



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Number: **200504035**

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Contact Person:

Date: 11/2/04

Identification Number:

Contact Number:

Fax:

Employer Identification Number:

Legend:

Year 1 =

A =

M =

X =

Y =

Dear _____ :

This refers to your letter dated May 20, 2004, and supplemented by your letters dated August 2, 2004 and September 2, 2004, requesting modifications of your income tax exemption under section 501(c)(12) of the Internal Code (the Code). You have provided us with the following information.

Since formation in Year 1, you have operated as a rural electric cooperative under the provisions of the A Cooperative Statute. Your Articles of Incorporation and Bylaws provide for your operation on a not-for-profit, cooperative basis for the mutual benefit of members. Your Bylaws also provide that each member has one vote in all general meetings, and that all operating margins collected from members in any given year shall be returned to them in the form of a capital credit allocation based upon their participation (patronage) in the cooperative.

You are exempt under section 501(c)(12) of the Code and since inception you have operated in providing electricity to member on a cooperative basis. Lately, however, there have been rapid changes in technology and the electric industry is integrating with the telecommunications industry due to advancement of technology. To remain competitive in the industry and relevant to members as a “utility service provider”, not just an electric “wires” company, you propose to add in providing them with internet service on a cooperative basis.

You will provide satellite based internet services called the M service, which you will secure under your agreement with the X. X has a master distribution agreement of the service with Y. You are a member of X, a national organization exempt under section 501(c)(12) of the Code.

You will offer two types of dial-up internet service:

. Your functions will include installation of equipment, service maintenance, and billings and collections.

The Internet, as well as the electric service, will be conducted on a cooperative basis through separate operating divisions with existing and new member patrons. To facilitate the separation of costs and expenses and the proper accounting of patronage margins, you will organize business by separate operating divisions.

You will establish two separate operating divisions—Electric Division and Communication Division. All electric energy and service sales will be conducted through the Electric Division. The Internet services will be conducted through the Communications Division. You intend to become an Internet service provider to current and new members of the cooperative allowing the surrounding rural communities access to all of the amenities of the Internet.

Subscribers to the services will be given member status under your bylaws. As a member, each subscriber will be entitled to one vote (and only one vote regardless of the number of divisions in which they participate) at annual meetings and in other governance matters requiring member approval. Patronage allocations will be made to members from each division in which they participate based on their patronage of that particular division. If a division experiences losses in any year, the losses will be assigned to members of that division based on their participation.

You made the following representations in conjunction with this request:

1. You are a rural electric cooperative that has been granted tax-exempt status under section 501(c)(12) of the Code.

2. You have in the past and continue to satisfy the member income test requirements for exemption specified at section 501(c)(12) of the Code.
3. With respect to prior tax years, you filed all required Forms 990, Return of Organization Exempt from Income Tax, and Forms 990-T, Exempt Organization Business Income Tax Return.
4. For each major line of utility or related business you enter, you will modify your Articles of Incorporation and Bylaws, as necessary, to authorize the provision of such services.
5. You will modify your Bylaws to:
 - a. Establish separate operating divisions and accounting for each major line of services in which the cooperative is engaged (i.e., electric service and communication service);
 - b. Extend full membership and voting rights on a one member, one vote basis to all customers subscribing to service through either of the operating divisions, with members participating in more than one activity entitled to only one vote;
 - c. Provide that each division (e.g., electric and communications) of the organization which is operated on a cooperative basis shall make patronage allocations to members based on their participation in that particular operating division;
 - d. Provide that if an operating division incurs losses in one or more years, losses shall be assigned on the books of the cooperative to participating members based on their patronage in the loss years; and
 - e. Provide that no patronage margin allocations shall be made to members in an operating division until such members' prior year loss assignments from the pool have been offset with either their allocable margins from other pools in which they participate, or, if none are available, subsequent year margin allocations from the loss pool.

Section 501(c)(12)(A) of the Code provides for the exemption from federal income tax of benevolent life insurance association 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 501(c)(12)(C) of the Code provides that subparagraph (A) shall apply to mutual or cooperative electric company without taking into account any income received or accrued from qualified pole rentals or prepayment of certain loans from the provisions of the Rural Electrification Act of 1936.

In *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3, three principles are described as fundamental to cooperative operation: subordination of capital; democratic control by the members; and, operation at cost. Subordination of capital requires that control of the cooperative and ownership of the pecuniary benefits arising from the cooperative's business remain in the hands of the members/patrons of the cooperative rather than with nonpatron equity investors in the cooperative. Democratic control of the cooperative is typically achieved by voting on a one-member, one-vote basis. The requirement of operation at cost is met if the cooperative's net earnings or savings are distributed to the cooperative's patrons in proportion to the amount of business conducted with them.

Rev. Rul. 72-36, 1972-1 C.B. 151 set forth certain requirements that cooperative companies must meet for exemption under section 501(c)(12) of the Code. These requirements include the following: A cooperative must keep adequate records of each member's rights and interest in the assets of the organization; the rights and interests of members in the organization's savings must be determined in proportion to their business with the organization; a member's rights and interest may not be forfeited upon the withdrawal or termination of membership; a cooperative must not retain more funds than it needs to meet current losses and expenses; and upon dissolution, gains from the liquidation of assets should be distributed to all current and former members in proportion to the value or quantity of business that each did with the cooperative over the years.

Rev. Rul. 57-420, 1957-2 C.B. 308 described an organization formed to provide and maintain a two-way radio system for the mutual benefit of its members and without profit. The ruling states that the organization is similar to a mutual or cooperative telephone company in that a two-way radio communication system on a mutual basis is an organization whose purpose is similar in nature to a mutual telephone company. The ruling held that the organization is a "like organization" and provided 85% or more of its income is collected from members for the sole purpose of meeting losses and expenses, it is exempt under section 501(c)(12) of the Code.

Rev. Rul. 67-265, 1967-2 C.B. 205 holds that an association which furnishes light and water to its members on a cooperative basis may qualify for exemption from federal income tax as a "like organization" under section 501(c)(12) of the Code.

Prior to your proposed addition of another service to members, you are engaged solely in furnishing electricity to them on cooperative basis for which you are a "like organization" exempt under section 501(c)(12) of the Code. See Rev. Rul. 67-265. You now propose adding internet service to be provided to members also on a cooperative basis. The internet service would provide members with a means to receive information from the internet network and to enable them to communicate with others in the network. This service is similar to the communication system provided by the organization described in Rev. Rul. 57-420. Therefore, as long as the internet service is conducted on a cooperative basis, and that 85% or more of its income is from members and used solely for meeting your losses and expenses, your provision of the service would continue to qualify you as a "like" organization under section 501(c)(12) of the Code.

Based on the foregoing and your representations, we rule on your rulings request as follows:

1. Your provision of internet service to members on a cooperative basis is a like activity contemplated under section 501(c)(12)(A) of the Code.
2. Your establishment of separate operating divisions for each major service (electric and communication) with separate patronage allocations for gains and losses in each will be consistent with cooperative operating principles.
3. Your current exemption is modified to include internet service in addition to your provision of electric energy and distribution services.
4. Your annual 85 percent income test prescribed by section 501(c)(25)(A) will be computed based on all approved "like" activities in the aggregate, not on each separate function.

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

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