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9 **Introduction**

10 I respectfully complain against the referred organization California Independent System
11 Operator Corporation (“CA ISO”). The organization is engaged in commercial, for-profit
12 business activities whose income was unrelated debt-financed income, which was not
13 excluded by reason of section 512(b)(3). Consequently, California Independent System
14 Operator Corporation is operated for the primary purpose of carrying on a "trade or
15 business" within the meaning of section 502, so as to preclude tax-exempt status under
16 section 501(c)(3).
17

18 **Supporting Documentation**

19 **Attached Exhibit A.** Prepared Written Testimony of Sandra S. McDonald for the
20 California Independent System Operator Corporation under Federal Energy Regulatory
21 Commission Docket ER98-211.¹ “The ISO’s start-up and development costs are
22 currently funded by the ISO Trust. The ISO Trust draws funds from a loan entered into
23 between the ISO Trust and Bank of America which is guaranteed by the State’s three
24 largest investor owned utilities, (SCE, PG&E and SDG&E). Prior to commencement of
25 commercial operations, the ISO Trust will transfer the assets acquired with proceeds of
26 the ISO Trust loan to the ISO in exchange for ISO Notes. After the commencement of
27 operations, the Corporation will continue to draw on the Trust loan for system completion
28 expenses until the permanent financing is executed.”

¹ <http://www.caiso.com/docs/1998/12/18/1998121810012429637.rtf> at page 2 line 21 to 22 through page 3 lines 1 to 6.

1 **Attached Exhibit B.** December 21, 2007, CALIFORNIA INDEPENDENT SYSTEM
2 OPERATOR CORPORATION FERC ELECTRIC TARIFF FOURTH REPLACEMENT
3 VOLUME NO. II, Original Sheet No. 837, Issued by: Charles A. King, PE, Vice
4 President of Market Development and Program Management, Issued on: December 21,
5 2007, Effective: March 31, 2008, CAISO Tariff Appendix A, Master Definitions
6 Supplement.² “CAISO Debtor, A Business Associate that is required to make a payment
7 to the CAISO under the CAISO Tariff and agreements with the CAISO.” [Page 11]
8 “CAISO Financing Costs, The CAISO's financing costs that are approved by the CAISO
9 Governing Board, including capital expenditures that may be financed over such period
10 as the CAISO Governing Board shall decide. CAISO Financing Costs shall also include
11 the CAISO Start Up and Development Costs. The amortized amount to be included in the
12 Grid Management Charge shall be equal to the amount necessary to amortize fully all
13 CAISO Start Up and Development Costs over a period of five (5) years, or such longer
14 period as the CAISO Governing Board shall decide. These costs include the requirement
15 to collect an amount in excess of the annual debt service obligations as specified in the
16 rate covenants of the official statements for each CAISO bond offering.” [Page 12] “Tax
17 Exempt Participating TO, A Participating TO that is the beneficiary of outstanding Tax
18 Exempt Debt issued to finance any electric facilities, or rights associated therewith,
19 which are part of an integrated system including transmission facilities the Operational
20 Control of which is transferred to the CAISO pursuant to the Transmission Control
21 Agreement.” [Page 132].

22 **Attached Exhibit C.** April 10, 2009, California Independent System Operator
23 Corporation (“ISO”) application for a FERC order authorizing the ISO to issue bonds in
24 an amount not to exceed \$225 million.³ “Access to Capital, As a not-for-profit entity,
25 CAISO is entirely debt financed and does not raise equity capital through the issuance of
26 stock or cash contributions from members. In order to assure sufficient resources, CAISO
27 must either apply available cash on hand, collect necessary funding for capital
28 expenditures through its annual GMC revenue requirement, or access debt capital from

² <http://www.caiso.com/2771/2771853b60570.pdf>

³ <http://www.caiso.com/238f/238f79c360890.pdf> at pages 90 to 91.

1 outside sources on acceptable terms. CAISO can give no assurances that its current and
2 future capital structure, operating performance or financial condition will permit it to
3 access the capital markets or obtain other debt capital at the times, in the amounts and on
4 the terms necessary for it to successfully carry out its business plan.”

5 **Attached Exhibit D.** August 19, 2010, ISO Service Agreement No. 1647, Non-
6 Conforming Large Generator Interconnection Agreement.⁴ “ARTICLE 12, INVOICE,
7 12.1 General. The Participating TO shall submit to the Interconnection Customer, on a
8 monthly basis, invoices of amounts due pursuant to this LGIA for the preceding month.
9 Each invoice shall state the month to which the invoice applies and fully describe the
10 services and equipment provided. The Parties may discharge mutual debts and payment
11 obligations due and owing to each other on the same date through netting, in which case
12 all amounts a Party owes to the other Party under this LGIA, including interest payments
13 or credits, shall be netted so that only the net amount remaining due shall be paid by the
14 owing Party. Notwithstanding the foregoing, any invoices between the CAISO and
15 another Party shall be submitted and paid in accordance with the CAISO Tariff.”

16 **Attached Exhibit E.** December 16, 2010 , Decision 10-12-034 BEFORE THE PUBLIC
17 UTILITIES COMMISSION OF THE STATE OF CALIFORNIA Order Instituting
18 Rulemaking to Integrate and Refine Procurement Policies and Consider Long-Term
19 Procurement Plans, Rulemaking 10-05-006 (Filed May 6, 2010), DECISION
20 AUTHORIZING INVESTOR OWNED UTILITIES TO PARTICIPATE IN
21 CONVERGENCE BIDDING IN THE CALIFORNIA INDEPENDENT SYSTEM
22 OPERATOR ELECTRICITY MARKETS.⁵ “Summary, In this decision, we adopt
23 upfront standards⁶ for investor owned utilities (IOUs), Pacific Gas and Electric Company
24 (PG&E), San Diego Gas & Electric Company (SDG&E), and Southern California Edison

⁴ <http://www.caiso.com/27f7/27f7d4f6c0a0.pdf> at page 57.

⁵ http://docs.cpuc.ca.gov/word_pdf/FINAL_DECISION/128621.pdf

⁶ Pursuant to Assembly Bill 57 (Stats. 2002, ch. 835), codified as Pub. Util. Code § 454.5, by approving procurement plans, the Commission establishes “upfront standards” for the IOUs’ procurement activities and cost recovery. This obviates the need for after-the-fact reasonableness review by the Commission of the resulting utility procurement decisions that are consistent with the approved plans.

1 (SCE), to participate in convergence bidding (also known as “virtual bidding”) in markets
2 operated by the California Independent System Operator (CAISO). Convergence bidding
3 currently is scheduled to commence in February of 2011.^[7]... **Theory of Convergence**
4 **Bidding in Multi-Settlement Electricity Markets**, A convergence bid (also known as a
5 virtual bid) is not backed by any physical generation or load, and therefore is completely
6 financial. Convergence bidding allows market participants to arbitrage expected price
7 differences between the Day-Ahead and Real-Time markets. Using convergence bids,
8 market participants can sell (buy) energy in the Day-Ahead market, with the explicit
9 requirement to buy (sell) that energy back in the Real-Time market without intending to
10 physically consume or produce energy in Real-Time. Convergence bids that clear the
11 Day-Ahead market will either earn, or lose, the difference between the Day-Ahead and
12 Real-Time market prices at a specified node multiplied by the megawatt volume of their
13 bids...Theoretically, convergence bids should cause the Day-Ahead and Real-Time
14 prices to “converge,” reducing the incentive for buyers and sellers to forgo bidding
15 physical schedules in the Day-Ahead market in expectation of better prices in the Real-
16 Time market,^[8] and thus improve price stability and market efficiency. In addition,
17 Federal Energy Regulatory Commission (FERC) believes that convergence bidding
18 improves market performance by adding liquidity, increasing the numbers of offers in the
19 Day-Ahead market and preventing the exercise of market power.^[9]»

20 **Background on Complaint**

21 Organizations otherwise exempt from federal taxation pursuant to § 501(c) remain
22 subject to tax on their "unrelated business taxable income." I.R.C. § 511(a). Unrelated
23 business taxable income is generally defined as "the gross income derived by any
24 organization from any unrelated trade or business (as defined in section 513) regularly
25 carried on by it, less the deductions allowed by this chapter which are directly connected
26 with the carrying on of such trade or business, both computed with the modifications
27 provided in subsection (b)." *Id.* § 512(a)(1). Section 513 defines "unrelated trade or

⁷ *Cal. Indep. Sys. Operator Corp.*, 130 FERC ¶ 61,122, at P 24 (2010) (Convergence Bidding Design Order).

⁸ *Cal. Indep. Sys. Operator Corp.*, 133 FERC ¶ 61,039, at par. 14 (2010).

⁹ *Cal. Indep. Sys. Operator Corp.*, 133 FERC ¶ 61,039, at par. 13 (2010).

1 business" to include "any trade or business the conduct of which is not substantially
2 related (aside from the need of such organization for income or funds or the use it makes
3 of the profits derived) to the exercise or performance by such organization of its
4 charitable, educational, or other purpose or function constituting the basis for its
5 exemption under section 501." *Id.* § 513(a). The related Treasury Regulation further
6 explains that a trade or business is "related to exempt purposes, in the relevant sense, only
7 where the conduct of the business activities has a causal relationship to the achievement
8 of exempt purposes (other than through the production of income)." 26 C.F.R. § 1.513-
9 1(d)(2).

10 This case turns on I.R.C. § 514 and § 512(b)(4), which modify the computation of
11 "unrelated business taxable income" under § 512(a)(1) when income is from a particular
12 source, namely "debt-financed property." *See* I.R.C. §§ 512(b)(4), 514(a). As relevant
13 here, § 514 provides that "[t]here *shall be included* with respect to each debt-financed
14 property ... an item of gross income derived from an unrelated trade or business." *Id.* §
15 514(a)(1) (emphasis added). Moreover, § 512(b)(4) requires that "in the case of debt-
16 financed property (as defined in section 514) there *shall be included*, as an item of gross
17 income derived from an unrelated trade or business, the amount ascertained under section
18 514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under
19 section 514(a)(2)." *Id.* § 512(b)(4) (emphasis added). "Debt-financed property" is defined
20 as "any property which is held to produce income and with respect to which there is an
21 acquisition indebtedness (as defined in subsection (c)) at any time during the taxable
22 year." *Id.* § 514(b)(1); *see also* 26 C.F.R. § 1.514(b)-1(a).¹⁰ In other words, § 512(b)(4)
23 and § 514(a) together define an additional category of unrelated business taxable income,
24 debt-financed property, which is accordingly subject to the unrelated business income tax
25 ("UBIT"). For items within this category, § 514 nullifies § 512(b)'s general exemption of
26 dividends, interest, royalties, and the like from the UBIT. *See id.* § 512(b)(4); *Henry E. &*
27 *Nancy Horton Bartels Trust for the Benefit of the University of New Haven v. United*

¹⁰ *Bartels Trust for Benefit of Cornell Univ. v. US*, 617 F. 3d 1357 - Court of Appeals,
Federal Circuit 2010 617 F.3d 1357 (2010).
http://scholar.google.com/scholar_case?case=11752554950890886853&

1 *States (Bartels Trust for New Haven)*, 209 F.3d 147, 150-51 (2d Cir.2000); [Kern Cnty.](#)
2 [Elec. Pension Fund v. Comm'r](#), 96 T.C. 845, 850-51, 1991 WL 106265 (1991).

3 As used in § 514, "acquisition indebtedness" means "the unpaid amount of ...
4 indebtedness incurred by the organization in acquiring or improving [debt-financed
5 property]." I.R.C. § 514(c)(1)(A). Acquisition indebtedness does not include
6 "indebtedness the incurrence of which is inherent in the performance or exercise of the
7 purpose or function constituting the basis of the organization's exemption, such as the
8 indebtedness incurred by a credit union described in section 501(c)(14) in accepting
9 deposits from its members." *Id.* § 514(c)(4).

10 The crux of this complaint is whether the CA ISO's income from its securities purchased
11 on margin is subject to the UBIT. The language of § 512(b)(4) and § 514 is plain and
12 unambiguous. It is undisputed that to purchase securities on margin, the CA ISO
13 borrowed funds. "[I]ndebtedness [was thus] incurred by the organization in acquiring"
14 these securities. *Id.* § 514(c)(1). Accordingly, under § 514(c), these securities were
15 subject to acquisition indebtedness and constitute "debt-financed property" within the
16 meaning of § 514(b)(1). *See Bartels Trust for New Haven*, 209 F.3d at 150-51; [Mose &](#)
17 [Garrison Siskin Mem. Found., Inc. v. United States](#), 790 F.2d 480, 483-84 (6th Cir.1986);
18 [Elliot Knitwear Profit Sharing Plan v. Comm'r](#), 614 F.2d 347, 350-51 (3d Cir.1980). As
19 the Court of Federal Claims correctly recognized, § 514(a) and § 512(b)(4) treat income
20 the CA ISO derived from selling these securities as "an item of gross income derived
21 from an unrelated trade or business," and therefore unrelated business taxable income
22 under § 512.

23 Respectfully Submitted,



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