



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Release Number: **200721020**

Release Date: 5/25/07

Date: March 2, 2007

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

501.12-03

Legend:

State =

U =

V =

W =

Dear _____ :

We have considered your ruling request dated March 15, 2004, regarding the tax consequences relating to the proposed transaction described below.

You are exempt from federal income tax under section 501(c)(12) of the Internal Revenue Code (hereafter Code). You are a cooperative under the laws of State. You have approximately U current and former members, with approximately V active member accounts in the south central 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 his or her patronage for that year. Pursuant to Article XI, Section II 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 member is clearly reflected and credited in an appropriate record to the capital account of each member. At the end of each fiscal year, each member 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 30 years, using the first-in, first-out (FIFO) method.

You propose to retire the current patronage allocations to current and former members in the following manner. All outstanding Type A capital credits would be retired and paid as

directed and approved by the board of directors. Once all Type A capital credits are retired and paid, then Type B capital credits would be retired and paid as directed by the board. Finally, once all Type A and Type B capital credits are retired and paid, then Type C capital credits would be retired and paid as directed by the board.

You represent that all capital credit retirements would be calculated on a discounted (net present value) basis. The proposed program is not voluntary. You are planning to retire capital credits based on a combination FIFO/LIFO (last-in, first-out) methodology.

Under the proposed retirement program, you will retire capital credits on an accelerated basis. The capital credits are paid on a discount. You represent that the discount rate is the Wall Street Journal Prime Rate as of December 31 of each applicable year, plus percent. The difference between the face value of the patrons' capital credit account and the cash payments to them will be credited to your net savings account. Upon dissolution and liquidation, the amount in the net savings account is distributed to the members and former members after retiring all debts and liabilities.

Sometimes your former members sometimes fail to claim the cash retirement of their capital credits, and your efforts to locate them are not always successful. You have attempted to contact such members by publishing their names in your newsletter and on your web site. Article XI, Section III of your bylaws provides that under State law, you shall recover any capital credits, patronage dividends, utility deposits, membership fees, account balances, or book equities that remain unclaimed for two years following your attempted payment to the member or former member. State's unclaimed property law does not apply to you, as it contains an explicit exception for dividends, capital credits, and other account balances of rural electric cooperatives.

You request the following rulings:

1. The recently revised bylaws related to your organization's capital credit rotation of a discounted cash amount will not adversely affect its cooperative status.
2. Your patronage allocations are qualified exclusions.
3. Your bylaws related to the contribution of unclaimed capital credits to the net savings of the cooperative will not adversely affect its cooperative status.

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 interest 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, including 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 organize and operate 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.

Section 501(c)(12)(A) provides that a cooperative exempt under this Code section must derive 85 percent or more of its income from members for the sole purpose of meeting losses and expenses in order to qualify for and maintain tax exemption. The 85 percent member income test requires that 85 percent or more of the cooperative's income be derived from members and used to pay for services listed in section 501(c)(12). See Rev. Rul. 2002-54 and Rev. Rul. 2002-55, 2002-37 I.R.B. 527 (Sept. 16, 2002). In each particular tax year, the cooperative must combine all income received and calculate under this test. The cooperative is not tax-exempt under section 501(c)(12) of the Code if less than 85 percent of its income is derived from members and used to pay for services listed in section 501(c)(12).

If the cooperative is not exempt under section 501(c)(12), it is a non-exempt, taxable cooperative. Its income is taxable in the same manner as the income of a taxable corporation but with one exception. The exception is that the income attributable to business done with or for members or patrons is deductible from the income of the cooperative. In order for the income to be "patronage source" and deductible from gross income, the income at issue must be produced by a transaction directly related to the cooperative's enterprise so that the transaction facilitates the cooperative's carrying on of that enterprise. See Farmland Industries, Inc. v. Commissioner, 78 T.C.M. 846 (1999), *acq.* AOD 2001-003. In the case of an electric cooperative, the patronage source income includes the refunds of part of the prices initially paid by members or patrons for electricity service obtained through the cooperative. In order to deduct patronage source income from gross income, an electric cooperative must allocate the patronage source income to the members or patrons in proportion to their patronage. See generally Pomeroy Cooperative Grain Company, a Corporation v. Commissioner, 31 T.C. 674, 685-686 (1958).

A. Redemption of Capital Credits at Discount

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 cooperative 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 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 30-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 to current or former members.

1. Compliance with Cooperative Requirements

The primary issue raised by the operation of the redemption program is whether it violates any of the cooperative requirements described in Puget Sound Plywood, *supra*, 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 former members, and the former members can enforce their rights in the courts. See Lamesa Cooperative Gin v. Commissioner, 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 30-year holding period or cycle. The discount rate is in accordance with the prevailing market rate.

2. Compliance with the 85 Percent Member Income Test

We also note that the participants of the capital credit redemption program do not receive debt or equity instruments for the difference between the discounted and face amounts in their capital credit accounts. There is an accession of wealth to the cooperative. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). Hence, the cooperative has income to the

extent of the difference, and it constitutes gross income as defined by section 1.61-1(a) of the Income Tax Regulations. Gross income equates income for purposes of the 85 percent member income test of section 501(c)(12) of the Code. See Rev. Rul. 80-86, 1980-1 C.B. 118. Member income is defined as amounts derived from a member and to be used for services listed in section 501(c)(12). See Rev. Rul. 2002-54 and 2002-55, 2002-37 I.R.B. 527 (Sept. 16, 2002). The difference between the discounted amount paid to the participants and the face value of the capital credits is not member income for purposes of calculating the 85 percent member income test because they are not paid for electricity services rendered to members or patrons. We also note that the discounted amount of a particular capital credit account is no longer considered a patronage dividend or patronage sourced income to the cooperative because it is not being paid on the basis of the electricity business done with the members or patrons.

B. Patronage Allocations and Exclusion from Gross Income

As discussed above, patronage source income is deductible from gross income. You represent that you allocate savings, the excess of operating costs and expenses from providing electricity service, to members. These savings are returned to your members and patrons via patronage allocations. Based on the representations made, we conclude that patronage allocations are patronage dividends and may be deducted from gross income.

C. Transfer to Net Savings of Unclaimed Credits

Your bylaws provide that you shall recover any capital credits, patronage dividends, utility deposits, membership fees, account balances, etc., that remain unclaimed for two years following your attempted payment to the member or former member. You propose that these amounts would be transferred to your net savings account.

The bylaws do not violate the cooperative requirements of democratic control by members and non-forfeiture of a member's right to your assets because your directors are subject to and responsive to the control of the members. We also note that the members of the cooperative elect the directors, and any members may submit resolutions to change the cooperative operations, subject to approval of the majority of members. Consequently, the transfer of unclaimed capital credits to your net savings does not violate any cooperative requirements and, therefore, your exempt status under section 501(c)(12) is not adversely affected, assuming you satisfy the 85 percent member income test for the particular tax year. This ruling does not supersede state escheat or abandoned property laws.

We understand that you have had success in locating former members through your web site. We would urge you to continue using the site to locate former members that have not claimed their capital credits, though you are not required by statute or regulation to do so.

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

1. The capital credit rotation program as described in your amended bylaws will not adversely effect your federal tax exemption under section 501(c)(12) of the Code.

2. Your patronage allocations derived from activities described in section 501(c)(12) of the Code are qualified patronage exclusions.
3. Your bylaws related to the contribution of unclaimed capital credits to the net savings of the cooperative will not adversely affect your cooperative status.

This ruling is conditioned on the understanding that there will be no material changes in the facts upon which it based. Also, we express no opinion as to the tax consequences of the transactions under other provisions of the Code or state laws.

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.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representative. A copy of this letter should be kept in your permanent records.

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. You should keep a copy for your permanent records.

Sincerely,

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

Enclosure
Notice 437