



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

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

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Date: March 2, 2007

Contact Person:  
Identification Number:  
Telephone Number:

501.12-03

Legend:

State =  
V =  
W =  
Y =

Dear \_\_\_\_\_ :

We have considered your ruling request dated September 17, 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 V active patron accounts in the northwestern part of State. Your members elect the board of trustees 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 2 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, 2005, your organization had a total capital of W, of which Y consisted of unredeemed patronage capital credits that had been previously allocated. Presently, you are retiring the previously allocated patronage capital over a period of not more than 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 voluntary.

Under the proposed retirement program, you will retire capital credits earlier than the current holding period or cycle. The capital credits would be paid on a discount. You propose to calculate the annual discount rate using the 20-year U.S. Treasury bond as a benchmark, and then adding to this rate an appropriate risk premium as determined by your board of trustees.

You have proposed certain changes to your bylaws. Following ratification by the members:

1. The board of trustees, in its sole discretion, may establish an equity discounting program whereby all or partial balances of existing allocated patronage capital may be paid in cash at a discount to members/patrons or former members/patrons.
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 your 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). You will keep records for each participant, to include name, amount not redeemed, and last known address.
4. Members/patrons and former members/patrons will be given the option of participating in the discounting program. The board of trustees may suspend the discounting program if in their sole judgment such action is in the best interests of your organization.

You have requested the following rulings:

- (a) Following the proposed modification of your bylaws with member ratification, you will be operating on a cooperative basis, and will not jeopardize your tax-exempt status under section 501(c)(12) of the Code.
- (b) Your proposed discounting of equity capital is consistent with the requirements of Revenue Ruling 72-36, and will not constitute a forfeiture of patronage capital.
- (c) The proposed methodology for determining the discount rate is consistent with the precepts of cooperative tax law, and if reasonably applied is within the board of trustees' discretion.

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.

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, a cooperative must combine all income 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 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, 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 Co. etc. v. Commissioner, 31 T.C. 674, 685-686 (1958).

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.

You are proposing to revise your bylaws to provide for the redemption of capital credits at a discount. The redemption program will provide for the redemption of your current and former members' capital credit accounts earlier than a cycle of 20 years. 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 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 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 point out not only that the proposed redemption program would be optional for present and former members/patrons. In addition, should current members be dissatisfied with the proposed redemption program, they may effect change by electing new board members.

We also note that the cooperative (and its board of trustees and management) has fiduciary duties to the 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 a 20-year holding period or cycle. The discount rate is in accordance with the prevailing market rate.

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

(a) Following the proposed modification of your bylaws with member ratification, you will be operating on a cooperative basis, and will not jeopardize your tax-exempt status under section 501(c)(12) of the Code, assuming you continue to meet the 85 percent member income test provided in section 501(c)(12).

- (b) Your proposed discounting of equity capital is consistent with the requirements of Rev. Rul. 72-36, and will not constitute a forfeiture of patronage capital.
- (c) The proposed methodology for determining the discount rate is consistent with the precepts of cooperative tax law, and if reasonably applied is within the board of trustees' discretion.

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.

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.

Sincerely,

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

Enclosure  
Notice 437