



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Date: 10/18/2005

Contact Person:

Identification Number:

Contact Number:
Fax:

Employer Identification Number:

Legend:

Cooperative =

A =

Dear _____ :

This is in response to your rulings request dated November 17, 2004, under section 501(c)(12) of the Internal Code (the Code).

The information submitted indicates that Cooperative has operated since 1939 as a rural electric cooperative under the laws of the State of X. Cooperative is exempt under section 501(c)(12) of the Code.

Cooperative's articles of incorporation and bylaws provide that it operates on a cooperative basis for the mutual benefit of its members. Provisions of Cooperative's bylaws pertinent to its operation include the following:

Article III, Section 5 of the bylaws provides that each active member who is receiving electric service from Cooperative shall be entitled to only one (1) vote. All questions shall be decided by a vote of majority of the members voting thereon in person, except as otherwise provided by law, the Articles of Incorporation or the bylaws.

Article II, Section 1 of the bylaws provide that the remaining property and assets of Cooperative shall be distributed among its members and former members in proportion to the aggregate patronage of each bears to the total patronage of all members during the ten (10) years next preceding the date of the filing or the certification of dissolution.

Article VII, Section 1 of the bylaws provides that Cooperative shall at all times be operated on a cooperative non-profit basis for the mutual benefit of its patrons but no interest or dividends shall be paid on any capital furnished by patrons.

Article VII, Section 2 of the bylaws provides that Cooperative is obligated to account on a patronage basis to all its patrons for all amounts received and receivable from the furnishing of electric energy in excess of operating costs and expenses properly chargeable against the furnishing of electric energy. All such amounts in excess of operating costs and expenses at the moment of receipt by Cooperative are received with the understanding that they are furnished by the patrons as capital. Cooperative is obligated to pay by credits to a capital account of each patron all such amounts in excess of operating costs and expenses. The books and records of Cooperative shall be set up and kept in such a manner that at the end of each fiscal year the amount of capital, if any, so furnished by each patron is clearly reflected and credited in an appropriate record to the capital account of each patron, and Cooperative shall within a reasonable time after the close of the fiscal year notify each patron of the amount of capital so credited to his account.

Article VII, Section 2 of the bylaws also provides that in the event of dissolution or liquidation, and after all outstanding indebtedness shall have been paid, outstanding capital credits shall be retired without priority on a pro rata basis before any payments are made on account of property rights or member. If at any time prior to dissolution or liquidation of the organization, the Board of Trustees shall determine that the financial condition of Cooperative will not be impaired thereby, the capital then credited to patrons' accounts may be retired in full or in part. Any such retirements of capital shall be made in order of priority according to the year in which the capital was furnished and credited, the capital firsts received by Cooperative being first retired.

Article VII, Section 2 of the bylaws further provides that notwithstanding any other provisions of the bylaws, the Board of Trustees, at its discretion, shall have the power at any time upon the death of any patron, if the legal representative of his estate shall request in writing that the capital credited to any such patron be retired prior to the time such capital would otherwise be retired under the provisions of these bylaws, to retire capital credited to any such patron immediately upon such terms and conditions as the Board of Trustees, acting under policies of general application, and the legal representatives of such patron's estate shall agree upon; provided, however, that the financial condition of Cooperative will not be impaired thereby.

Proposed Transaction

Cooperative proposes to establish an equity discounting program whereby members may redeem their patronage capital early and receive amounts discounted from the face value of the capital accounts. The program is voluntary to current and former members. The program is

intended to equitably clear patronage capital accounts of receivers in bankruptcy, departing member and former members that might otherwise become lost.

The patronage capital will be redeemed at a discounted rate based on the 20 year U.S. Treasury Bond rate, plus a risk premium as determined by the Board. The difference between the face value and the discounted amounts will be transferred to temporary equity accounts. Cooperative will keep adequate records, including contact information of the participants. These equity accounts would be redeemed only upon dissolution of Cooperative.

Cooperative's Board of Trustees will have the sole discretion to determine the rotation period for redemption of capital credit accounts. The rotation period is on a first-in, first-out basis. The Board will be given the sole authority to suspend or limit the discounting program depending on the overall financial condition of Cooperative.

The mechanics of the program are as follows:

1. Cooperative's Board of Trustees will establish a capital rotation period for all allocated patronage capital.
2. The annual discount rate to be applied for each year of early redemption will be established at year-end by the Board of Trustees based on Cooperative's estimated cost of patronage capital.
3. In the sole discretion of the Board of Trustees, each member/patron, departing member/patron, former member/patron and deceased member's/patron's estate may be offered the option to receive the discounted value of their cumulative allocated patronage capital, or, in the discretion of the Board, a limited number of years or year (assuming the financial condition of Cooperative permits).
4. For each participant in this program, records will be maintained of the amount not redeemed, Cooperative identification number, and the last known address of the party.
5. The Board of Trustees will be given the authority to suspend the discounting program if in their sole judgment such action is in the best interest of Cooperative.
6. Members/patrons and former members/patrons will be given the option of participating in the discounting program.

Cooperative will amend its bylaws for implementation of the equity discounting program. The amendments must be ratified by members.

In connection with the proposed transaction, Cooperative makes the following representations:

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

- (b) Members' and former members' vested interests in the net savings of the organization (including those participating in the discount program) will be accounted for.
- (c) Article II, Section 1 of the Cooperative's bylaws will be amended changing the ten (10) years period of computing vested property rights to "a period that corresponds to the capital credit redemption cycle of the Cooperative."
- (d) The proposed changes discussed above will be subject to approval of the Cooperative's democratically elected Board of Trustees and will be ratified by a majority vote at Cooperative's members at its next annual meeting.
- (e) When Cooperative's Bylaws are modified as proposed above, any necessary other changes will be made to the current Bylaws to comport with the proposed discounting program.
- (f) Cooperative has in the past and continues to satisfy the member income requirements for exemption under section 501(c)(12).

Law and analysis:

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 v. Commissioner*, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3, the court stated that an organization must meet certain common law requirements in order to be a cooperative. These common law requirements include the following: democratic control of the organization by members; the organization operates at cost for the benefit of members; and the contributors of capital to the organization do not control or receive most of the pecuniary benefits of the organization's operations (i.e., subordination of capital).

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: keeping adequate records of each member's rights and interest in the assets of the organization; determining the rights and interests of members in the organization's savings in proportion to their business with the organization; non-forfeiture of member's rights and interest may upon withdrawal or termination of membership; not retaining more funds than needed to meet current losses and expenses; and upon dissolution, distributing gains from the liquidation of assets to all current and former members in proportion to the value or quantity of business that each did with Cooperative over the years.

Under the provisions of its current bylaws, Cooperative is structured and operated on a cooperative basis. This is shown by allowing only one vote per member in corporate governance matters, prohibiting payment of dividends or interest on capital, allocating the savings from operation of providing electric distribution services to members in proportion to their respective patronage, and distributing such savings in the form of patronage dividends.

Cooperative is proposing to amend its bylaws to implement the proposed patronage capital discounting program. The program will be available to all members and former members on an equitable basis. Moreover, no members or former members will be compelled to participate; each individual may choose to redeem allocated patronage capital earlier, but at a lesser amount, or wait for the regular rotation of his or her retained capital at full face value. One exception is that Cooperative's Board of Trustees will have the discretion to redeem patronage capital to estates on terms mutually agreeable to Cooperative and the estate.

While the program provides for the redemption of equity capital at a discounted amount, this does not represent forfeiture of a portion of patronage capital in violation of Rev. Rul. 72-36, *supra*. The difference between the face amount and the discounted amount of patronage capital is transferred to a temporary retained earnings account under the participant's name for which the participant would be entitled for redemption upon the dissolution of Cooperative. You have represented that the program will have to be approved by members. The program is voluntary for current and former members. Patronage capital will be discounted on a same rate and on equal terms to all participants. There will be no forfeiture of member capital under the program as any difference between the face amount and the discounted amount of the redeemed patronage capital will be transferred to a temporary equity capital with records of the participants for distribution to participants upon the dissolution of Cooperative.

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

1. The proposed modification of Cooperative's Bylaws will not jeopardize its tax exempt status under section 501(c)(12) of the Code.
2. Cooperative's proposed discounting of patronage capital, as described, is consistent with the requirements of Rev. Rut. 72-36 and will not constitute forfeiture of patronage capital.

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.

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 who requested it. Section 6110(k)(3) of the Code

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

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,

Lois G. Lerner
Director, Exempt Organizations
Rulings & Agreements

Enclosure
Notice 437