

KEMPEL, HUFFMAN AND ELLIS, P.C.

MEMORANDUM

TO: Dave Carlson  
Southeast Conference Intertie Coordinator

FROM: Dean Thompson

DATE: March 16, 2004

SUBJECT: Legal Entity Options for Southeast Alaska Intertie Project

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**I. Introduction.**

In response to the Southeast Conference's January 23, 2004, RFP and the subsequent teleconferences with you and the legal entity formation subcommittee, below is my analysis of the viable legal entity options available for ownership and/or operation of segments of the Southeast Alaska Intertie Project. There are several legal entity options available under Alaska law. However, based on the entity requirements and characteristics that were identified in the RFP, during our teleconference, and in the prior comments and discussions regarding intertie ownership, I believe that there are four primary, potentially viable options that should be discussed and considered in detail: (1) an electric transmission cooperative, (2) a limited liability company ("LLC"), (3) a nonprofit corporation, and (4) a for profit corporation. As will be explained below, each have advantages and disadvantages, but it appears that a transmission cooperative best satisfies the requirements for the project.

As requested in the RFP, I have also prepared a matrix, which is attached to this memorandum. That matrix summarizes various aspects of each of the four potentially viable entities and relates them to entity requirements and characteristics that are of greatest concern with respect to the intertie project.

**II. Other Entity Options Not Addressed in Detail.**

As an initial matter, I would like to briefly address some of the other legal entities that have been discussed in previous comments.

**A. Joint Action Agency.**

As you recall, two years ago there was significant discussion of forming a joint action agency ("JAA") pursuant to AS 42.45.300. As you indicated in the RFP, this met with considerable opposition for various reasons. Among the most significant was that in order for the JAA to be tax exempt under federal income tax law, investor owned utilities ("IOUs") could

TO: Dave Carlson  
FROM: Dean Thompson  
DATE: March 16, 2004  
SUBJECT: Legal Entity Options for Southeast Alaska Intertie Project  
PAGE: 2

---

not be members. In addition, AS 42.45.300 would have to be amended to ensure the requisite sovereign powers to obtain a federal income tax exemption. Finally, in contrast to AS 42.45.310 (the statute for special JAAs like the Four Dam Pool JAA), AS 42.45.300 is very brief and lacks any detailed provisions regarding the governance and operation, let alone limited liability, for such a JAA. For reasons such as these, this is not a viable option for this project.

#### **B. Nonprofit Cooperative.**

In previous comments, a nonprofit cooperative under AS 10.15 was raised as a potential legal entity for the project. However, AS 10.15.005 expressly prohibits such a cooperative to be organized under those statutes for furnishing electric utility services.

#### **C. Limited Partnerships and Limited Liability Partnerships.**

Previous comments have raised the potential for use of a limited partnership or a limited liability partnership. Limited partnerships are often used in real estate developments and similar businesses. These entities have one or more general partners, who are primarily responsible for active management of the partnership, and one or more limited partners who are more “passively” involved and who have limited liability. However, for the intertie project, all interested parties will want to be more active in the legal entity and will want to maximize their limited liability and exemption from taxation. For these reasons, limited partnerships are not analyzed in further detail in this memorandum.

Under Alaska law, a limited liability partnership provides more flexibility and greater overall limited liability for all partners. However, that same flexibility and liability protection exists with a LLC, and a LLC has the additional option of electing to be treated as a partnership or a corporation for purposes of federal income taxation without being subject to state law partnership rules. The LLC was discussed in detail in previous comments by one of the utilities that will participate in the intertie project, and it is addressed in detail below as well. Accordingly, limited liability partnerships are not analyzed further in this memorandum.

#### **D. Public Corporation.**

The RFP listed public corporations as a potential legal entity. Primary public corporations in Alaska include incorporated local governments and regional electrical authorities. However, public entities such as these do not allow for inclusion of other entities such as cooperatives and IOUs.

TO: Dave Carlson  
FROM: Dean Thompson  
DATE: March 16, 2004  
SUBJECT: Legal Entity Options for Southeast Alaska Intertie Project  
PAGE: 3

---

### **E. Pooling Arrangements.**

Finally, the RFP contemplated consideration of a pooling arrangement to facilitate the intertie project. Any such arrangement, without new statutory provisions, would be based solely on contractual relations between the users of the intertie segments. This would not satisfy the limited liability, tax exemption, and organizational requirements identified for development of the intertie project in Southeast Alaska.

### **III. Electric Transmission Cooperative.**

Based on the requirements listed in the RFP and our recent teleconference, it appears that the primary considerations for the choice of legal entity involve (1) inclusiveness of all utilities and power purchasers who are located near the future intertie segments; (2) protection of members from liability and undue risk; (3) exemption from income taxation; and (4) productive interface with the Southeast Conference regarding prioritization of future intertie segments. Of course, there are other considerations, but those four appear to be the most salient issues. Accordingly, much of this analysis will be concerned with those issues, particularly income tax issues.

Regarding membership, nothing in AS 10.25 restricts utilities or power purchasers from being members of a cooperative for the purchase of transmission service. For decades electric cooperatives have had municipalities, private persons, and other utilities as members. Further, Alaska Statutes 10.25.010 and 10.25.020 provide electric and telephone cooperative utilities with broad powers to perform different types of activities. In several provisions, these statutes expressly allow a cooperative to construct, operate, and maintain “electric lines” and “transmission lines” and to “transmit electric energy.” AS 10.25.010(a)(4) and (a)(7); AS 10.25.020(1).

AS 10.25.020(1) states, in relevant part:

An electric cooperative may . . . generate, manufacture, purchase, acquire, accumulate, and transmit electric energy, and distribute, sell, supply, and dispose of electric energy to its members, to governmental agencies and political subdivisions, and to other persons not exceeding 10 percent of the number of its members . . . (Emphasis added).

TO: Dave Carlson  
FROM: Dean Thompson  
DATE: March 16, 2004  
SUBJECT: Legal Entity Options for Southeast Alaska Intertie Project  
PAGE: 4

---

Specifically, generation and transmission cooperatives have operated for decades, and there are at least two transmission-only cooperatives currently operating in Georgia and the Southwestern United States. Accordingly, a transmission cooperative is well suited to serve the generation utilities and power purchasers in Southeast Alaska.

You asked that I address when a utility or purchaser might become a member of the cooperative with respect to an intertie segment that will be constructed several years in the future. Alaska Statute 10.25 does not compel an absolute answer to that question. Instead, AS 10.25.080 simply requires that a person may not become a member unless he agrees to “use the services furnished by the cooperative when they are made available through its facilities.” However, it might be prudent to establish some standard in the articles or bylaws regarding how imminent the planning of a segment should be prior to having a future customer formally join as a member. Perhaps this standard could also incorporate when a specific segment recommendation or plan is recommended by the Southeast Conference.

That would serve the dual purpose of facilitating interface between the planning and prioritization function of the Southeast Conference with the ownership and operation function of the transmission entity. Moreover, such a standard could also be included in the articles or bylaws of one of the other types of potential legal entities in the event a transmission cooperative entity is not pursued.

With respect to limited liability, AS 10.25.410 expressly provides that a member of a cooperative is not liable or responsible for any debts of the corporation. Similarly, AS 10.25.141 provides that directors, officers, employees, and agents of a cooperative are not individually liable for conduct performed within the scope of the person’s duties for the cooperative.

Exemption from federal income taxation is an important benefit of a cooperative utility. Internal Revenue Code (“IRC”) Section 501(a) and (c)(12) exempt a mutual or cooperative electric company from federal income taxation if it derives at least 85 percent of its income from its members. The basic requirements for satisfying “cooperative principles” are (1) democratic control—one member-one vote; (2) operating at cost; and (3) subordination of capital. *E.g., Puget Sound Plywood v. Commissioner*, 44 T.C. 305, 307-08 (1965).

Operating at cost means that the cooperative will not collect income from members greater or less than what is required to meet current losses and expenses. Of course, that does not mean that a cooperative cannot recover reasonable margins. In Revenue Ruling 72-36, the IRS held that operating at cost allows the cooperative to retain margins to

TO: Dave Carlson  
FROM: Dean Thompson  
DATE: March 16, 2004  
SUBJECT: Legal Entity Options for Southeast Alaska Intertie Project  
PAGE: 5

---

expand the services of the cooperative and to maintain reserves for necessary purposes. The limit is that those funds cannot be accumulated beyond the “reasonable needs of the organization’s business.” *Id.* The IRS’ recognition of the need for a cooperative to earn and retain reasonable reserves for current and future operations fits well with the overall plan for the long-term development of the intertie project.

Subordination of capital refers to the fact that cooperatives operate for the benefit of their member customers, not for equity investors. This means that over time, excess margins are returned to members and former members based on their patronage in the cooperative. *Id.*

One issue that was raised in the RFP was whether different intertie segments could be operated on a stand-alone basis with respect to wheeling rates, O&M, and reserves. Neither AS 10.25 nor IRS rules prevent this. In fact, the general cooperative principle of serving members at cost implies that a cooperative should seek to charge different classes of members different rates based on differences in costs and allocations. *See* Unpublished TAM, Oct. 24, 1996. This supports the ability of a transmission cooperative to operate different segments based on the costs and circumstances of the service.

One of the distinct benefits of a transmission cooperative over other potential legal entities is that the IRS has routinely granted tax exempt status to electric cooperatives under IRC 501(c)(12). In addition, the IRS has routinely granted those exemptions to G&T electric cooperatives, not just distribution cooperatives. In previous discussions, there was a question raised regarding whether a transmission-only cooperative would qualify for tax exemption under IRC 501(c)(12). There is nothing in the IRC or the IRS regulations that preclude that exemption, and the IRS granted Southwestern Transmission Electric Cooperative, Inc. a 501(c)(12) exemption as recently as January 4, 1999. Accordingly, it can be expected that a transmission cooperative formed to own and/or operate the Southeast Alaska Intertie Project would not draw undue scrutiny from the IRS.

A related issue is whether plans to operate fiber optic facilities along the intertie segments would threaten the cooperative’s tax exempt status. This should not be a concern. So long as the cooperative satisfies the 85 percent member revenue test from wheeling income, this would not be a problem. In fact, another Alaska cooperative, Chugach Electric Association, Inc., owns and operates fiber optic facilities along its transmission facilities, and it has never presented an issue for its tax exempt status or authority under AS 10.25.

Apart from federal income taxation, it has been asserted that a transmission cooperative would be required to pay the 0.25 mil per kWh cooperative gross revenue tax under

TO: Dave Carlson  
FROM: Dean Thompson  
DATE: March 16, 2004  
SUBJECT: Legal Entity Options for Southeast Alaska Intertie Project  
PAGE: 6

---

AS 10.25.540 and .555. However, despite the relatively small amount of that tax, it is doubtful that a transmission cooperative would be required to pay that tax since it applies only to kWh of “electricity sold at retail.” Providing transmission services for other utilities to sell either wholesale or retail power would not appear to be selling electricity at retail.

Similarly, AS 10.25.580 provides that the inventory and fixtures of a business operated by a cooperative that is incidental to the furnishing of central station electric service, including “appliance stores or departments,” are not exempt from ad valorem taxes. However, it would appear that providing transmission service to a generating member is not “incidental” in the way that operating an appliance store would be. Accordingly, it appears doubtful that a transmission cooperative would be liable for these taxes.

The primary disadvantages of a transmission cooperative legal entity are its 10 percent non-member service limit and the administrative burden of keeping records of member patronage and capital credits. The 10 percent non-member service limit is a state law requirement (AS 10.25.020(1)), not an IRS rule. It does impose a limitation on the ability of the cooperative to provide service to a large number of non-members. However, given that the participants appear to have decided that the entity should be as inclusive as possible with respect to the users of the interties that are allowed to become member, this likely will not be a significant impediment.

The other primary disadvantage of a cooperative is that operating on cooperative principles requires careful record-keeping of past and current patronage capital. However, to the extent that any of the other potential entities seek to obtain their IRS tax exemption through IRC 501(c)(12), they would have the same type of record-keeping requirements.

#### **IV. Limited Liability Company.**

One of the participants advocated a LLC (AS 10.55) as a legal entity that might be preferable to a cooperative. As was noted by that participant, LLCs are very flexible entities, similar to a partnership, but with the benefit of having limited liability like a corporation or cooperative. Like a transmission cooperative, a LLC has no restrictions precluding it from having the participating utilities or power purchasers as members.

Similarly, a LLC provides limited liability to its members in the same way that a corporation does. One potential drawback in that regard, however, is that LLCs are relatively new entities, and there is not a well-established body of law regarding the standards for piercing a LLC’s “corporate veil.”

TO: Dave Carlson  
FROM: Dean Thompson  
DATE: March 16, 2004  
SUBJECT: Legal Entity Options for Southeast Alaska Intertie Project  
PAGE: 7

---

Also like an AS 10.25 cooperative, a LLC could arrange its articles and operating agreement to allow future users to become members as the planning for their segment becomes imminent. This could also incorporate a cooperative interface with the Southeast Conference, as was discussed above.

The main disadvantage of a LLC, however, is the difficulty it will likely face in obtaining exemption from federal income taxation. It is true that there is nothing inherent about a LLC that precludes it from becoming exempt. However, I believe it would be much more difficult for a LLC to obtain such an exemption than it would be for an AS 10.25 cooperative.

Under the Internal Revenue Code, there are not a lot of options for a transmission utility owned by IOUs and cooperatives to become exempt from federal income taxation. The only conceivable possibilities are IRC 501(c)(3) (charitable organizations), IRC 501(c)(4) (social welfare organizations, and IRC 501(c)(12) (electric cooperatives). I do not believe that the first two are applicable, as the purpose of the entity would not be what the IRS has traditionally granted exemptions for under IRC 501(c)(3) and (4).

In his previous comments, the participant referenced above appeared to agree, but claimed that it may be possible for a LLC to qualify for an exemption under IRC 501(c)(12) by setting up its articles and operating agreement to satisfy the IRS' cooperative principles requirements. There has been a recent trend at the IRS to allow LLCs certain beneficial tax treatments.

For example, the IRS has held that a LLC that is wholly owned by a single, 501(c)(3) tax-exempt organization may be disregarded as an entity separate from its owner when numerous conditions are met. Ann. 99102, 1999-43 I.R.B. 545. Similarly, in a non-precedential private letter ruling, the IRS allowed a LLC to elect to be taxed as a taxable cooperative under Subchapter T where a taxable agricultural cooperative merged into the wholly-owned LLC in order to raise needed equity capital. PLR 200119016. However, to the best of my knowledge, the IRS has declined to extend this trend to granting a LLC tax exempt status under any other 501(c) exemptions.

It may be that such an exemption will be possible in the future under the right circumstances, such as when the member of the LLC is otherwise exempt, but to the best of my knowledge, the IRS has not yet moved further in that direction. In any event, I believe the IRS would be much more willing to grant a 501(c)(12) exemption to an AS 10.25 cooperative than a multi-member LLC for purposes of operating a transmission utility. Moreover, even if a LLC

TO: Dave Carlson  
FROM: Dean Thompson  
DATE: March 16, 2004  
SUBJECT: Legal Entity Options for Southeast Alaska Intertie Project  
PAGE: 8

---

obtained an exemption from income taxes, that does not necessarily mean that it would be exempt from state and local taxes.

Another disadvantage of a LLC compared to a cooperative is that, although a LLC may technically be able to qualify for some types of grant funding, it is probably less politically attractive for a funding entity to issue such funds to a LLC. The perception, which is correct, is that most LLC's are for-profit, taxable entities. In addition, although LLCs have significant flexibility, that flexibility exists at the cost of certainty and experience regarding what is required, allowed, and discretionary under AS 10.50. That adds a level of complexity in drafting, revising, and abiding by governing documents.

For all of these reasons, I believe a cooperative is better suited than a LLC for ownership and operation of the Southeast Alaska Intertie Project.

#### **V. Nonprofit Corporation.**

Another potential entity is a nonprofit corporation under AS 10.20. Like a cooperative and a LLC, a nonprofit corporation is able to have all of the potential participants as members, provides limited liability, can accommodate participants joining as members prior when planning for a segment is imminent, and can also provide for interface with the Southeast Conference.

However, a nonprofit corporation would not be able to obtain a federal tax exemption, as it usually does, under IRC 501(c)(3) or (4). In addition, although it is possible that a nonprofit corporation might have a better chance than a LLC of persuading the IRS to grant it an exemption under 501(c)(12), the IRS would be less likely to grant it to a nonprofit corporation than to a cooperative.

Beyond, the federal income tax issue, a nonprofit corporation would not enjoy the broad exemption from property taxes that a cooperative enjoys. The primary basis for a nonprofit corporation's exemption from those taxes is Article IX, § 6, of the Alaska Constitution, which provides an exemption for property used exclusively for "non-profit religious, charitable, cemetery, or educational purposes." Ownership and operation of a transmission project would not qualify for that exemption. By contrast, the ad valorem tax exemption for cooperatives in AS 10.25.540 is not dependent on such purposes.

Although a nonprofit corporation has some potential advantages over a LLC, I believe a cooperative is preferable for ownership and operation of the intertie.

TO: Dave Carlson  
FROM: Dean Thompson  
DATE: March 16, 2004  
SUBJECT: Legal Entity Options for Southeast Alaska Intertie Project  
PAGE: 9

---

## **VI. For Profit Corporation.**

There has not been significant discussion of using a for profit corporation for ownership of the intertie project. As was stated in the RFP, there is an obvious tax disadvantage associated with this option.

In addition, AS 10.06.420 vests voting rights not on a one member-one vote basis, but based on the number of shares of stock that is owned. This is a significant departure from the democratic principles of a cooperative. In addition, AS 10.06.338 requires payment of consideration (contributions) for shares. Accordingly, under this statutory scheme, it would be difficult to retain equal voting rights within the entity.

## **VII. Tax Ownership.**

One of the IOU participants expressed concern that a member performing contractual construction or operation and maintenance work for the cooperative might be deemed by the IRS to be a "tax owner" of the intertie facilities. I have discussed the issue with the IOU and have reviewed what I believe is the general basis for that concern. IRC 263-A and implementing Treasury Regulations at 1.263-A. However, I have not seen the precise tax accountant opinion that determined the "tax ownership" relating to the hydroelectric project. This is a complex, very fact-intensive area of federal income taxation, and more information would be needed regarding that prior situation to provide an exhaustive opinion on this issue as it relates to the intertie project.

Nevertheless, it appears that there are substantial differences between the intertie project and the hydroelectric project that significantly reduce the likelihood that tax ownership would be imputed to a member of the intertie entity. First, a contract with the IOU or another member would, in form and substance, be nothing more than a services-type contract, presumably on a cost-plus or not-to-exceed amount basis. Second, there would be no implied or actual agreement that would give the contractor any expectation, however contingent, of obtaining direct ownership of the intertie. Third, the intertie entity, not the contractor, would have legal title to the facility as well as bear all risks of loss or damage to the property. Fourth, when the IOU purchases transmission service from the owning entity, it would be under traditional, per-unit-type wheeling rates. Under these circumstances, it appears that the instant situation is significantly different from the arrangements the IOU had regarding the hydroelectric facility.

TO: Dave Carlson  
FROM: Dean Thompson  
DATE: March 16, 2004  
SUBJECT: Legal Entity Options for Southeast Alaska Intertie Project  
PAGE: 10

---

Therefore, balancing the benefits and burdens aspects discussed in Treasury Regulation 1.263A-2, as well as in various court decisions implementing that type of test, appears to reduce the risk of tax ownership with respect to this project. However, it would be prudent to carefully review this issue when forming the contractual arrangement between the intertie entity and a member contractor. In addition, all parties should ensure that the contract is negotiated at arms-length, at reasonably justifiable pricing, with the member abstaining from any entity vote on the contract. Finally, it would be advisable to obtain a more fact-specific tax analysis prior to finalizing that contract.

It is also important to note that whatever risks may exist regarding this tax ownership issue, they do not appear to be significantly affected by the type of legal entity that is chosen to own the intertie. Instead, the material facts seem to be the relationship of the contracting member with the services to be performed and the terms and conditions under which that member obtains transmission services from the entity in the future.

### **VIII. Conclusion.**

None of the potential legal entities discussed above are without advantages and disadvantages. However, based on the requirements and characteristics that most of the potential participants believe are important for the long term success of the Southeast Alaska Intertie Project, it appears that a nonprofit, electric transmission cooperative formed under AS 10.25 best satisfies those requirements.

Specifically, a transmission cooperative has the greatest chance of obtaining an expeditious grant of a federal income taxation exemption under IRC 501(c)(12). The IRS is accustomed to granting such exemptions to electric cooperatives that are organized and operated under state electric cooperative statutes. In addition, a cooperative provides the same level of limited liability protection to its members as any of the other potential entities. Finally, the statutory scheme of AS 10.25 fits well with the general consensus that the intertie entity should be operated on an at-cost basis, under democratic, one member-one vote governance procedures, for the mutual benefit of all users of the intertie facilities.

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