National Rural Electric
Cooperative Association

April 15, 2015

<u>NRECA Submission to the Business Income Tax and the Infrastructure and Community Development Working Groups</u>

<u>Issues and Code Sections</u>

I. Maintain current tax treatment of not-for-profit cooperatives under Sec. 501(c)(12) and 1381(a)(2)(A), (C).

II. Provide equitable incentives for not-for-profit electric cooperatives when tax exempt financing, interest free loans, or other energy incentives are made available to other utilities.

III. Other Provisions including bonus depreciation, small business expensing, the research and development tax credit and the taxation of self-insured pools.

For more information

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I. Tax Treatment of Electric Cooperatives - Retain Sec. 501(c)(12) and 1381(a)(2)(C)

Not-for-profit electric cooperatives should maintain their current tax treatment to ensure that safe, reliable and affordable electricity is available in rural/difficult to serve areas of the United States.

Policy Background

While most electric cooperatives are exempt from federal income taxation under Internal Revenue Code (the "Code") section 501(c)(12), all electric cooperatives pay state and local property taxes, sales tax and payroll and excise taxes – over $1 billion annually.

The predecessor to section 501(c)(12) was created with the passage of the Revenue Act of 1916. Since then, Congress has recognized the unique not-for-profit and operation "at cost" nature of the cooperative business model. Exempting them from taxation makes the Code fairer and promotes the important policy objective of providing affordable electric energy in rural areas where electric cooperatives serve fewer consumers per mile than municipal and investor-owned utilities, and have higher operating costs per consumer.

Electric cooperatives utilize three principles fundamental to cooperative operation: subordination of capital, democratic control and ownership by the members, and operation at cost accomplished by returning net margins to the members on the basis of their patronage with the cooperative. However, a tax exempt electric cooperative must pay tax on its unrelated business taxable income, which is derived from business transactions that are not substantially related to the cooperative's exempt purpose. Because electric cooperatives are owned by those they serve, there are no third party shareholders to bear part of the costs associated with changes in national energy policy. Electric cooperatives' service territories include some of the most rural and impoverished areas of the United States, and, as a result, our members bear a disproportionate share of any cost increases which may occur in the electric utility sector of the economy.

To remain exempt under section 501(c)(12), an electric cooperative must collect at least 85 percent of its income from members for the sole purpose of meeting losses and expenses ("85 percent member income requirement"). Under section 501(c)(12), certain income is excluded when determining compliance with the 85 percent member income requirement. This income is generally incidental to providing electric energy, or promotes important policy objectives. For example, income is excluded if associated with pole attachments, nondiscriminatory open access transmission or distribution service, nuclear decommissioning, and electric energy asset exchanges. If this income is related to providing electric energy, then it is usually excluded from the unrelated business income tax (UBIT). Some income is expressly excluded from UBIT. *See* Code sections 512(b)(18), 513(g).

In addition, pursuant to their purpose under state law, some electric cooperatives meet community needs by providing goods and services through a subsidiary entity. These entities are often taxable. Excluding dividends, interest, loan repayments, rent, and similar amounts from the UBIT promotes the important policy objective of providing needed goods and services in rural areas. *See* Code sections 512(b)(1), (3), (13)(e). Retaining all of these UBIT exclusions

makes the Code fairer and effectively promotes important policy objectives.

Electric cooperatives incur higher capital costs and infrastructure expenses than most other cooperatives. For this reason, exempt and nonexempt rural electric cooperatives are excluded from Code subtitle A, chapter 1, subchapter T ("Subchapter T"). *See* Code sections 1381(a)(2)(A), (C). Taxable rural electric cooperatives operate under the tax law as it existed prior to the enactment of Subchapter T in 1962.

We support efforts to retain these two important sections of the Code which enable our membership to operate on a not-for-profit and "at cost" basis at the lowest possible cost to our members.

Preserve the current tax treatment of electric cooperatives under sections 501(c)(12) and 1381(a)(2)(C).

All the applicable provisions of 501(c)(12) ensure that tax exempt electric cooperatives can meet their public service obligation of providing reliable electric power, at cost. The tax law has recognized that electric cooperatives are unique entities that operate on a not-for-profit basis and serve their members at cost. Additionally, the IRS has long recognized that electric cooperatives achieve at cost operation by the allocation of prior year margins in the form of capital credits to the member providing that portion of the margin. The IRS treats capital credits as deferred price adjustment and they are not taxable to the member unless the member received a prior tax benefit from deducting the cost of power. It is critical to the continued economic development of rural America that these provisions be maintained.

Similarly, it is critical that taxable electric cooperatives continue to be able to operate outside the provisions of Subchapter T. In a capital intensive endeavor such as providing electricity, it is vitally important that taxable electric cooperatives have the flexibility to manage their capital in order to keep their costs as low as possible. For this reason, the current tax law treatment of taxable electric cooperatives needs to be maintained.

II. Energy Tax Policies

Cooperatives should be treated equitably to other energy providers with respect to energy incentives such as the Production Tax Credit (PTC), the Investment Tax Credit (ITC), and other incentives such as tax exempt financing or other subsidized lending provisions. Programs, such as the Clean Renewable Energy Bonds (CREBs), help provide reasonably equitable comparable benefits and should be available for electric cooperatives.

Renewable (PTC – ITC) Tax Credits

The Production Tax Credit (PTC) and the Investment Tax Credit (ITC) for renewable energy generation investment in wind and solar allows an income tax liability to be reduced by a tax credit and therefore the current structure of the PTC effectively does not work for not-for-profit entities such as electric cooperatives.

If renewable tax incentives are extended or enacted in the future, an equitable policy should be

developed which would provide some alternative form of assistance to tax-exempt entities such as electric cooperatives. Any technology-neutral policy considered for domestic production of clean electricity that moves forward which provides tax incentives should include alternative provisions that will help tax-exempt electric cooperatives embrace and implement those new technologies without placing disproportionate costs on our member-owners.

Nuclear Tax Credit

Because of the massive investment that is needed to finance the construction of new nuclear power plants, projects now and in the future are being developed and constructed by partnerships that include investor-owned companies, electric cooperatives and public power systems. New nuclear plants can help to reduce the electric power industry's carbon emissions, achieve clean reliable energy, provide needed base load generation (24/7) electricity and create thousands of new jobs during construction and operation.

Under current law, the nuclear PTC is allocated to facilities on a pro-rata basis, and shared among the joint venture parties in those facilities. Tax credits allocated to electric cooperatives, however, cannot be used either because the electric cooperative is tax exempt or because it does not have sufficient taxable income to utilities the credit. This situation results in a disproportionate net cost among the joint venture participants. The solution is to allow the not-for-profit cooperative to assign its proportionate share of any credit to their joint venture taxable entities that are involved in the project.

Although there is certainly a cost associated with amending the PTC to include nuclear, expanding the nuclear production tax credit will create energy independence, and encourage energy generation research and technology development.

Create tax exempt financing for electric cooperatives

A number of NRECA members are public power systems and are eligible to issue tax-exempt bonds. In addition, generation and transmission cooperatives have utilized billions of dollars in tax-exempt bonds for pollution control facilities. Congress should create tax-exempt financing for electric cooperatives, which can best serve their members by utilizing this alternative.

III. Other Provisions

Depreciation Expenses and Research and Development Credits

We support extending and making permanent the provision under Section 179 which would allow the current expensing of items which would otherwise have to be capitalized and depreciated. We support the annual cap associated with the Section 179 election of $500,000. This provision incentivizes demand for physical goods and allows for the immediately expensing of otherwise depreciable assets. Furthermore, we recommend that the 50 percent bonus depreciation for the purchase of new capital assets be made permanent.

Although not-for profit, member -owned cooperatives are not directly eligible for Research and Development Tax Credit we support making permanent the research and development credit which was first adopted in 1981. The R & D tax credit can play a critical role in creating storage

of renewable energy on the grid. Electricity is the essence of modern civilization. Creating a viable storage mechanism for electricity will enable the full utilization of intermittent renewable assets such as wind. The more efficient we can become, the more value we will create for all American consumers.

Enact tax-exempt status for cooperative group self-insured pools

Certain cooperative electric membership corporations have pooled their resources and formed statewide group self-insured pools to collectively insure their workers' compensation insurance needs in an effort to reduce the ultimate incurred workers' compensation costs to those cooperatives. The ultimate objective for these workers' compensation self-insured pools is not a profit motive; rather, the ultimate goal is reducing the overall cost of workers' compensation to an affordable cost. All excess premiums (surplus) generated by the group self-insured pools are returned to members once all claims have been closed out and appropriate reserves and special regulatory funding stipulations are no longer required. Returned premiums (surplus) are either paid out in the form of cash dividends or allocated capital credits.

Pool members, as cooperative electric membership corporations, are non-taxable due to their cooperative status. Cooperatives could, if large enough, set up an employer self-insured program whereby the reserves and earnings on these reserves would be considered non-taxable as they relate to member operations. However, the Internal Revenue Service had deemed group self-insured pools be treated as a taxable entity for federal income tax purposes and taxed accordingly. This creates an adverse distinction between cooperative *group* self-insured pools and cooperative *individual-employer* self-insured programs.

The Code should be amended to provide a tax-exempt status for cooperative group self-insured pools by allowing these group self-insured pools to allocate surplus earnings to pool members thereby moving the tax burden, if any, to the cooperative members of the pool rather than the pool itself, thus extending the same privileges to cooperative group self-insured pools that individualemployer self-insured cooperative employers enjoy.