

## Deregulation of Electricity: Nature of the Industry and Taxes

---

August/September 2000  
© 2001 – 14 The Electricity Journal 7

Haynes and Boone, LLP  
1000 Louisiana St., Suite 4300  
Houston, TX 77002

Chris Wolfe  
713.547.2024  
wolfec@haynesboone.com

Paul Dickerson  
713.547.2235  
dickersp@haynesboone.com

Stuart Miller  
713.547.2224  
millers@haynesboone.com

---

### I. INTRODUCTION

#### A. Industry Overview

Deregulation of the power industry sounds straightforward.<sup>1</sup> Conceptually, power deregulation will convert a cost-plus monopoly into a market-driven system. In theory, this conversion to a market-driven system will result in greater efficiencies as industry players maximize profits. Consumers should ultimately benefit with lower prices from this competitive profit-maximizing model. However, the power industry is not a single, profit-maximizing behemoth, but rather follows three distinct business models:

- (i) investor owned for-profit enterprises (“private power”);
- (ii) entities owned by the public (“public power”); and
- (iii) rural cooperatives owned by member/customers (“co-op power” or “co-op”).

Private power constitutes about 75% of the total power industry and follows the profit-maximizing model implicit in the logic of electricity deregulation.<sup>2</sup> In contrast, neither public nor co-op power follow this model.

Public power comprises approximately 14% of the industry.<sup>3</sup> Its business model is the provision of a fee-based service to the public. Such enterprises must meet certain federal income tax rules to be classified as a public, as distinguished from for-profit, entity.

Co-op power represents almost 11% of the total power industry.<sup>4</sup> Co-op power's business model is to break even through the distribution of any earnings, based upon each member's power usage amount,

---

<sup>1</sup> The terms *power* and *electricity* will be used interchangeably.

<sup>2</sup> See, APPA, 2001 Public Power Annual Directory & Statistical Report (2001), at <http://www.appanet.org/general/issues/stats.htm> (basing statistics on the number of ultimate consumers).

<sup>3</sup> *Id.*

<sup>4</sup> See, *supra* note 3.

back to the consumer. Distinguished from a for-profit entity, co-op power enterprises must meet certain federal income tax rules to qualify as a non-profit cooperative.<sup>5</sup>

The emerging rules of electricity deregulation are geared toward the private power model. This means that the substantial not-for-profit portion of the power industry (about one-fourth of the total) does not fit the driving model. These emerging rules will cost public and co-op power their special federal income tax status without changing their underlying not-for-profit models. Only the enactment of new tax legislation can prevent this pending conflict of policy objectives.

## **B. Rural Electric Co-ops Background**

Electric co-ops are not-for-profit, customer-owned businesses that serve customers in rural areas. These co-ops helped electrify rural America during the Great Depression and continue to play a critical role in providing affordable electricity to their customers.<sup>6</sup> Electricity deregulation, however, threatens the long-term future of these co-ops.

The problem currently facing rural electric co-ops is commonly referred to as the “85/15” test-codified in Section 501(c)(12) of the Internal Revenue Code of 1986, as amended (the “Tax Code”).<sup>7</sup> This test requires that a rural electric co-op receive 85 percent of its income from its members to remain exempt from federal income taxes.<sup>8</sup> New laws and regulations deregulating the electric utility industry make it increasingly difficult for rural electric co-ops to comply with these rules, yet remain in compliance with the 85/15 test. To survive, rural electric co-ops must do both.

On April 26, 2001, Senate Finance Committee member Fred Thompson (R-Tennessee) introduced legislation that he said would help rural electric co-ops compete in a deregulated electricity market without risking their tax-exempt status.<sup>9</sup> On that same day, United States Representative Scott McInnis (R-Colorado) of the House Ways and Means Committee introduced a companion measure to the House of Representatives.<sup>10</sup> Both bills are collectively referred to as the “Rural Electric Tax Equity Act” or the “Equity Act.”

The Equity Act updates the tax laws to reflect the changes that have occurred in the deregulating electricity marketplace over the past few years, as well as anticipated changes. The Equity Act will allow electric co-ops to effectively compete in the new environment and continue to serve their rural owners/customers. This article provides a detailed explanation of the changes proposed by the Equity Act.

---

<sup>5</sup> I.R.C. § 501(c).

<sup>6</sup> For a brief history of the electric cooperative network, see [http://advocacy.nreca.org/html/govt\\_relations/gr\\_history.html](http://advocacy.nreca.org/html/govt_relations/gr_history.html).

<sup>7</sup> I.R.C. § 501(c)(12).

<sup>8</sup> I.R.C. § 501(c)(12)(C).

<sup>9</sup> S. 794, 107<sup>th</sup> Cong. (2001).

<sup>10</sup> H.R. 1601, 107<sup>th</sup> Cong. (2001).

## II. ELECTRIC INDUSTRY RESTRUCTURING INCOME EXCLUDED FROM MEMBER INCOME TEST

The Tax Code provides that rural electric co-ops are exempt from federal income taxes if “85 percent or more of the[ir] income consists of amounts collected from members for the sole purpose of meeting losses and expenses.”<sup>11</sup> To compute a co-op’s income, the Tax Code currently ignores two types of revenue.<sup>12</sup> The Equity Act proposes eight additional exclusions from the income calculation.

### A. Income Earned by Affiliates

Initially, the Equity Act excludes the income of affiliates from the 85/15 test.<sup>13</sup> Rural electric co-ops often provide non-electric services. Many states require that co-ops form affiliated entities to provide these services.<sup>14</sup> Under the Equity Act, income earned by affiliates is not counted in the co-op’s 85/15 test until paid to the co-op. Subsidiary income is to be taxed at the subsidiary level unless or until dividend payments flow back to the parent rural electric co-op. Furthermore, if state law prohibits the rural electric co-op from offering the non-electric service on a co-op basis, the dividend payments from the subsidiary that were derived from rural electric co-op members can be deemed member income.

### B. Waiver Income

Similarly, the Equity Act excludes waiver income from the 85/15 test calculation.<sup>15</sup> In order to operate on an at-cost basis, rural electric co-ops are required to assign and distribute capital credits (or “patronage dividends”) to their members.<sup>16</sup> This capital credit or patronage dividend represents the difference in revenue received from a member less the operating cost to serve that member.<sup>17</sup> For example, if a rural electric co-op collects \$11 million in revenues and incurs \$10 million in operating costs, the excess \$1 million in revenue is allocated and distributed to the rural electric co-op’s members in proportion to each member’s electric use. In a competitive market, certain members may be willing to forego their capital credits or patronage dividends in exchange for lower rates. To allow for this type of transaction, the Equity Act provides that income “from any patron that voluntarily waives any right to capital credits,

---

<sup>11</sup> I.R.C. ' 501(c)(12)(A).

<sup>12</sup> I.R.C. ' 501(c)(12)(C)(i),(ii). The two types of revenue currently ignored when computing a co-op’s income are from qualified pole rentals, and from the prepayment of a loan under ' ' 306A, 306B, or 311 of the Rural Electrification Act of 1936.

<sup>13</sup> H.R. 1601, 107<sup>th</sup> Cong. ' 2 (2001); S. 794, 107<sup>th</sup> Cong. ' 2, (2001) in the proposed new ' 512(b)(12)(E).

<sup>14</sup> See [http://www.nreca.org/news/codes\\_conduct.html](http://www.nreca.org/news/codes_conduct.html).

<sup>15</sup> H.R. 1601, 107<sup>th</sup> Cong. ' 4 (2001); S. 794, 107<sup>th</sup> Cong. ' 4, (2001) in the proposed new ' 7701(n)(1)(B)(iii).

<sup>16</sup> I.R.C. ' 1382.

<sup>17</sup> *Id.*

patronage dividends, or similar amounts allocated or paid by the nonexempt electric company” will be excluded from the 85/15 calculation.<sup>18</sup>

### **C. Incremental Cost Electric Energy Income**

Under the Equity Act, incremental cost electric energy income will also be excluded from the 85/15 test.<sup>19</sup> For competitive reasons, a rural electric co-op may need to sell electricity below fully allocated cost and at a price based on incremental cost in order to meet market rates (any price above incremental cost lowers the remaining fixed cost the other rural electric co-op members must cover). The Equity Act excludes any income “from any patron for electric energy sold or furnished by the nonexempt electric company based upon the company’s incremental cost of generating, purchasing, transmitting, or distributing the electric energy” thereby allowing the rural electric co-op to better participate in this competitive process.<sup>20</sup>

### **D. Nuclear Decommissioning Income**

In addition, nuclear decommissioning income is not considered when calculating the 85/15 test.<sup>21</sup> A number of electric generation and transmission co-ops are part owners of nuclear power plants with other utilities. Under current tax law, investment income is treated as non-member income for purposes of the 85/15 test.<sup>22</sup> As the nuclear decommissioning fund grows over the life of the nuclear power plant, investment earnings on the fund could cause the electric generation and transmission co-op to fail the 85/15 test. The Equity Act’s language excludes such income from the 85/15 test.<sup>23</sup>

### **E. Condemnation Income**

Furthermore, condemnation income under the Equity Act is not considered when performing a calculation of the 85/15 test.<sup>24</sup> Nationwide, rural electric co-ops suffer the condemnation and annexation of their service territories by municipalities. Under current tax law, condemnation income is non-member income for purposes of the 85/15 test.<sup>25</sup> The Equity Act’s states that income “from any organization or entity, including any municipality, resulting from the compulsory or involuntary requisition or condemnation, or

---

<sup>18</sup> *Id.*

<sup>19</sup> H.R. 1601, 107<sup>th</sup> Cong. ' 4 (2001); S.794, 107<sup>th</sup> Cong. ' 4, (2001) in the proposed new ' 7701(n)(1)(B)(iv).

<sup>20</sup> *Id.*

<sup>21</sup> H.R.1601, 107<sup>th</sup> Cong. ' 4 (2001); S. 794, 107<sup>th</sup> Cong. ' 4, (2001) in the proposed new ' 7701(n)(1)(B)(v).

<sup>22</sup> I.R.C. ' 501(c)(12)

<sup>23</sup> H.R. 1601, 107<sup>th</sup> Cong. ' 4 ,(2001); S. 794, 107<sup>th</sup> Cong. ' 4, (2001) in the proposed new ' 7701(n)(1)(B)(v).

<sup>24</sup> H.R. 1601, 107<sup>th</sup> Cong. ' 4, (2001); S. 794, 107<sup>th</sup> Cong. ' 4, (2001) in the proposed new ' 7701(n)(1)(B)(vii).

<sup>25</sup> I.R.C. ' 501(c)(12)(C).

the threat or imminence of a compulsory or involuntary requisition or condemnation, of any property, asset, or service territory” will be excluded from the 85/15 test calculation.<sup>26</sup> This will not limit a municipality’s right to authority to condemn territory. It merely will allow the rural electric co-op to exclude condemnation income from the 85/15 test, so that the condemnation cannot threaten the rural electric co-op’s tax-exempt status.

#### **F. Prepayment Income**

Moreover, the Equity Act proposes that prepaid income not be considered income to rural electric co-ops.<sup>27</sup> This clarification is important because approximately 20 percent of all rural electric co-ops have prepaid their debt to the Rural Utilities Service, an agency of the United States Department of Agriculture.<sup>28</sup> Because the present-value payment is a discount from the par value of the debt, the IRS presently considers the discounted amount to be non-member income.<sup>29</sup>

#### **G. Contributions in Aid of Construction Income and Property Transfer Income**

Finally, the Equity Act excludes contributions by members or non-members to facilitate establishing or improving electric service from the 85% member income test.<sup>30</sup> In addition, the Equity Act provides that if a rural electric co-op enters into a mutually beneficial agreement to sell, lease or swap service territory or other assets, the income from that transaction is excluded from the 85/15 test.<sup>31</sup>

### **III. ELECTRIC INDUSTRY RESTRUCTURING INCOME INCLUDED AS MEMBER INCOME IN MEMBER INCOME TEST**

In addition to the exclusions from member income described above, the Equity Act deems other types of income to be member income for the 85/15 test. In general, the items deemed to be member income are those which were member income or patronage-sourced income prior to electricity industry restructuring. These newly defined income sources include:

#### **A. Wheeling Income**

The Equity Act clarifies that income from transmission and distribution wheeling transactions conducted to, with or for co-op members, even if actually collected from a third party, are member income for

---

<sup>26</sup> H.R. 1601, 107<sup>th</sup> Cong. ' 4, (2001); S. 794, 107<sup>th</sup> Cong. ' 4, (2001) in the proposed new ' 7701(n)(1)(B)(vii).

<sup>27</sup> H.R. 1601, 107<sup>th</sup> Cong. ' 2, (2001); S. 794, 107<sup>th</sup> Cong. ' 2, (2001) in the proposed new ' 501(c)(12)(C)(iii).

<sup>28</sup> See <http://www.usda.gov/rus/>.

<sup>29</sup> I.R.C. ' 1274.

<sup>30</sup> H.R. 1601, 107<sup>th</sup> Cong. ' 4, (2001); S. 794, 107<sup>th</sup> Cong. ' 4, (2001) in the proposed new ' 7701(n)(1)(B)(vi).

<sup>31</sup> *Id.*

purposes of the 85/15 member income test.<sup>32</sup> Wheeling is the transmission of electricity by an entity that does not own or directly use the power it is transmitting. Wholesale wheeling means bulk transactions in the wholesale market. Retail wheeling allows power producers direct access to retail customers.

#### **B. Regional Transmission Organization Income**

The Equity Act also provides that, if properly authorized, regional transmission organization income will be considered member income for the 85/15 test.<sup>33</sup> Specifically, the new provision states that income from:

[t]he joining, participation in, transfer of ownership or control of property to, or provision of any other goods or services to or for a regional transmission organization, independent system operator, regional transmission group, or similar organization or entity, all as approved or authorized by the Federal Energy Regulatory Commission, the Public Utility Commission of Texas, the Rural Utilities Service, or other appropriate entity

will be considered member income.<sup>34</sup> This provision is needed because it is quite likely that either a statute, regulation or market condition will force rural electric co-ops to participate in regional transmission organizations, placing the co-op's transmission assets or control of its transmission assets within the organization.

#### **C. Unbundling Income and Electric Energy Sales Income**

In addition, the Equity Act provides that unbundling income and electric energy sales income will both be considered member income when calculating the 85/15 test.<sup>35</sup> These provisions clarify that member income is comprised of billing and collection income resulting from unbundling the rural electric co-op's services and income from electric energy sales transactions conducted to, with or for co-op members, even if actually collected from a third party.

#### **D. Replacement Electric Energy Sales Income**

Finally, the Equity Act identifies replacement electric energy sales income as member income for the 85/15 test.<sup>36</sup> To the extent that a rural electric co-op loses kilowatt-hour sales in an open market, the co-op will be allowed to replace those sales with an equal amount of outside kilowatt-hour sales and treat such outside sales as member income for purposes of the 85% member income test.

### **IV. CONCLUSION**

---

<sup>32</sup> H.R. 1601, 107<sup>th</sup> Cong. ' 4, (2001); S. 794, 107<sup>th</sup> Cong. ' 4, (2001) in the proposed new ' 7701(n)(1)(B)(i)(I).

<sup>33</sup> H.R. 1601, 107<sup>th</sup> Cong. ' 4, (2001); S. 794, 107<sup>th</sup> Cong. ' 4, (2001) in the proposed new ' 7701(n)(1)(B)(i)(II).

<sup>34</sup> *Id.*

<sup>35</sup> H.R. 1601, 107<sup>th</sup> Cong. ' 4, (2001); S. 794, 107<sup>th</sup> Cong. ' 4, (2001) in the proposed new ' 7701(n)(1)(B)(i)(III),(IV).

<sup>36</sup> H.R. 1601, 107<sup>th</sup> Cong. ' 4, (2001); S.794, 107<sup>th</sup> Cong. ' 4, (2001) in the proposed new ' 7701(n)(1)(B)(i)(V).

Co-ops were formed to serve a need for energy in rural areas. They are consumer-owned, consumer-driven businesses that exist to provide a service rather than generate a profit. To assist these entities and to maintain a fair competitive environment within the electric industry, the Equity Act proposes needed revisions to the Tax Code's 85/15 test. These changes will allow rural electric co-ops to participate in the new emerging restructured marketplace without fear of losing their tax-free status. In addition, the changes will give all segments of the electric industry an even playing field on which to compete. By excluding certain income from the 85/15 test calculation and deeming that other types of income are member income, the Equity Act accomplishes these objectives.