payments will not be added to either the numerator or the denominator for purposes of calculating the percentage of Chugach's income that is member income.

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**E. CONCLUSION**

Based on the analysis contained above, it is clear that the early retirement of former patrons' capital credits pursuant to the Plan will not adversely affect Chugach's tax exempt status as an organization described in Code Section 501(c)(12) because the Plan is not inconsistent with Chugach operating on a cooperative basis. Furthermore, it is clear that the early retirement of former patrons' capital credits pursuant to the Plan will not generate income for purposes of the 85 percent test, under the tax benefit rule or any other theory, and therefore will not affect the annual determination of whether Chugach has satisfied this test.

**F. PROCEDURAL MATTERS**

**1. Rev. Proc. [2003-4] Statements**

To the best of the knowledge of the Taxpayer and the Taxpayer's representative, the same issue is not in an earlier return of the Taxpayer (or in a return for any year of a related taxpayer within the meaning of Code Section 267, or of a member of an affiliated group of which the Taxpayer is also a member within the meaning of Code Section 1504).

To the best of the knowledge of the Taxpayer and the Taxpayer's representative: (a) the Service has not previously ruled on the same or a similar issue for the Taxpayer (or a related taxpayer within the meaning of Code Section 267, or a member of an affiliated group of which the Taxpayer is also a member within the meaning of Code Section 1504) or a predecessor; (b) neither the Taxpayer, a related taxpayer, a predecessor nor any representative has previously submitted the same or a similar issue to the Service but withdrawn the request before a letter ruling was issued; (c) neither the Taxpayer, a related taxpayer, nor a predecessor has previously submitted a request involving the same or a similar issue that is currently pending with the Service; and (d) at the same time as this request, neither the Taxpayer nor a related taxpayer is presently submitting another request involving the same or a similar issue to the Service.

The law in connection with this ruling request is not entirely free from doubt and the issues are not adequately addressed by relevant authorities.

There are no authorities contrary to the positions advanced by the Taxpayer in this ruling request.

In the event that there is any question regarding the issuance of a favorable ruling, a conference at the National Office is respectfully requested.

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**2. Administrative**

A power of attorney on IRS Form 2848 is enclosed.

The deletions statement and checklist required by Revenue Procedure [2003-4] are enclosed.

The required user fee as set forth in Revenue Procedure [2003-8] is enclosed.

CHUGACH ELECTRIC ASSOCIATION, INC.

By:

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date

\_\_\_\_\_  
Pamela Charles Brown, Authorized Representative

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DECLARATION:

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the request contains all the relevant facts relating to the request and such facts are true, correct, and complete.

CHUGACH ELECTRIC ASSOCIATION, INC.

By:

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Title

\_\_\_\_\_  
Date

\_\_\_\_\_  
Donald W. Edwards, Esq.

Enclosures

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