



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Dear :

Employer Identification Number:

Person to Contact and ID Number:

Contact Telephone Number:

FAX Number:

This is in response to your request dated July 25, 2011, for rulings as to whether your establishment of a central counterparty structure pursuant to which you will become the central counterparty to transactions that take place in the markets you administer will affect your status as an organization described in section 501(c)(3) of the Internal Revenue Code (the "Code") or will give rise to income from an unrelated trade or business within the meaning of section 513(a).

Facts

You are recognized as an organization exempt from Federal income tax under section 501(c)(3). You are organized and operated exclusively for the purpose of lessening the burdens of government within the meaning of section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations (the "regulations"). You are designated as the regional transmission organization ("RTO") for a specific area and are the only RTO authorized by the Federal Energy Regulatory Commission ("FERC") for that jurisdiction.

FERC is responsible for regulating the transmission and wholesale sale of electric energy in interstate commerce to ensure reliability of electric service, nondiscriminatory access to transmission facilities, and that rates charged are reasonable. Prior to your creation, FERC directly regulated the vertically integrated utilities that owned generation, transmission, and distribution facilities in your region.

As part of the process of deregulation and the introduction of market competition into the wholesale electricity market, FERC charged you with providing independent, open and fair access to electricity transmission systems, facilitating market-based wholesale electricity rates, and ensuring effective and reliable management and operation of the bulk power system in your region. This includes the responsibility of ensuring that rates charged for transmission and sale of electric energy are reasonable. If you ceased to operate, FERC would be required to directly assume these responsibilities for your region.

In furtherance of your responsibilities, you administer markets for the wholesale purchase and sale of electric energy and related products and services. In order to cover your operating expenses, you collect fees from the producers and wholesale purchasers of electric power in your region. These fees as well as the rules and procedures for the electricity markets you

administer are set forth in your tariffs, which must be approved by FERC. The contracts, agreements or transactions offered under your FERC-approved tariffs are for the purchase and sale of electric energy and related products and services, including related financial transactions which do not involve physical delivery of electricity.

Currently, the transactions you administer are not structured as direct bilateral contracts, *i.e.*, individual purchase and sale contracts between a particular seller and a particular purchaser. Rather, you administer central markets for the benefit of market participants. Each market participant has established a settlement account with you, and you settle the various positions of the market participants on an aggregate basis. While you act as the administrator of the markets, clearing and settling purchases and sales by market participants, you do not take title to the electric energy and related products and services purchased and sold in the markets.

FERC monitors the credit practices of the wholesale electric markets. In its Order No. 741, "*Credit Reforms in Organized Wholesale Electric Markets*," (Oct. 21, 2010), 133 FERC ¶ 61,060, and its Order No. 741-A "*Credit Reforms in Organized Wholesale Electric Markets*," (Feb. 17, 2011), 134 FERC ¶ 61,126, FERC raised a question about the ability of an RTO or an independent system operator ("ISO"), in the event of the bankruptcy of a market participant, to set off or net the market positions of the bankrupt market participant. You state that FERC's concern is that an ISO or RTO might not satisfy the "mutuality" requirement for setoff when those obligations are based upon different purchase and sale transactions because there is potential ambiguity as to the role of the ISO and RTO in the transactions. FERC therefore directed you (as well as other ISOs and RTOs) to submit a compliance filing with a proposed tariff revision that includes one of the following options:

1. establish yourself as a central counterparty to transactions with market participants;
2. require market participants to provide a security interest in their transactions in order to establish collateral requirements based on net exposure;
3. propose another alternative, which provides the same degree of protection as the two above-mentioned methods; or
4. choose none of the three above alternatives, and instead establish credit requirements for market participants based on their gross obligations.

In response to the specific FERC orders above, you intend to pursue option 1: tariff amendments proposing to establish yourself as the central counterparty to all transactions that take place in the markets you administer. Specifically, you will take title to the electric energy and related products and services purchased and sold in the markets. You represent that your role as central counterparty will not affect the clearing price, because the prices you pay to providers will exactly match the prices you receive from the sellers. You concluded that option 1 is the best balance between 1) fostering market liquidity and efficiency; and 2) minimizing the risk of defaults. All transactions in which you engage will be pursuant to a FERC-approved tariff. The revisions to the tariff establishing you as central counterparty will be filed with FERC and will go into effect only if approved by FERC.

You have represented that your activities as the central counterparty to transactions in the markets you administer (1) will not require an amendment to any of your organizing documents or any change to your organization; (2) will require only minor revisions to your FERC-approved tariff; (3) will result in no net profit or loss to you; and (4) will not directly affect market clearing prices for electric energy and related products and services in the wholesale electric markets you administer. You have also represented that you are not aware of any statute or law that prohibits a government from acting as or performing the functions of an RTO and that your operations will not change materially following your assumption of the central counterparty role.

Rulings Requested

1. Your establishment and implementation of a central counterparty structure pursuant to which you will become the central counterparty to transactions consummated through the markets you administer will not adversely affect your status as an organization exempt from Federal income tax under section 501(c)(3) of the Code.
2. The revenues you receive by virtue of being the central counterparty to transactions consummated through the markets you administer will not be classified as income from an unrelated trade or business within the meaning of section 513(a).

Law

Section 501(c)(3) of the Code exempts from Federal income tax a corporation organized and operated exclusively for charitable, educational, and other purposes, provided that no part of its net earnings inures to the benefit of any private shareholder or individual.

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c)(3).

Section 512(a) of the Code states that the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the applicable deductions, and computed with the modifications in section 512(b)).

Section 513(a) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the purpose or function constituting the basis for its exemption under section 501.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such purposes described in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1) of the regulations provides that an organization may be recognized as exempt under section 501(c)(3) of the Code if it is operated exclusively for one or more of the following purposes: religious, charitable, scientific, testing for public safety, literary, educational, or prevention of cruelty to children or animals.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense. This term includes relief of the poor and distressed or of the underprivileged; the erection of public buildings, monuments, or works; and lessening the burdens of government. It also includes the promotion of social welfare by relieving the poor and distressed or the underprivileged, combating community deterioration, lessening neighborhood tensions, and eliminating prejudice and discrimination.

Section 1.513-1(d)(1) of the regulations provides that gross income derives from "unrelated trade or business" within the meaning of section 513(a) of the Code if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income). A trade or business is "substantially related" only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplish of those purposes.

Rev. Rul. 85-1, 1985-1 C.B. 178, and Rev. Rul. 85-2, 1985-1 C.B. 178, set out a two-part test for determining whether an organization's activities are lessening the burdens of government. First, it is necessary to determine whether the governmental unit considers the organization's activities to be its burden. The second part of the test is whether these activities actually lessen the burdens of the government. An activity is a burden of the government if there is an objective manifestation by the governmental unit that it considers the activities of the organization to be its burden. The interrelationship between the governmental unit and the organization may provide evidence that the governmental unit considers the activity to be its burden. Whether the organization is actually lessening the burdens of government is determined by considering all relevant facts and circumstances.

In *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283, 66 S. Ct. 112, 90 L. Ed. 67, 1945 C.B. 375 (1945), the Court stated that "the presence of a single . . . [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes."

Analysis

Ruling 1

As the RTO for your particular region, you lessen the burdens of government by being responsible for administering the market-based regulation of the wholesale electricity market

and ensuring that rates charged for transmission and sale of electric energy are reasonable, a responsibility that FERC would be required to assume directly if you ceased to operate.

Your establishment and implementation of a central counterparty structure pursuant to which you will become the central counterparty to transactions in the markets you administer, is a response to credit reforms mandated in FERC Order Nos. 741 and 741-A. Your activities as the central counterparty will not require an amendment to any of your organizing documents, though certain revisions to your FERC-approved tariff will be required for implementation of the central counterparty structure. These revisions must be approved by FERC.

As central counterparty, you will take title for a brief period of time to the electric energy and related products that are the subject matter of those transactions. Your role as a central counterparty will not affect the clearing price, because the prices you pay to producers will exactly match the prices you receive from the wholesale purchasers. Apart from taking title to electric energy and related products in your capacity as central counterparty, your market administration activities will remain essentially the same. Your activities as the central counterparty will result in no net profit or loss to you.

By mandating that ISOs and RTOs revise their tariffs to implement enhanced credit practices, FERC has established how you must conduct your market administration activities to provide for the nondiscriminatory and efficient transmission of electric energy. A default by one or more market participants could lead to a larger default in the market, disrupting services and the flow of electricity as well as raising the costs of doing business in the electricity market and a corresponding increase in rates paid. By acting as the central counterparty, you will be able to offset the obligations of a defaulting participant against payments owed to that participant, reducing the impact of one participant's default on the operations of other participants. The market participants are not able to do this themselves because of the clearing price system you use and the lack of contract privity with the defaulting party. Your sole purpose in acting as a central counterparty is to reduce the disruptions caused by a participant's default and in turn fulfill your responsibility for administering the market-based regulation of the wholesale electricity market and ensuring that rates charged for transmission and sale of electric energy are reasonable, in line with your exempt purpose within the meaning of section 1.501(c)(3)-1(d)(2) of the regulations and Rev. Rul. 85-1, supra, and Rev. Rul. 85-2, supra. You will not generate any net income from the activity.

Accordingly, the implementation of the central counterparty structure, and your activities as the central counterparty to each transaction in the markets you administer, will not adversely affect your status as an exempt organization described in section 501(c)(3) of the Code as compared to your previous operations.

Ruling 2

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business which is not substantially related to the performance of an organization's exempt purpose. Section 1.513-1(d)(2) of the regulations states that a trade or business is substantially related to an organization's exempt purpose if it contributes importantly to the accomplishment of that purpose. As stated above, by acting as a central counterparty you will reduce the disruptions caused by a market participant's default. This contributes importantly to the accomplishment of your exempt purpose of lessening the burdens of government by

administering the market-based regulation of the wholesale electricity market and ensuring that rates charged for transmission and sale of electric energy are reasonable. Therefore, acting as a central counterparty is substantially related to your exempt purpose and will not constitute an "unrelated trade or business within the meaning of section 513(a).

Rulings

1. Your establishment and implementation of a central counterparty structure pursuant to which you will become the central counterparty to transactions consummated through the markets you administer will not adversely affect your status as an organization exempt from Federal income tax under section 501(c)(3) of the Code.
2. The revenues you receive by virtue of being the central counterparty to transactions consummated through the markets you administer will not be classified as income from an unrelated trade or business within the meaning of section 513(a).

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 Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or Regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your Federal income tax status, this ruling should be kept in your permanent records.

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.

In accordance with the Power of Attorney currently on file with the Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Andrew F. Megosh, Jr.
Manager, Exempt Organizations
Guidance Group 2

Enclosure
Notice 437