



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

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Contact Person:

Identification Number:

Telephone Number:

501.12-01

A =
B =
C =

Dear _____ :

This is in reply to a ruling request dated February 3, 2003, regarding whether a proposed recapitalization and reorganization will jeopardize your tax exempt status under section 501(c)(12) of the Internal Revenue Code.

Your organization is recognized as exempt under section 501(c) (12) of the Code. The capital stock of your organization consists of one thousand authorized and issued shares, each with a par value of one hundred dollars. The shares are held by numerous individuals and entities, with no one individual or entity owning more than 10 percent of the outstanding shares. Only one class of shares is presently authorized. Every shareholder is entitled to one vote for each share held. Cumulative voting is not allowed.

A is an organization recognized as exempt under section 501(c) (5) of the Code. A's capital stock consists of four hundred fifty shares without par value. Your organization owns one-third of A's outstanding shares. B owns the remaining two-thirds of its outstanding shares.

C is an organization that has applied for and received exemption under section 501(c) (12) of the Code, and will operate as a mutual ditch company. C will operate a system of water storage reservoirs interconnected by canals and ditches, which will receive water from a local river. C will own water that is received during spring runoff and is captured and stored in the reservoirs. C will store the water in its reservoirs until it is needed for irrigation.

Your organization's shareholders have approved a resolution amending your articles of incorporation and bylaws to authorize the creation and issuance of a second class of stock

consistent with state law. The stock will have no par value, and will be denominated as Class B stock. The total number of Class B shares to be issued will be one hundred fifty shares. The pre-existing class of stock will be denominated as Class A stock. Both Class A and Class B stockholders will be entitled to one vote per share held.

You contemplate that all water, facilities, and other assets of your organization, excluding those associated with ownership of A, will be transferred to C. In return, you and your shareholders will hold 100 percent of the outstanding common stock of C, and will hold a minority interest in A. The Class A stockholders will possess the rights and obligations associated with the ownership of C, and the Class B stockholders will possess the rights and obligations associated with the ownership of A. After the transfer, each Class A stockholder shall be responsible for his or her proportional obligations associated with such ownership interest.

Upon dissolution, gains from the sale of your stock shall be distributed to the Class A stockholders in proportion to their stock ownership, and gains from the sale of A's stock shall be distributed to Class B stockholders in proportion to their ownership interests. Alternatively, upon dissolution your stock may be distributed in kind to the Class A stockholders in proportion to their stock ownership, and A's stock may be distributed in kind to the Class B stockholders in proportion to their ownership interests.

Similarly, a Class B stockholder in your organization shall be entitled to the use and benefit of all water, facilities and assets associated with A stock provided that, if less than one hundred fifty Class B shares are issued and outstanding, a Class B shareholder shall be entitled to the rights, benefits and obligations of one share of A stock for each Class B share owned by such shareholder.

You have made the following additional representations in connection with the proposed transactions:

- (a) Your Class A and Class B common stock will constitute stock of your organization for federal income tax purposes.
- (b) No stock will be issued for services rendered to or for the benefit of C in connection with the proposed transaction, and no stock will be issued for the indebtedness of C which accrued on or after the beginning of your holding period for the debt.
- (c) No assets to be transferred were received by you as part of a plan of liquidation of another corporation.
- (d) Income items, such as assessments receivable and accounts receivable, may be transferred to C. You have neither accumulated receivable nor made extraordinary payments of payables in anticipation of this transaction. C will report items which, but for the transfer, would have resulted in income or deduction to a transferor in a period subsequent to the transfer, and such items will constitute income or deductions to C.

- (e) The transfer is not the result of a solicitation by a promoter, broker, or investment house.
- (f) You did not retain any rights in the property transferred to C.
- (g) No property to be transferred to C will be leased back to you, another shareholder or a related party.
- (h) The value of the stock received in the exchange for accounts receivable will be equal to the net value of the accounts transferred, that is, the face amounts of the accounts receivable previously included in income less the amount of reserve for bad debts.
- (i) The adjusted basis and the fair market values of the assets to be transferred by you to C will, in each instance, be equal to or exceed the sum of the liabilities to be assumed by C plus any liabilities to which transferred assets are subject.
- (j) The liabilities to be assumed by C from you were incurred in the ordinary course of business and are associated with the assets to be transferred.
- (k) There is no indebtedness between you and C, and there will be no indebtedness created in favor of you as a result of the transaction.
- (l) The transfers and exchanges will occur under a plan agreed upon before the transaction in which the rights of the parties are defined.
- (m) All exchanges will occur on approximately the same day.
- (n) None of the stock issued will be placed in escrow. None of the stock will be issued later under a contingent stock arrangement.
- (o) There is no plan or intent for C to redeem or otherwise reacquire any stock or indebtedness to be issued in the proposed transaction.
- (p) Taking into account any issuance of additional shares of C stock; any issuance of stock for services; the exercise of any C stock rights, warrants, or subscriptions; a public offering of C stock; and the sale, exchange, transfer by gift, or other disposition of any stock of C to be received in the exchange, you will be "in control" of the transferee within the meaning of section 368(c) of the Code.
- (q) You will receive stock, securities, or other property approximately equal to the fair market value of the property to be transferred to C or for services rendered or to be rendered for the benefit of C.
- (r) C will remain in existence and retain and use the property transferred to it in a trade or business.

- (s) There is no plan or intent for C to dispose of the transferred property other than in the normal course of business.
- (t) Each party to the transaction will pay his own expenses, if any, incurred in connection with the proposed transaction.
- (u) C will not be an investment company within the meaning of section 351(e)(1) of the Code and section 1.351-1(c)(1)(ii) of the regulations.
- (v) You are not under the jurisdiction of a court in a title 11 or similar case.
- (w) C will not be a "personal service corporation" within the meaning of section 269A of the Code.

You have requested the following rulings:

- (1) The creation, issuance, and sale of a second class of stock for cash which represents the exclusive rights and obligations associated with ownership of A's stock will not result in loss of your tax exempt status under section 501(c)(12) of the Code.
- (2) The creation, issuance, and sale of a second class of stock for cash which represents the exclusive rights and obligations associated with A's stock will not result in unrelated business taxable income under section 512(a)(1).
- (3) No taxable income will be recognized by you or your shareholders from the issuance and sale of a second class of stock for cash.
- (4) The transfer of all your assets, excluding A stock, to C in exchange for 100 percent of the outstanding stock of C will not result in the loss of your exemption under section 501(c)(12).
- (5) The transfer of all your assets, excluding A stock, to C in exchange for 100 percent of the outstanding stock of C will not result in unrelated business taxable income under section 512(a)(1).
- (6) No taxable income will be recognized by C, your organization or its shareholders as a result of the transfer of all your assets, excluding A stock, to C in exchange for 100 percent of the outstanding stock of C.
- (7) After the transfer of all your assets, excluding A stock, to C in exchange for 100 percent of the outstanding stock of C, the basis of the stock in C received by you will be equal to the basis of the property transferred to C under section 358.
- (8) After the transfer of all your assets, excluding A stock, to C in exchange for 100 percent of the outstanding stock of C, the basis of each asset received by C will equal the basis of that asset in your hands immediately before the contribution pursuant to section

362(a).

- (9) The holding period of the C stock received by you will include the holding period of the assets transferred by you provided the assets transferred are capital assets on the date of the transfer pursuant to section 1223(1).
- (10) After the transfer of all your assets, excluding A stock, to C in exchange for 100 percent of the outstanding stock of C, the holding period of each asset received by C will include the period during which you held that asset pursuant to section 1223(2).

LAW

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.

Rev. Rul. 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.

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.

By creating a second class of stock for cash or undergoing a recapitalization, your organization is in effect creating an additional class of membership. Such an event is consistent with the purposes of 501(c) (12) organizations. Thus, your organization will not jeopardize its exemption. Moreover, since your organization does not appear to be in a business of issuing and selling stock, no unrelated business income is present because there is no trade or business under section 512(a)(1) of the Code. The consideration received by your organization will not cause the violation of because the income is from members that does not exceed the 85 percent test under section 501(c) (12) of the Code.

Based on the information submitted, and representations made, we rule as follows:

- (1) The creation, issuance, and sale of a second class of stock for cash which represents the exclusive rights and obligations associated with ownership of A's stock will not result in loss of your tax exempt status under section 501(c)(12) of the Code.
- (2) The creation, issuance, and sale of a second class of stock for cash which represents the exclusive rights and obligations associated with A's stock will not result in unrelated business taxable income under section 512(a)(1).
- (3) Neither you nor your shareholders will recognize taxable income as a result of the denomination of your existing common stock as Class A common stock and the creation, issuance, and sale of Class B common stock for cash, pursuant to sections 368(a)(1)(E) and 1032(a).
- (4) The transfer of all your assets, excluding A stock, to C in exchange for 100 percent of the outstanding stock of C will not result in loss of your exemption under section 501(c)(12).
- (5) The transfer of all your assets, excluding A stock, to C in exchange for 100 percent of the outstanding stock of C will not result in unrelated business taxable income under section 512(a)(1).

- (6) No taxable income will be recognized by C, your organization or its shareholders as a result of the transfer of all your assets, excluding A stock, to C in exchange for 100 percent of the outstanding stock of C pursuant to section 351(a).
- (7) After the transfer of all your assets, excluding A stock, to C in exchange for 100 percent of the outstanding stock of C, the basis of the stock in C received by you will be equal to the basis of the property transferred to C under section 358(a)(1).
- (8) After the transfer of all your assets, excluding A stock, to C in exchange for 100 percent of the outstanding stock of C, the basis of each asset received by C will equal the basis of that asset in your hands immediately before the contribution under section 362(a).
- (9) The holding period of the C stock received by you will include the holding period of the assets transferred by you, provided the assets transferred are capital assets on the date of the transfer, pursuant to section 1223(1).
- (10) After the transfer of all your assets, excluding A stock, to C in exchange for 100 percent of the outstanding stock of C, the holding period of each asset received by C will include the period during which you held that asset pursuant to section 1223(2).

This ruling is based on the understanding that there will be no material changes in the facts and representation 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, 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

Enclosure: Notice 437