



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Dear :

This is in reply to a letter from your authorized representatives dated March 21, 2003, who requested a ruling on your behalf concerning your status as an electric cooperative described in section 501(c)(12) of the Internal Revenue Code.

You have been exempt from federal income tax under section 501(c)(12) of the Code (hereafter Code) since June 1973. You have consistently computed your compliance with the 85 percent member income test under section 501(c)(12) on the basis of gross income. You are a calendar year organization using the accrual method of accounting. You operate as a power supply cooperative supplying wholesale electric power to your members. You currently have thirteen members, each of which is purchasing electricity from you on a wholesale basis.

You are looking for ways to lower your interest costs pursuant to an interest rate swap. You have been advised that long-term fixed rates can be achieved in the swap markets that are substantially lower than the long-term fixed rates in the bond market. As a result, you intend to issue up to \$300 million of floating rate debt. To accomplish this you will enter into interest rate swap agreements with one or more financial institutions. None of these financial institutions are members of your organization. Under the swaps, you will make periodic payments equal to a fixed-rate on a notional principal amount and receive periodic payments equal to a floating-rate on the same notional principal amount. The periodic payments will be netted on each payment date and you will make or receive a net payment equal to the difference between the fixed and floating-rate multiplied by the notional principal amount. The swaps will be identified as hedges in your books and records.

In order to manage price risk associated with fuel, you intend to use certain financial instruments in order to reduce or eliminate price risk on fuel. To hedge your fuel price risk, you will enter into natural gas futures contracts with entities that are not members of your organization. You will execute futures contracts at a predetermined price. You stipulate the following in connection with the futures contracts: (1) The contracts will be used for purposes of hedging your purchase of gas and for hedging your purchase of power where the cost of the power is related to the daily price of gas; (2) you intend on cash settling all contracts on a net basis; (3) the contracts will qualify as

hedges as set forth in section 1.1221-2(a) of the Income Tax Regulations; and (4) the NYMEX contracts will be identified in your books and records as hedges in accordance with section 1.1221-2(f) of the regulations.

Section 501(c)(12) of the Code provides for the exemption from federal income tax of benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Section 1.446-4(a) of the regulations generally provides that a hedging transaction, as defined in section 1.1221-2(b), must be accounted for under the rules of section 1.446-4.

Section 1.446-4(b) of the regulations provides that the method of accounting used by a taxpayer for a hedging transaction must clearly reflect income by reasonably matching the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged.

Section 1.446-4(e)(5) of the regulations provides that the rules of section 1.446-3 govern the timing of income and deductions with respect to a notional principal contract (NPC) unless, because the NPC is part of a hedging transaction, the application of those rules would not result in the matching that is needed to satisfy the clear reflection requirement of section 1.446-4(b). For example, the regulations provide that if an NPC hedges a debt instrument, the method of accounting for periodic payments described in section 1.446-3(e) generally clearly reflects the taxpayer's income.

Section 1.446-3(c) of the regulations defines a NPC as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.

Section 1.446-3(e)(2) of the regulations states that all taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a periodic payment for the taxable year to which that portion relates.

Section 1.446-3(d) of the regulations provides the net income or net deduction from an NPC for a taxable year is included in or deducted from gross income for that taxable year. The net income or net deduction from an NPC for a taxable year equals the total of all of the periodic payments that are recognized from that contract for the taxable year.

Section 1221(b)(2) of the Code defines a hedging transaction to include any transaction entered into in the normal course of business primarily to manage risk of price changes with respect to ordinary property that is held or to be held by the taxpayer. See also section 1.1221-2(b)(1).

The swaps between your organization and the financial institutions are NPC's (notional

principal contracts) pursuant to section 1.446-3(c) of the regulations. Thus, section 1.446-3 of the regulations governs the timing of income and deductions with respect to periodic payments.

Pursuant to section 1.446-3(e)(2) of the regulations, you will recognize the ratable daily portion of each periodic payment for the taxable year to which that portion relates. Under section 1.446-3(d) of the regulations, your organization shall recognize only the net periodic payment from the swaps. Thus, for purposes of the 85 percent of the member income test, your organization may calculate nonmember income by reference to the net income derived from the swaps.

Your organization's inventory of natural gas and electricity is ordinary income property under section 1221(a)(1) of the Code. Therefore, assuming that the contracts manage risk of price changes with respect to the natural gas and electricity inventories, the contracts are hedging transactions within the meaning of section 1221(b)(2) and section 1.1221-2(b)(1) of the regulations.

As explained above, section 1.446-4 of the regulations governs the timing of hedging transactions as defined in section 1.1221-2(b) and generally requires that the method of accounting used by a taxpayer for a hedging transaction must clearly reflect income by reasonably matching the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged.

For hedges of purchased electricity, section 1.446-4(e)(3) of the regulations provides that if a hedging transaction hedges purchases of inventory, gain or loss on the hedging transaction may be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of the cost of inventory. Under section 1.471-1 of the regulations, you must include the cost of the purchased electricity inventory in your ending inventory until you sell the electricity to members. Consequently, you may not recognize your net gain or loss on the contracts that hedge electricity purchases until you sell the related electricity inventory.

For hedges of the natural gas inventory, the cost of natural gas becomes a cost of the electricity inventory produced when the natural gas is consumed in the ordinary course of production. Section 1.263A-1(e)(2)(i)(A) of the regulations provides that producers must capitalize direct material costs, which include the cost of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced. Thus, you must include the cost of the natural gas inventory in your ending inventory until you sell the electricity to members. Accordingly, you may not recognize your net gain or loss on the contracts that hedge the natural gas inventory until you sell the related electricity.

Accordingly, we conclude as follows:

1. For purposes of the 85 percent member income requirement under section 501(c)(12) of the Code, you may calculate nonmember income by reference to the net income derived from the interest rate swaps; and

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2. For purposes of the 85 percent member income test under section 501(c)(12) of the Code, your nonmember income from the contract transactions will be the amount of gain that you recognize from the contract, if any, at the time the contract is settled.

This ruling is conditioned on the understanding that there will be no material change in the facts upon which it is based. Also, we express no opinion as to the tax consequences of the transactions under other provisions of the Code.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited by others as precedent.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter. You should keep a copy for your permanent records.

Sincerely,

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3

Enclosure
Notice 437