

# 2014 Florida Electric Cooperative Finance & Accounting Conference

Clearwater, Florida  
September 18, 2014

## *IRS Private Letter Rulings and Discounted Capital Credit Retirements*

*Presented by:*  
Bill Miller, CPA



**Bolinger, Segars, Gilbert & Moss, L.L.P.**  
**8215 Nashville Avenue; Lubbock, Texas 79423**  
**(806) 747-3806; (806) 747-3815 Fax**  
**[www.bsgm.com](http://www.bsgm.com)**

# What is the hierarchy of tax research?

- ▶ Primary Sources – Authoritative; May be cited as precedent
  - Statutory Authority – Internal Revenue Code
  - Treasury Regulations – Final, Temp, Proposed
  - Legislative History
  - Judicial Authority
  - IRS Rulings – Revenue Procedures, Revenue Rulings, Notices, & Announcements

# What is the hierarchy of tax research?

- ▶ Primary Sources – Non Authoritative; May not be cited as precedent
  - IRS Rulings –Private Letter Rulings, Technical Advice Memorandums, Field Service Advice, etc.
  - Taxpayer Assistance – Publications, Forms, & Instructions
- ▶ Secondary Sources – Interpretive Sources, Journals, Commentaries, etc.

# What is a Private Letter Ruling?

- ▶ Ruling from the IRS to a specific taxpayer based on the taxpayer's specific set of facts.
  - Taxpayer sends letter presenting facts, tax law and requested rulings.
  - IRS issues ruling to the Taxpayer based on facts, analysis of applicable tax; can be revoked.
  - Ruling is specific to Taxpayer and **may not** be relied upon as precedential authority by others.
  - In general, the IRS will publish a PLR; therefore, a PLR is an indication of the IRS' position on an issue.

# What are the basic components of PLRs?

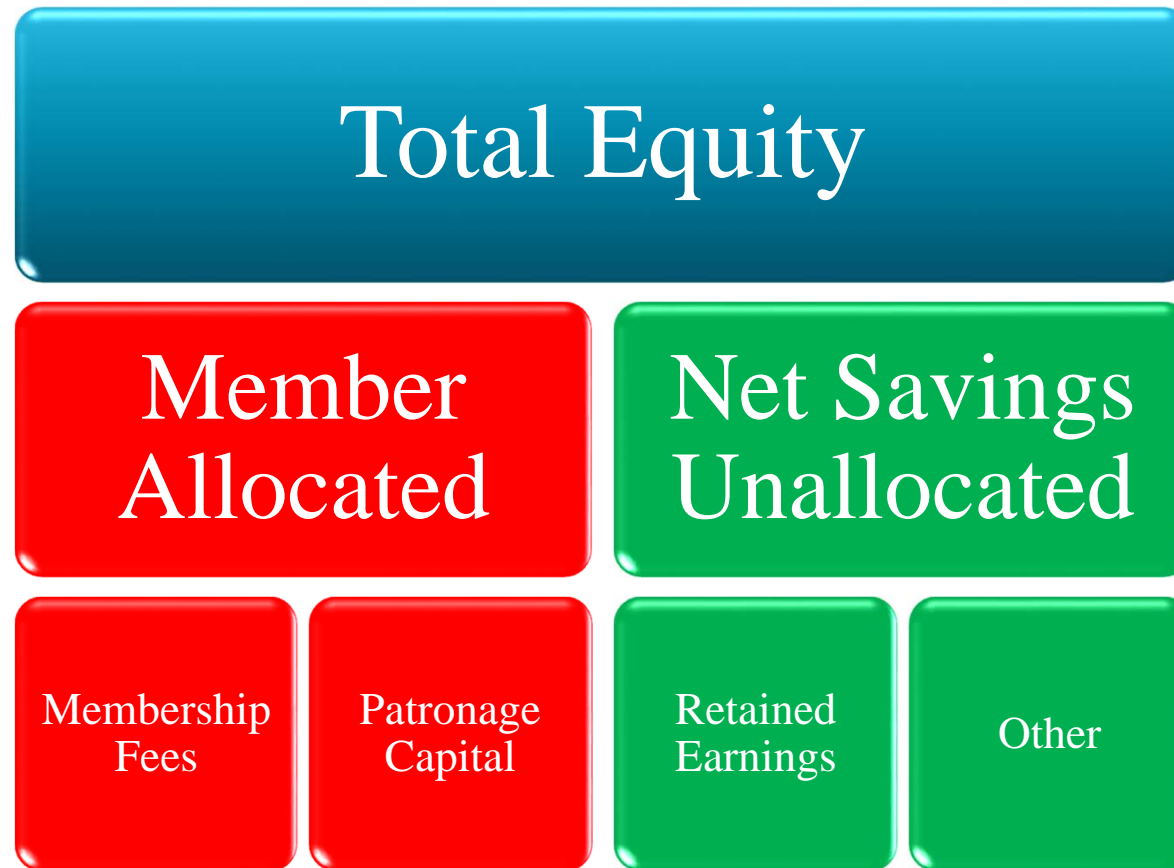
- ▶ Heading
- ▶ Legend
- ▶ Facts and Ruling Request
- ▶ Law
- ▶ Discussion/Analysis
- ▶ Ruling & Disclaimer

# PLRs Addressing Capital Credit Discounting

	PLR Number	Release Date		PLR Number	Release Date
1.	200601031	01/06/2006	11.	200806018	02/08/2008
2.	200602035	01/13/2006	12.	200907040	02/13/2009
3.	200602043	01/13/2006	13.	200946057	11/13/2009
4.	200625033	06/23/2006	14.	201016081	04/23/2010
5.	200634048	08/25/2006	15.	201036012	09/10/2010
6.	200721020	05/25/2007	16.	201143021	10/28/2011
7.	200721021	05/25/2017	17.	201309017	03/01/2013
8.	200803021	01/18/2008	18.	201340017	10/18/2013
9.	200806014	02/08/2008	19.	201423027	06/06/2014
10.	200806017	02/08/2008			

# The Starting Point

- Understand the sources from which equity is derived.





# What were the basic facts of the PLRs?

- ▶ Description of member voting rights;
- ▶ Description of Non-profit Operation Article of Bylaws:
  - Pre-existing obligation to allocate patronage capital;
  - Authority of the Board to adopt the method, basis, timing and order of retirements.
- ▶ Description of Current Capital Credit Retirement Program:
  - Retirement Cycle
  - Method



# What were the basic facts of the PLRs?

- ▶ Tenets of Proposed Discounting Programs:
  - Targeted Groups – Current & former members; bankruptcy and former members only;
  - Participation – Voluntary; involuntary;
  - Discount Period – Number of years with unretired capital credit balances.
  - Discount Rate – Long term Treasury or *Wall Street Journal* Prime interest rate plus risk premium;
  - Authority – current bylaws or proposed bylaw amendments; Policy of general application.

# What were the basic facts of the PLRs?

- ▶ Tenets of Proposed Discounting Programs (continued):
  - Discount tracked as either (1) a separate class of equity maintained in the name of the patron taking the discount or (2) part of the net savings of the Cooperative.

# What were the primary ruling requests?

- ▶ Revised bylaws and policies on retiring capital credits at a discount are consistent with cooperative tax law and do not adversely impact the cooperative's tax exempt status.
- ▶ Patronage capital allocations are qualified exclusions.
- ▶ The discount is excluded from the 85/15 Test.

# What is the primary tax law on which the PLRs are based?

- ▶ Section 501(c)(12) of the IRC
- ▶ Operating on a Cooperative Basis - *Puget Sound Plywood, Inc. vs Commissioner*  
principles of :
  - (1) Democratic control,
  - (2) subordination of capital, &
  - (3) operation at cost.

# What is the primary tax law on which the PLRs are based?

- ▶ Compliance with Revenue Ruling 72-36, which also provides for the following:
  - **Members' rights & interests – Determine, Maintain, & Protect.**
  - Equities must not exceed reasonable needs.
  - Distribution of net assets upon dissolution – To all members and former members patronizing the cooperative **to the extent practicable.**

# What other points did the IRS make?

- ▶ Defined a cooperative as “...voluntary, membership business organization that is organized in response to the economic needs of and to perform services for its members, and not realize monetary gains as a separate legal entity.
- ▶ Regarding unretired capital credits referred to as reserves, “...the cooperative needs to have reserves in order to operate, meet unexpected expenses or to expand.

# What other points did the IRS make?

- ▶ The discount rate is “in accordance with prevailing market rates”.
- ▶ Discounting insures that... “former members are not treated more favorably than current members.”
- ▶ The Board of Directors and Management have “...fiduciary duties to former members and former members can enforce their rights in the courts.



# What did the IRS Rule?

- ▶ The discounting programs described in the letter ruling requests did not adversely effect the cooperative's tax-exempt status.
- ▶ “Patronage allocations” related to exempt purpose activities are qualified exclusions.
- ▶ The discount is not non-member income if tracked in the name of the patron as a form of allocated equity distributable only upon dissolution.

# Summary of IRS Private Letter Rulings on Capital Credit Discounting

		Comment
1.	Bylaw Amendment Authorizing Discounting	Key – granting the Board authority to offer such programs; impacts type of participation
2.	Participation	May be voluntary or involuntary; determine eligible groups
3.	Board has Authority to: (1) Set Discount Rate (2) Discount Period	Prevailing market rates Number of years of unretired patronage capital
4.	Method Used to Account for Discount	Temporary Equity in Name of Member or Net Savings
5.	Operating on a Cooperative Basis	Comply with bylaws and operate with a fiduciary duty toward all members
6.	Compliance with Rev Ruling 72-36	Avoid processes that forfeit a member's rights and interests in the cooperative

# What is the impact of the Private Letter Rulings?

- ▶ Special retirements at a discount are consistent with cooperative tax law.
- ▶ Membership approval of plan provides the Board with flexibility and authority to implement.
- ▶ Discount rate and discount period should be reasonable.
- ▶ Treat similarly situated patrons in a similar manner.

# Questions & Closing Comments

# Contact Information

- ▶ Bill Miller, CPA  
Tax Partner  
Bolinger, Segars, Gilbert & Moss, LLP  
8215 Nashville Ave  
Lubbock, Texas 79423  
Phone: (806) 747-3806  
Fax: (806) 747-3815  
E-mail: [bmiller@bsgm.com](mailto:bmiller@bsgm.com)

# Appendices

- ▶ Appendix A – Example of a Discounted Retirement Calculation
- ▶ Appendix B – Case Study of an Early Retirement for Natural Person Estates

# Appendix A – Example of a Discounted Retirement Calculation

- ▶ Net Present Value – Time value of money
  - Formula:  $PC \times (1/(1+r)^n)$ 
    - “PC” = patronage capital to be retired at a discount.
    - “r” is the discount rate.
    - “n” is the discount period.
  - Apply formula to each year of a patron’s capital credit balance being retired on a discounted basis.



# Appendix A – Example of a Discounted Retirement Calculation

## Net Present Value - Example:

Retirement Cycle		<u>7</u>	Discount Rate:		<u>4.50%</u>
Year Outstanding	Discount Period	Discount Rate	Factor	Patronage Capital	
				Face Value	Discounted Retirement
2005	0	4.50%	100.0000%	\$ 300	\$ 300
2006	1	4.50%	95.6938%	250	239
2007	2	4.50%	91.5730%	275	252
2008	3	4.50%	87.6297%	300	263
2009	4	4.50%	83.8561%	325	273
2010	5	4.50%	80.2451%	225	181
2011	6	4.50%	76.7896%	225	173
2012	7	4.50%	73.4828%	225	165
				<u>\$ 2,125</u>	<u>\$ 1,846</u>
Less: Discounted Retirement				(1,846)	
Net Savings or other equity account				<u>\$ 279</u>	

# Appendix A – Example of a Discounted Retirement Calculation

## ▶ Net Present Value Example – (Discount becomes part of Net Savings):

- Journal Entry :

Account No.	Account Description	Debit	Credit
201.100	Patronage Capital Assigned	\$ 2,125	\$ -
131.100	Cash - General		1,759
217.000	Retired Capital Credits - Gain		366
		<u>\$ 2,125</u>	<u>\$ 2,125</u>

- Other:
  - Net savings are generally distributable upon liquidation to current & former patrons on the basis of historic patronage.
  - Calculate the 85/15 Test using the discount as non-member income for determining if a lesser amount should be redeemed at a discount.

# Appendix A – Example of a Discounted Retirement Calculation

- ▶ Net Present Value Example –  
(Discount becomes part of Net Savings):

- Journal Entry :

Account No.	Account Description	Debit	Credit
201.100	Patronage Capital Assigned	\$ 2,125	\$ -
131.100	Cash - General		1,759
201.1XX	Patronage Capital Assigned - Other		366
		<u>\$ 2,125</u>	<u>\$ 2,125</u>

- Other:
    - The discount remains allocated to the patron but is reclassified as patronage capital not redeemable except upon liquidation.
    - Calculate the 85/15 Test without considering the discount.

## Appendix B – Case Study of an Early Retirement for Natural Person Estates

### ► Assumptions:

- Date of death: September 30, 2012.
- Deceased member was an irrigator.
- Farming activities were conducted individually and not through a legal entity.
- Unretired balance of patronage capital of \$288,690 (Distribution - \$117,146; G&T - \$171,544).
- Estimated allocation for 2012 electricity purchases - \$36,252 (Distribution - \$9,158; G&T – 27,094).
- Planned general retirement of \$1,000,000.

## Appendix B - Case Study of an Early Retirement for Natural Person Estates

- ▶ The Independent Executor of this member's estate requests an early retirement of \$288,690 plus estimated allocation for 2012 of \$36,252 for a total of \$324,942.
- ▶ Since \$324,942 represents over 32% of the annual amount of general retirements, will this reduce the amount of general retirements? Will this impact amounts retired to other Estates?
- ▶ Is this an anomaly or are others expected?

## Appendix B - Case Study for an Early Retirement for Natural Person Estates

- ▶ What does the policy say?
  - Early retirements? Yes.
  - All unretired capital credits? Yes, G&T has history of retiring.
  - Estimate allocation for current year? Yes.
  - Face amount? No, Discounted at NPV.
  - Other Limitations – None.
  - Discount rate? 6.70%, which is the highest rate on long-term fixed rate debt owed by the Co-op.
  - Discount period? 20 years.

## Appendix B - Case Study of an Early Retirement for Natural Person Estates

- ▶ The estate receives a check for \$124,220 which is the NPV of \$324,942. The discount of \$200,722 is retained by the Co-op.
- ▶ Include the discount as non-member income for the 85/15 Test.
- ▶ The decision to make the early retirement at a NPV allows for Co-op to proceed with planned general retirement.
- ▶ Aggregate or individual limits may be in order.



## Appendix B - Case Study of an Early Retirement for Natural Person Estates

- ▶ Periodically review the policy changes in membership and applicability.
- ▶ Clarify eligibility.
  - Joint membership account – all, none or partial.
  - Time frame for making the request.
  - Residential vs. other rate classes for the Estate.
- ▶ Imposed limits can take on a life of their own.
- ▶ If implementing for first time, determine impact of retroactive implementation.

# Disclaimer

- ▶ Unless otherwise stated, the statements and advice provided herein represent general information only, are based on limited facts and circumstances and are not intended to constitute written tax advice.