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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Number: **200634048**
Release Date: 8/25/2006
Date: May 4, 2006

Contact Person:

Identification Number:

Telephone Number:

501.12-03

Legend:

State =
U =
V =
W =

Dear :

We have considered your ruling request dated October 13, 2003, regarding the tax consequences relating to the proposed transaction described below.

You are exempt from federal income tax under section 501(a) of the Internal Revenue Code (hereafter Code), as an organization described in section 501(c)(12). You are a cooperative under the laws of State. You have approximately U current and former members, with approximately V active patron accounts in the southeastern part of State. Your members elect the board of directors on a one member, one vote basis. The margins from the patronage–sourced income are allocated to members in the form of capital credits on the basis of their patronage for that year. Pursuant to Article VII, Section 7.02 of the bylaws, the books and records are set up in 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. At the end of each fiscal year, each patron will be notified of his patronage balance.

As of December 31, 2002, your organization has allocated W in patronage capital to your members and former members. Historically, you have retired the previously allocated patronage capital on a cycle of approximately 20 years.

You propose to retire the current patronage allocations to current and former members on an accelerated basis. This retirement would occur through a payment to the members that would reflect a discount from the stated amount of the allocated payment. The proposed redemption program is not voluntary.

Under the proposed retirement program, you will retire capital credits earlier than the current -year cycle. The capital credits would be paid on a discount. The discounted amount is equal to the current value of the allocated capital credits as opposed to the value at the end of the -year cycle. You propose to calculate the annual discount rate using the *Wall Street Journal* prime rate as of December 31 of each applicable year, and a discount period equal to the number of years of patronage capital then outstanding.

You request the following rulings:

1. The recently revised bylaws related to your capital credit rotation of a discounted cash amount will not adversely affect your cooperative status.

2. Your patronage allocations are qualified exclusions.

LAW:

Section 501(c)(12) of the Code provides for the exemption from federal income tax of benevolent life insurance associations 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.

Revenue Ruling 72-36, 1972-1 C.B. 151, describes certain basic characteristics an organization must have in order to be a cooperative organization described in section 501(c)(12)(A) of the Code. These characteristics include the following: A cooperative must keep adequate records of each member's rights and interests in the assets of the organization. A cooperative must not retain more funds than it needs to meet current losses and expenses. 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 interests may not be forfeited upon the withdrawal or termination of membership. 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.

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: 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).

Discussion:

Section 501(c)(12) of the Code provides for the federal tax exemption of electric cooperatives and other cooperative organizations not relevant here. While the term "cooperative" is not defined in section 501(c)(12) or the regulations thereunder, a cooperative has been traditionally and historically defined as a voluntary, membership business organization

that is organized in response to the economic needs of and to perform services for its members, and not to realize monetary gains as a separate legal entity. A cooperative is organized and operated for the benefit of and is democratically controlled by its members. See Puget Sound Plywood v. Commissioner, 44 T.C. 305, 308 (1966), *acq.* 1966-1 C.B. 3. Hence, to qualify for exemption under section 501(c)(12), an organization must be a cooperative and organized and operated as such. Puget Sound Plywood, supra, describes the principles that are fundamental to the organization and operation of cooperatives. They are: (1) democratic control by the members, (2) operation at cost, and (3) subordination of capital. These principles apply to organizations described in section 501(c)(12).

Democratic control requires that the cooperative be governed by members and on a one-member, one-vote basis. Each member has a single vote regardless of the amount of business he or she does with the organization. The issue of democratic control is a question of fact.

Operation at cost requires that the cooperative's net earnings or savings derived from furnishing services in excess of costs and expenses be returned to its members in proportion to the amount of business conducted with them. This principle ensures that a cooperative's net savings from members are returned to members in proportion to the amount of business each transacts with the cooperative. A cooperative satisfies this requirement by making periodic allocations of patronage to members.

Subordination of capital has two requirements. First, control of the cooperative and ownership of the pecuniary benefits arising from the cooperative's business remains in the hands of the members rather than with non-patron equity investors. Second, the returns on equity investments must be limited. Hence, the net savings that accrue to the cooperative from the business activities it transacts with its members will largely inure to the benefit of those members rather than to its equity investors. The rationale for these limitations is to ensure that the cooperative remains faithful to its purpose—providing services at the lowest possible prices (or highest possible prices for a marketing cooperative) to its members and not to realize profits for capital. If it were otherwise, the emphasis then would likely be on protection of returns of equity capital rather than services to members, and this would destroy the basic purpose of cooperatives. See Puget Sound Plywood, supra.

Rev. Rul. 72-36, supra, also describes additional requirements that are fundamental to the organization and operations of cooperatives described in section 501(c)(12). Rev. Rul. 72-36 requires that a member's rights and interest in the assets of a cooperative cannot be forfeited upon termination of membership. It also requires that upon dissolution, a cooperative must distribute any gains from the sales of its assets to those who were members during the period that the assets were owned.

A fundamental tenet of cooperative operation is that the earnings of a cooperative are allocated and ultimately distributed to its members based on the amount of business (patronage) done with those members. The amount a cooperative member pays for the cooperative's services less the cost of providing such services is allocated to the member. Thus, the presumption is that the cooperative's services are provided at cost to the members. But it is impractical for such a cooperative to return immediately all the amounts or earnings to its members because the cooperative needs to have reserves in order to operate, meet unexpected expenses, or to expand. These amounts or earnings are held by the cooperative for a certain period of time as prescribed by the cooperative's bylaws and are allocated as capital credits to accounts kept for each member. These capital credits are returned to the members or former members when the cooperative redeems them (i.e., sends a check for the amount of the capital credits) at the end of the prescribed time.

Your bylaws will provide for the redemption of capital credits at a discount. The redemption program provides for the redemption of your current and former members' capital credit accounts earlier than the 20-year holding period or cycle. The redemption is at a discount, i.e., the capital credits are not paid on the face value of the accounts but at the present value. You will transfer the difference between the discounted amount and the original amount in the capital credit accounts to your net savings account. The redemption program will not be voluntary for current or former members.

The primary issue raised by the operation of the redemption program is whether it violates any of the cooperative requirements described in <u>Puget Sound Plywood, supra</u>, and Rev. Rul. 72-36. The cooperative principle of democratic control by members is satisfied because the redemption of capital credits at discount will not affect member voting rights or governing rights. We also note that the cooperative (and its board of directors and management) has fiduciary duties to the former members, and the former members can enforce their rights in the courts. See <u>Lamesa Cooperative Gin v. Commissioner</u>, 78 T.C. 894 (1982). The cooperative principle of operating at cost is satisfied because the members' right to receive the excess (i.e. capital credits) over the cost of electricity service is also not adversely affected.

The cooperative principle of subordination of capital is satisfied because the proposed redemption program does not adversely affect the members' control and ownership of the cooperative assets. The cooperative requirement that there is no forfeiture of former members' rights to assets of the cooperative is not violated. Specifically, the redemption program permits members and former members to receive the present value of their capital credit accounts (i.e., patronage savings) at a date earlier than the 20-year holding period or cycle. The discount rate is in accordance with the prevailing market rate.

Regarding whether your patronage allocations are qualified exclusions, in <u>Pomeroy Cooperative Grain Co. v. United States</u>, 31 T.C. 674 (1958), the U.S. Tax Court held that allocations must represent true patronage dividends to be given an exclusion from gross income. The court went on to say that three prerequisites must be satisfied to exclude patronage dividends from gross income:

(1) The allocation must have been made under a pre-existing legal obligation, one which existed when the members transacted their business with the cooperative.

(2) The allocation must have been made out of profits or income realized from transactions with the particular patrons (members) for whose benefit the allocations were made, and not out of profits or income realized from transactions with other persons or organizations.

(3) The allocations must have been made equitably, so that profits realized from selling merchandise or services to patrons, and profits from marketing products purchased from patrons, were allocated ratably to the particular persons whose patronage created each particular type of profit.

You maintain that your patronage dividends are excluded from gross income because they were made under a pre-existing legal obligation, were made on the basis of patronage, and were made from profits derived from the members' business dealings with you.

Based on your representations, it appears that the requirements set forth by the U.S. Tax Court in the Pomeroy Cooperative Grain case have been satisfied, and we have found no contrary authority.

Accordingly, based on the foregoing facts and circumstances, we rule as follows:

(1) Following incorporation into the bylaws of the provisions described above, you will still be operating on a cooperative basis. Therefore, the capital credit retirement program as described in your amended bylaws will not adversely effect your federal tax exemption as an organization described in section 501(c)(12) of the Code, assuming you continue to meet the 85 percent member income test provided in section 501(c)(12).

(2) Your patronage allocations may be considered qualified exclusions from gross income.

This ruling is based on the understanding that there will be no material changes in the facts and representations upon which it is based. Except as we have ruled herein, we express no opinion as the tax consequences of the transactions under other sections of the Code and Income Tax Regulations.

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 that requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited by others 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.

Sincerely,

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3