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Person To Contact:
, ID No.

Telephone Number:

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Request for Private Letter Regarding Proper Treatment of Nuclear Decommissioning Liability in Sale of Electric Cooperative's Nuclear Generating Facility Ownership Interest and Proper Allocation Between Member and Nonmember of Electric Cooperative's Section 1245 Depreciation Recapture

Legend

Taxpayer	=
State	=
A	=
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C	=
D	=
E	=
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H	=
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AA =

BB =
$CC =
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Dear :

This letter responds to a letter dated June 19, 2008, and subsequent correspondence, submitted on behalf of Taxpayer, requesting a letter ruling on (1) the proper treatment of Taxpayer's nuclear decommissioning liability in the computation of taxable income resulting from a sale of its undivided ownership interest in a nuclear generating facility and (2) the proper allocation of depreciation recapture under section 1245 of the Internal Revenue Code between members and nonmembers of Taxpayer.

FACTS

Taxpayer represents that the facts are as follows:

Taxpayer, a member-owned K electric cooperative, was formed in A and first granted income tax exemption under section 501(c)(12)(A) of the Code shortly thereafter. Taxpayer remained tax exempt until B when Taxpayer failed to satisfy the 85 percent member sales (income test) requirement of section 501(c)(12)(A). In B and all subsequent years, Taxpayer failed to satisfy the income test because of nonmember revenue received from C. Taxpayer uses the accrual method of accounting and files its federal income tax returns on a calendar year basis.

In D, Taxpayer entered into an agreement with C for the purchase of an E percent undivided ownership interest in Unit 1 and Unit 2 of the F, a nuclear power plant, and a G percent ownership interest in other supporting facilities. The F and the other supporting facilities (all collectively, referred hereinafter as "the Station") are located in State. Beginning in B for Unit 1 of the Station and in H for Unit 2 of the Station there was a power sales agreement with C to purchase Taxpayer's Station output on a I percent declining basis each year for I years.

The lead owner and operator of the Station, C, commissioned periodic studies to be performed to determine the future costs to decommission the Station. C submitted the results of the studies to the J to fulfill the J's requirement that licensees provide financial assurance for the decommissioning of a nuclear power plant, and obtained the J's approval. Based on the results of the studies, C has also obtained from the Internal Revenue Service (IRS), with respect to the decommissioning of its interest in the Station, a schedule of ruling amounts for a nuclear decommissioning fund qualifying under section 468A, for each unit of the Station.

As an owner of a nuclear power plant, Taxpayer is also required by J to recover from current ratepayers and maintain an external trust fund to provide for the decommissioning of the Station to include the dismantlement, clean up, and final disposal of the Station's components. Taxpayer's nuclear decommissioning fund does not qualify under section 468A. Taxpayer fulfills its obligation under its J license to decommission the Station and makes contributions to its nonqualified nuclear decommissioning fund based on its proportionate share of the Station's total decommissioning costs as determined by C's decommissioning studies of the Station on which C received a schedule of ruling amounts from the IRS under section 468A. Taxpayer's nonqualified nuclear decommissioning fund has been treated as a grantor trust under section 677.

Based on a L updated study commissioned by C, Taxpayer's Station's decommissioning cost was estimated to be $M assuming decommissioning in N with a present value of approximately $O. Taxpayer's nuclear decommissioning fund is presently valued at $P.

Financial History of Taxpayer's Station

Taxpayer's interest in the Station was financed by the Q and guaranteed by the R in amount of $S. R, as first lien holder, had the right to take possession of the property in the event of any future default. In T, Taxpayer refinanced $U of its Q obligation with other lenders. In V, Taxpayer reached an agreement with the R for the restructuring of its then-outstanding debt into three separate notes. After experiencing continuing losses in the years subsequent to the debt restructuring, Taxpayer reached an agreement with the R in W in which the sale of Taxpayer's interest in the Station would occur on or before X, or Y would take possession of Taxpayer's assets. A Request for Proposal was issued by the R in W.

On Z, Taxpayer entered into an asset purchase agreement with C and AA (collectively, referred hereinafter as the "Buyers") for the sale of Taxpayer's interest in the Station. Under the agreement, Taxpayer is obligated to transfer to Buyers the Station plus the assets in its nonqualified nuclear decommissioning fund with a fair market value as of BB, of $CC. In exchange, Buyers will pay the purchase price and

assume Taxpayer's nuclear decommissioning liability at a present value of $O. This sales transaction will occur by DD.

Taxpayer will be a nonexempt K electric cooperative for EE, the year of the sales transaction. All gross receipts from the sale of Taxpayer's interest in the Station will be derived from nonmembers. All of Taxpayer's net income from this sales transaction will be ordinary income pursuant to the provisions of section 1245.

Taxpayer has made nonmember electric power sales on a kilowatt (kW) basis and allocated depreciation expense between members and nonmembers based on their percentage usage of the Station through their purchase of electricity measured on kilowatt hours (kWh) basis. At Taxpayer's conference of right, Taxpayer's representatives submitted and discussed information relating to the historic usage of the Station's depreciable property by the members and nonmembers based on their respective usage percentages of the electricity generated by the Station. Based on Taxpayer's representations and the submission, during Taxpayer's period of ownership of Station, member usage of the Station has been FF percent, on weighted basis, of the total kWh of electricity generated by the Station for members and nonmembers use.

RULINGS REQUESTED

Taxpayer requests that the Internal Revenue Service issue the following rulings:

(1) As a result of Buyers' express assumption of Taxpayer's nuclear decommissioning liability, the amount of such liability will be included in the amount realized by Taxpayer and is incurred in the year of sale and is capitalized to the cost of the property produced (electricity) under section 263A during the year of sale and is deductible through cost of goods sold in the year of sale, and

(2) For purposes of section 1245 income recognition, Taxpayer will allocate the amount of income between member and nonmember activity based on its historic use of depreciable property.

LAW AND ANALYSIS

Ruling Request (1)

Section 1.446-1(c)(1)(ii)(A) of the Income Tax Regulations provides that under an accrual method of accounting, a liability is incurred and generally taken into account for federal income tax purposes in the year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 461(h) provides that the all events test is not treated as having been met any earlier than the taxable year in which economic performance has occurred with respect to a liability. See also § 1.461-(4)(a)(1).

Section 461(h)(2)(B) provides that in the case of a liability that requires the taxpayer to provide services, economic performance occurs as the taxpayer provides the services. Section 1.461-4(d)(4) provides that economic performance occurs with respect to such service liabilities as the taxpayer incurs costs in connection with the satisfaction of the liability. Section 1.461-4(d)(5) provides an exception to the general economic performance rule for services where the taxpayer sells a trade or business. Where the purchaser expressly assumes a liability arising out of the taxpayer's trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the sale by the taxpayer.

The first prong of the all events test requires that the fact of the liability be established at the time of the deduction. This prong of the all events test is satisfied in the instant case. Here, Taxpayer clearly has the obligation to decommission the Station. The fact of the obligation arose at the time Taxpayer obtained its ownership interest in the Station and became subject to the decommissioning requirements associated with the Station's license. See 10 C.F.R. section 50.33 and section 72.30, requiring the operator of a nuclear power plant to decommission it. Moreover, Congress recognized the existence of the decommissioning liability when, in 1984, it enacted section 461(h) and section 468A, noting that "generally, under Federal and State laws, utilities that operate nuclear power plants are obligated to decommission the plants at the end of their useful lives." H.R. Conf. Rep. No. 98-861, 877 (1984). See also S. Prt. No. 169, Vol. 1, 98th Cong., 2d Sess. 277 (1984).

The second prong of the all events test requires the amount of the liability to be reasonably determinable. See § 1.461-1(a)(2)(ii). This prong is also satisfied. In the instant case, the amount of Taxpayer's decommissioning liability has been determined by experts in the nuclear decommissioning industry. Their calculations have been reviewed and accepted by the J, which is charged with ensuring that sufficient funds are available to decommission the nuclear power plants. In addition, there is also support in the Internal Revenue Code for finding that the amount of the decommissioning liability is reasonably determinable at the time of sale. Section 468A(d) generally permits a current deduction for a "ruling amount," based on estimated future decommissioning expenses. To the extent the decommissioning costs are sufficiently determinable to entitle a utility to a deduction under section 468A, it is reasonable to conclude that the costs must also be sufficiently determinable to satisfy the second prong of the all events test.

Given that the two prongs of the all events test are satisfied in the instant case, economic performance with respect to the decommissioning liability occurs as of the date of the sale to the extent the liability is included in Taxpayer's amount realized.

Section 1001(b) provides that a seller's amount realized from the sale of property is the sum of any money received plus the fair market value of the property (other than money) received. Section 1.1001-2(a)(1) provides that a seller's amount realized from the sale of property includes the amount of liabilities from which the seller is discharged as a result of the sale. This amount may include debt and non-debt liabilities. See Fisher Co. v. Commissioner, 84 T.C. 1319, 1345-47 (1985) (assumption of lessee's repair liability was part of amount realized on sale of leasehold). The decommissioning liabilities from which Taxpayer will be relieved are fixed and determinable. As an owner and operator of nuclear plants, Taxpayer is required by law to provide for eventual decommissioning. See 10 C.F.R. sections 50.33 and 50.75.

Accordingly, the amount of Taxpayer's nuclear decommissioning liability that is assumed by C and AA will be included in Taxpayer's amount realized and taken into account in computing taxable income in the year of the sale of the Station. As a result, the amount of Taxpayer's nuclear decommissioning liability is incurred in the year of the sale of the Station.

Section 263A(a) provides that the direct costs and indirect costs properly allocable to property that is inventory in the hands of the taxpayer shall be included in inventory costs.

Section 1.263A-1(a)(3)(i)(A) provides that taxpayers subject to section 263A must capitalize all direct costs and certain indirect costs properly allocable to real property and tangible personal property produced by the taxpayer.

Section 1.263A-1(a)(3)(ii) provides that taxpayers producing real property and tangible personal property (producers) must capitalize all the direct costs of producing the property and the property's properly allocable share of indirect costs, regardless of whether the property is sold or used in the taxpayer's trade or business.

Section 1.263A-1(c)(1) provides that under section 263A, taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to property produced or property acquired or acquired for resale. In order to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production or resale activities. After section 263A costs are allocated to the appropriate production or resale activities, these costs are generally allocated to the items of property produced or property acquired for resale during the taxable year.

Section 1.263A -1(c)(4) provides that costs that are capitalized under section 263A are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer.

Section 1.263A-1(e)(3) provides, in part, that taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced and that indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities.

In the instant case, the nuclear decommissioning liability incurred by Taxpayer in the year of the sale of the Station is clearly related to the production of electricity by Taxpayer at the Station. Accordingly, Taxpayer's nuclear decommissioning liability incurred in the year of the sale of the Station will be capitalized to the cost of the electricity produced by Taxpayer during such year under section 263A and section 1.263A-1(e)(3) and will be recoverable by Taxpayer through cost of goods sold under section 1.263A-1(c)(4) in the year of the sale of the Station.

Ruling Request (2)

In the event a K electric cooperative such as Taxpayer loses its tax-exempt status, section 501(c)(12) no longer applies until such time as the cooperative again satisfies the requirements for exemption. During any taxable period, the rules applicable to the electric cooperative depend on the reasons why it failed its exemption test. If exemption was lost because the company failed to operate on a cooperative basis, then it will be taxed under the same rules applicable to for-profit corporations. Alternatively, if the cooperative becomes taxable because it failed the so-called 85-percent-income test imposed by section 501(c)(12), then the organization will be taxed as a nonexempt cooperative.

While the requirements of Subchapter C regarding corporate distributions and adjustments and other provisions are generally applicable to nonexempt cooperatives, these entities are distinguished from other types of corporations by a specific body of tax law. The scheme of taxation for nonexempt cooperatives was developed from the administrative pronouncements of the Service and decisions of the judiciary over a fifty-year period. These rules for tax treatment of most nonexempt cooperatives and their patrons were finally codified with the enactment Subchapter T as part of the Revenue Act of 1962. Pub. L. No. 87-834 (H.R. 10650).

With passage of Subchapter T, the rules for deduction of patronage dividends and the treatment of patronage dividends in the hands of a cooperative's patrons were defined. However, section 1381(a)(2)(C) states that Subchapter T is not applicable to organizations engaged in furnishing electric energy, or providing telephone service to persons in rural areas. According to the Senate Finance Committee Report

accompanying the 1962 Act, the intent of Congress was that nonexempt rural electric and telephone cooperatives would continue to be treated as under "present law."

In its report accompanying the legislation, the Senate Finance Committee described "present law" as follows:

> Under present law patronage dividends paid by taxable cooperatives result in a reduction in the cooperative's taxable income only if they are paid during the taxable year in which the patronage occurred or within the period in the next year elapsing before the prior year's income tax return is required to be filed (including any extensions of time granted).

S. Rep. No. 1881, 87th Cong., 1st Sess. 113 (1962).

Under this earlier body of tax law applicable to nonexempt electric cooperatives, a cooperative may reduce its taxable income by any qualifying patronage dividends paid to its members/patrons. Further, under pre-1962 cooperative rules, the term "paid" means paid in cash or paid by notice of allocation. See also Rev. Rul. 83-135, 1983-2 C.B. 149 (A taxable cooperative not subject to the provisions of Subchapter T may exclude from gross income the patronage dividends paid or allocated to its patrons in accordance with its by-laws).

While Subchapter T does not control the taxation of nonexempt electric cooperatives, its foundations rest upon pre-1962 cooperative tax law. As a result, there are certain basic parallels between the tax treatment of nonexempt utility cooperatives and treatment of other cooperative organizations under Subchapter T. Therefore, to extent that Subchapter T reflects cooperative taxation as it existed prior to 1962, it is instructive in resolving certain issues facing rural electric cooperatives. This is because Congress stated that in enacting Subchapter T it was merely codifying the long common law history of cooperative taxation (with the exception of ensuring at least one annual level of tax at the cooperative or patron level (See S. Rep. No. 1881, 87th Cong., 1st Sess. 113 (1962)) and, arguably, the case law post-enactment is merely a continuation and refinement of the pre-enactment common law. This is particularly true with respect to defining certain terms such as "operating on a cooperative basis" and "patronage income."

Perhaps the most succinct definition of the term "cooperative" for Federal income tax purposes was provided by the U.S. Tax Court in Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305 (1965), acq. 1966-1 C.B. 3. The Tax Court said:

> Under the cooperative association form of organization, on the other hand, the worker- members of the association supply their own capital at their own risk; select their own management and supply their own direction for the enterprise, through worker meetings conducted on a democratic basis; and then themselves

> receive the fruits of their cooperative endeavors, through allocations of the same among themselves as co-owners, in proportion to the amounts of their active participation in the cooperative undertaking.

The Tax Court went on to describe three guiding principles at the core of economic cooperative theory as:

> (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 allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members active participation in the cooperative endeavor.

44 T.C. at 308.

Although the Code does not provide specific guidance as to what constitutes patronage-sourced income for a nonexempt electric cooperative, regulations and rulings address the issues for cooperatives governed by Subchapter T. While not directly applicable to taxable utility cooperatives per se, arguably they reflect the correct analysis with respect to patronage income of cooperatives subject to pre-1962 law.

The Senate Committee Report accompanying the cooperative provisions in the Revenue Act of 1951 indicated that the Congress intended to tax “ordinary” (i.e., non-farmer) cooperatives for:

> non-operating income…not derived from patronage, as for example in the case of interest or rental income, even if distributed to patrons on a pro rata basis.

S. Rep. No. 781, 82d Cong. 1st Sess. (1951).

In response to that guidance of Congress, the Service promulgated regulations distinguishing nonpatronage income from that which is patronage derived.

Section 1388(a)(3) specifies that a patronage dividend must be “determined by reference to the net earnings of the organization from business done with or for its patrons.” That section further provides that the term “patronage dividend” does not include any amount paid to a patron to the extent that such amount is out of earnings other than from business done with or for patrons. Further, it does not include earnings from business done with or for other customers “to whom no amounts are paid, or to whom smaller amounts are paid with respect to substantially identical transactions.”

In Rev. Rul. 69-576, 1969-2 C.B. 166, a nonexempt farmers' cooperative borrowed money from a bank for cooperatives (itself a cooperative) to finance the acquisition of agricultural supplies for resale to its members. The bank for cooperatives allocated and paid interest from its net earnings to the nonexempt farmers' cooperative which it in turn allocated to its members.

In determining whether the allocation was from patronage sources, the ruling states:

> The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources.

Rev. Rul. 69-576 at 167.

The ruling concluded that in as much as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its members, thereby directly facilitating the accomplishment of the cooperative's marketing, purchasing, or service activities, the income was patronage sourced.

Section 1.1382-3(c)(2) defines income from sources other than patronage (nonpatronage income) to mean incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association such as income derived from lease of premises, from investment in securities, or from the sale or exchange of capital assets.

Section 1245(a)(1) and section 1.1245-1(a)(1) provide that, upon a disposition of section 1245 property, the amount by which the lower of (i) the recomputed basis of the property, or (ii) the amount realized on a sale, exchange, or involuntary conversion (or the fair market value of the property on any other disposition), exceeds the adjusted basis of the property shall be treated as ordinary income (that is, gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231). Such gain shall be recognized notwithstanding any other provision of subtitle A of the Code.

Section 1245(a)(3) provides that "section 1245 property" means any property which is or has been property of a character subject to allowance for depreciation

provided in section 167 and is described in one of the categories of property listed in subparagraphs (A) – (F) of section 1245(a)(3).

Rev. Rul. 74-84, 1974-1 C.B. 244, provides that the ordinary income portion of gain recognized from the sale of section 1245 property by a nonexempt cooperative is patronage sourced income to be allocated between member and nonmember workers in accordance with the applicable method of allocation, either quantity or value, utilized in those prior years in which depreciation deductions were taken on the property sold and to the extent allocated to member workers qualifies as a patronage dividend.

In the instant case, Taxpayer is disposing of its interest in the Station, which is used in Taxpayer's business. Thus, the amounts at issue are realized in a transaction that is directly related to the cooperative enterprise. Taxpayer represents that it has allocated depreciation expense between members and nonmembers based on their percentage usage of the electricity generated by the Station as measured on a kilowatt hours (kWh) basis. Accordingly, in order to determine the amount allocable as patronage dividends for members, the gain recognized by Taxpayer under section 1245 from the sale of the Station must be allocated between the members and nonmembers in accordance with their respective usage percentages of the electricity generated by the Station.

CONCLUSION

Based on the facts and representations submitted and the relevant law and analysis as set forth above, we conclude:

(1) As a result of Buyers' express assumption of Taxpayer's nuclear decommissioning liability, the amount of such liability will be included in the amount realized by Taxpayer and is incurred in the year of sale and is capitalized to cost of the property produced (electricity) under section 263A during the year of sale and is deductible through cost of goods sold in the year of sale.

(2) For purposes of section 1245 income recognition, Taxpayer will allocate the amount of income between member and nonmember activity based on its historic use of depreciable property.

Except as specifically set forth above, we express no opinion concerning the federal income tax consequences of the facts described above under any other provisions of the Code. Specifically, no opinion is expressed or implied on whether Taxpayer's nonqualified nuclear decommissioning fund is a grantor trust or on the federal income tax consequences to Buyers resulting from their purchase of the Station (including the assets of Taxpayer's nonqualified nuclear decommissioning fund) and assumption of Taxpayer's nuclear decommissioning liability.

In accordance with the power of attorney, we are sending a copy of this letter to Taxpayer's authorized representative. We are sending a copy of this letter to the appropriate operating division director.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Kathleen Reed

Kathleen Reed
Chief, Branch 7
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures:
Copy of this letter
Copy for section 6110 purposes

cc: