



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

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

Date: November 13, 2007

Contact Person:

Identification Number:

Telephone Number:

501.12-03

Legend:

State =

U =

V =

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 U active patron accounts in 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 VI, 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 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, , you have allocated and have an unretired patronage capital of V. 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.

You have represented that you will adopt a formal policy stating that:

\*You will continue to allocate excess amounts collected over costs to the members based on their (member) participation.

\* In the years that your board of trustees determines that you have sufficient-cash to redeem previously allocated capital credits, it shall determine the total amount of-cash redemption using a 20-year rotation cycle.

\* At the board of trustees' discretion, a portion of the total redemption may be dedicated to a voluntary capital credit discounting for early redemption of outstanding credits.

\* The discount rate to be used will be the 20-year Treasury bond rate determined as of January 1 of the year in question plus an equity risk premium determined by the board of trustees.

\* Members or former members will be offered the opportunity to redeem all or part of their outstanding capital credits early on a voluntary basis, first-come, first-served, up to the total amount authorized by the board for that year.

\* Members will be advised of the availability of early redemption in a separate mailing, the monthly newsletter, and other means such as local newspapers.

\* Each member or former member who voluntarily participates in the discounting program will be notified of participation on the transaction date as to the amount paid and the amount retained by you.

\* Amounts retained by you will be reclassified from allocated equity to permanent equity

You have represented that you have already modified your bylaws to give your board of trustees discretion to establish discounting policies following issuance of this letter.

You have requested the following rulings:

- (1) 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.
- (2) Your proposed discounting of equity capital, as contemplated, is consistent with the requirements of Rev. Rul. 72-36, 1972-1 C.B. 151, and will not constitute a forfeiture of patronage capital.
- (3) Your 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 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).

**ANALYSIS:**

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. The redemption will be at a discount, i.e., the capital credits are not paid on the face value of the accounts, but at the present value. 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 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 will permit 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:

- (1) 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.
- (2) Your proposed discounting of equity capital, as contemplated, is consistent with the requirements of Rev. Rul. 72-36, 1972-1 C.B. 151, and will not constitute a forfeiture of patronage capital.
- (3) Your 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 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