February 22, 2019

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-106089-18]

RIN 1545-BO73

Limitation on Deduction for Business Interest Expense Internal Revenue Service

Via email

Dear Sir or Madam,

The National Rural Electric Cooperative Association (NRECA) is the national service organization for America's Electric Cooperatives. The nation's member-owned, not-for-profit electric co-ops constitute a unique sector of the electric utility industry – and face a unique set of challenges. NRECA represents the interests of the nation's more than 900 rural electric utilities responsible for keeping the lights on for more than 42 million people across 47 states. Electric cooperatives are driven by their purpose to power communities and empower their members to improve their quality of life. Affordable electricity is the lifeblood of the American economy, and for over 75 years electric co-ops have been proud to keep the lights on. Because of their critical role in providing affordable, reliable, and universally accessible electric service, electric cooperatives are vital to the economic health of the communities they serve.

America's Electric Cooperatives serve 56 percent of the nation, 88 percent of all counties, and 12 percent of the nation's electric customers, while accounting for approximately 11 percent of all electric energy sold in the United States. NRECA's member cooperatives include 63 generation and transmission (G&T) cooperatives and 834 distribution cooperatives. The G&Ts are owned by the distribution cooperatives they serve. The G&Ts generate and transmit power to nearly 80 percent of the distribution cooperatives, those cooperatives that provide power directly to the end-of-the-line consumer-owners. Remaining distribution cooperatives receive power directly from other generation sources within the electric utility sector. NRECA members account for about five percent of national generation and, on net, generate approximately 50 percent of the electric energy they sell and purchase the remaining 50 percent from non-NRECA members. Both distribution and G&T cooperatives share an obligation to serve their members on a not-for-profit basis by providing safe, reliable, and affordable electric service.

Market Rates

We do not believe it is appropriate to subject electric cooperatives to the same basis allocation approach and market rate assumptions as other electric utilities. In the case of electric cooperatives, investments are made in electric plant which are highly leveraged. Given the nature of baseload generation and adequate transmission capacity, electric cooperatives typically and historically construct baseload assets which allow them to grow into the needs of the membership over time. Given the lengthy construction periods and expensive nature of baseload capacity, it is not something which can be subject to small incremental additions to meet the growing demands of the membership. We urge you to consider and apply the guidance in Litigation Guideline Memorandum 1990 LGM-86 1990 which concluded "On the other hand, a growing electrical power cooperative might find it easier to establish a patronage purpose associated with excess generating capacity where generating capacity must be constructed in large incremental units." In doing so, the Service would recognize that electric cooperatives are organized to serve their membership, operate on a not-for-profit basis and do not speculate in the wholesale energy markets with the intention of earning a profit but invest in infrastructure in excess of their immediate needs to provide reliable electric energy to their members at the lowest reasonable cost.

The Proposed Regulations note on page 26 that a public utility may sell some of its electrical energy output at market rates. The Proposed Regulations specify that, in this situation, the activity related to the sales at market rates would not be treated as activities related to an excepted regulated utility trade or business under these proposed regulations. Accordingly, the proposed regulations provide that to the extent a taxpayer is engaged in both excepted and non-excepted regulated utility trades or businesses, the taxpayer must allocate tax items between the trades or businesses if less than 90 percent of the total output is sold on a cost of service or a rate of return basis. Some regulated utility trades or businesses with de minimis market rate sales, rather than pursuant to a cost of service or rate of return basis, are treated as entirely excepted trades or businesses. See proposed §1.163(j)-10(c)(3)(iii)(C)(3).

Since electric cooperatives are not public utilities under the tax law, we respectfully suggest that the concept of "market rate" should not include any sale pursuant to a contract or tariff approved by the cooperative's board of directors. While electric cooperatives may sell energy into the organized wholesale markets, we believe that only those sales which are not made subject to a contract or tariff approved by an electric cooperative's board should be considered to be sales made at "market rates".

Di Minimis Test

We believe that the Di Minimis threshold for electric cooperatives should be 85% rather than 90%. The legislative history of cooperative taxation began in 1916 when Congress established exemption from federal income tax for mutual ditch or irrigation companies, mutual or cooperative telephone companies, and like organizations. (1916 Revenue Act, P.L. 64-271, sec. 11(a)(10), 39 Stat.766 (1916)). In 1924, Congress extended exemption from the federal income tax to benevolent life insurance associations of a purely local character and reduced the member income requirement for exemption from 100 percent to 85 percent. (Revenue Act of 1924, ch. 234, sec. 231(10), 43 Stat. 283 (1924)). In 1924, Congress determined that a 15% nonmember income threshold was di minimis for tax exempt entities described in section 231(10). These provisions were reenacted in successive revenue acts, and in the 1939, 1954 and 1986 Internal Revenue Codes. Electric cooperatives, which were not specifically listed in the 1916 Statute, but

were recognized by the Service as "like organizations" in I.T. 1671, C.B. II-1, 158 (1923) and Rev. Rul. 67-265, 1967-2 C.B. 205, were added to I.R.C. 501(c)(12)(C) in 1980. The changes to the 85% member income exempt threshold wrought by the Revenue Act of 1924 have continue in place for the 95 years since. As a result of this legislative and administrative history, we believe that a 15% Di Minimis threshold is appropriate for electric cooperatives.

Electric cooperatives invest in electric utility assets to serve their members. National energy policy may require, for reliability and security of the electric grid that electric cooperatives sell energy into organized wholesale markets, but this was not the reason nor the purpose electric cooperatives exist. Electric cooperatives exist to serve their members who are their owners. Allocation of asset basis to transactions compelled to take place as a result of national energy policy essentially assumes that the electric cooperative made investments in utility assets, borrowed substantially all of their cost, and would have interest expense on those borrowings in effect assumed to be part of a separate trade or business associated with making energy sales into organized markets. Allocating asset basis (and interest expense) in a manner that distorts this underlying economic reality for electric cooperatives is, we believe, a fundamental error in the Proposed Regulation.

Proposed §1.163(j)-10(c)(3)(iii) provides that, for utility trades or businesses, the only permissible method for allocating asset basis between excepted and non-excepted utility activities is the relative amounts of output of the trades or businesses. Page 123 of the Proposed Regulations provide that an asset is used to furnish or sell electric energy, and a portion of the energy is sold to wholesale customers where rates are not set on a cost of service or rate of return basis while the remaining portion is sold at a rate established by a ratemaking body described in proposed §1.163(j)-1(b)(13), the taxpayer must allocate the basis in the asset between the taxpayer's excepted and non-excepted trades or businesses.

We strongly believe that the Treasury Department and the IRS should consider other means of allocation rather than simply output. Allocation based on output alone may distort the economic effect of the use of the assets to the electric cooperative. Since electric cooperatives operate on a not-for-profit basis, the value of utility assets to the cooperative's membership may be more accurately reflected if other measures of allocation, such as dollars of sales, were allowed. The members of the cooperative are responsible for paying the principle and interest on the loans undertaken to construct the assets of the electric cooperative. Most electric cooperatives are highly leveraged with utility assets substantially or entirely financed with debt. Allocating interest expense in a manner for income tax purposes that differs with the substantial economic effect of interest expense for cost recovery purposes may distort the income tax cost associated with the actual economic use of the underlying assets.

The IRS has, since the 1960s, accepted that, for taxable electric cooperatives, several methods of allocating expenses between patronage and non-patronage sales and assigning patronage are appropriate. These methods have historically included output, dollar of sales, gross income (sales less cost of sales) or any other method that is fair, rational and consistently applied. We strongly encourage the Treasury Department and the IRS to consider allowing alternative options for the allocation methodology of asset basis for electric cooperatives under Proposed Regulation §1.163(j)-10(c)(3)(iii) in order to more clearly capture the economic effect of a highly leveraged asset.

Basis of Grants and Contributions in Aid of Construction

The tax basis associated with grants and contributions in aid of construction should be entirely allocated to non-excepted utility operations for purposes of the Proposed Regulation under section 163(j). Grants and contributions in aid of construction are typically excluded from the determination of electric cooperative rates. As a result, we believe that the allocation of asset basis associated with such items should be assigned to non-excepted utility functions. Such a result would align the economic consequence of the receipt of the grant or contribution in aid of construction with the cooperative's rate setting practices.

We appreciate the opportunity to comment on this important issue. If you have any questions, please don't hesitate to contact me via email at russell.wasson@nreca.coop or via phone at (703) 402-2510.

Warm regards,

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